PSD2 is Changing The Payments Market

About this article

The second payment service directive (PSD2) is opening up the Payments Market for fintechs. Will the traditional banks be able to adjust in time to keep their customer base?

421 has analysed the consequences of the PSD2 directive coming into effect early 2018.

Directive background

The first payment service directive (PSD1) was issued by the European Commission to regulate payment services and payment service providers (PSPs) throughout the EU and EEA. The Directive's purpose was to increase pan-European competition and participation in the payment industry – including non-banks.

When PSD2 went into effect in the beginning of 2016 – with the obligation for local legislation to be implemented by early 2018 – the Commission intended to further strengthen competition in the payment industry by lowering the market entry barriers considerably.

Directive in summary

The new directive seeks to extend and clarify some of the provisions of the first directive. It also fosters payment innovation, particularly in mobile applications, and harmonises some of the national interpretations. Key elements of the directive include opening access across the industry to payment processing services, as well as to the customer accounts held by banks.

It recognises a market demand for PSPs granting third parties access to their online payment services in a regulated and secure way. This is called Third Party Payment service provision and will in turn open up the playing field for payment initiation service providers (PISPs). Also, under

the 'Access to Accounts' (XS2A) rule, banks are forced to facilitate access to their customer accounts via application programming interfaces (APIs) and provide account information to third party apps, so-called account information service providers (AISPs), if the account holder i.e. customer wishes to do so.

Implication on today's market

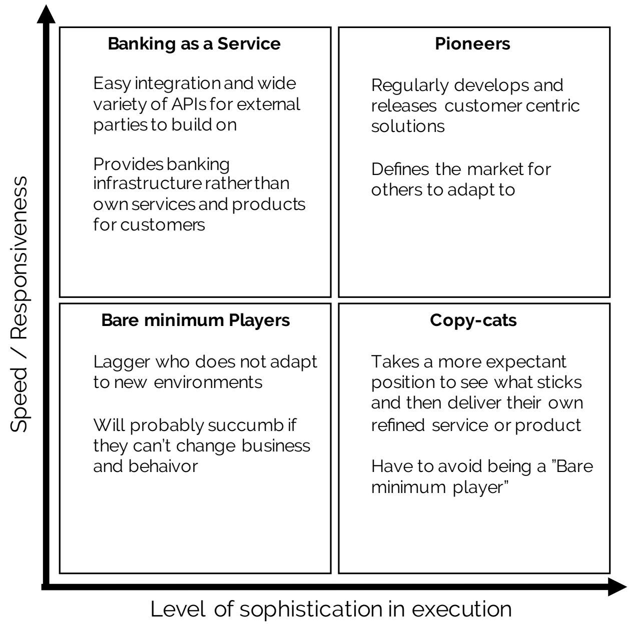
When banks are forced to open up their systems to competitors (both banks and non-banks), the competitive situation will change dramatically. For a long time, European banks have acted in an oligopoly-like market with high barriers of entry. New competitors have been rare and the ones that have tried have not been able to change the marketplace to the extent that they have wanted.

PSD2 will break up a part of the oligopoly-like market by making it possible for existing PSPs and new entrants to the market to compete on fair terms.

For today's banking customers this will mean that they can use third party solutions for most of their everyday banking business. Now, if customers use multiple banks, only one solution (either third party or provided by one of the banks) is needed to access information from all banks. The current customer demand for solutions to access multiple banks is probably not so large that it will drive a revolution in the market on its own, but it could be the first step towards an Amazon for banking services.

The big impact on today's banks will be emerging competition from non-banks that will change the playing field considerably. New financial technology (fintech) companies entering the payment market, as well as some old established PSPs, will come in with a substantially less complex IT infrastructure and legacy. This will make it possible for these companies to rapidly develop new services based on the ability to provide account access and payment initiation services at a speed that few of the established banks will be able to compete with.

The risk for banks is that they will lose the commission from payments and decrease income due to churn in customer base. This, in turn, limits the extent to which they can settle payment transactions and perform costly anti-money laundering and fraud prevention activities. This poses an imminent threat to traditional banks, since the growth potential in the financial market is connected to the capability to improve the digital experience for both consumers and businesses.



Going forward, there are generally two different proactive strategies for banks:

- Deliver banking as a service by opening up a wide variety of APIs – in excess of PSD2 requirements – to their banking platform by partnering with fintech companies to be more competitive.
- Becoming an aggressive PSP itself and competing with the fintech PSPs to broaden the existing customer base at the expense of other banks. This can be done by offering sophisticated services – either developed as a pioneer or as a second mover (copy-cats).

Open up for multiple APIs

Some banks have already chosen to partner with fintechs to provide their customers with competitive services in a rapidly changing environment. Deutsche Bank currently offers an app store for its corporate clients from which customers can chose the app of their liking to execute banking services towards Deutsche.

In this way, banks hope to increase volumes in their transaction systems as well as, to some extent, the possibility to sell value adding services through their partner's channels.

It will be interesting to see how much this strategy will shift power towards fintech companies, which are owning the channels and therefore controlling the major part of the customer interaction. To which extent will banks that "give up" their channels towards the customers be able to develop their relationship with the customers?

Becoming an aggressive PSP

Another way to secure future income is for banks to change their focus from being merely an account holder and a transaction executor to delivering broader value in end-to-end financial interactions. Making the buying experiences of consumers and the payment processes of corporations as easy as possible are key factors.

To compete with fintech PSPs, banks need to broaden their service offerings by integrating related services, such as invoicing and financing, to the payment process. Connecting all pre and post payment services to the payment process requires a more seamless interaction within the banks. Services from partners should also be included to enrich traditional banking solutions and services.

To go down this path seems like the easier route for banks to take but it is the more challenging option when it comes to execution. Most banks will not be able to compete with the top performers of the new fintech PSPs when it comes to time to market and functionality. However, banks have other competitive advantages.

Banks looking to extend their PSP capabilities can consider several sourcing strategies. In addition to building in-house solutions, different partnerships and in-licencing solutions are also possible ways forward.

Nowadays, banks already have strong relationships with almost all consumers and they are a trusted partner to the customer. The banks that will be successful as an aggressive PSP will need to start capitalising on these assets right now. There are some examples of banks moving in this direction, for example by offering non-PSD2 PSP services to customers of other banks. Danske Bank's mobile pay is one of these examples. It uses card schemes to create post-PSD2 services that attract customers from other banks to their PSP service.

In addition to the above strategies, banks can choose to not do anything more than becoming a back-end payment and account supplier, as well as continuing to offer the current services to the existing customer base. However, over time this will degenerate their existing payment business.

Conclusion

It is not very hard to foresee that a number of new, or relatively new, fintechs will successfully enter the market and claim a substantial piece of the pie. The banks that will be successful in competing with these fast moving fintechs must be able to improve their time-to-market and capitalise on their strengths when it comes to their existing customer base and trust.

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