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INSIGHT

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PAYMENT SERVICES DIRECTIVE 2 (PSD2)

AN EXPLANATION OF THE REGULATION, ITS IMPLICATIONS AND OPPORTUNITIES

The Directive on Payment Services (PSD) was developed with the aim of legally creating and regulating a single payment services market, applicable EU-wide. A revision of the directive (PSD2) was put in place in 2013 and intends to further improve competition on the payment markets, which accordingly fosters greater efficiency and higher cost-reductions. Traditional financial institutions generally see PSD2 as a threat. However, it provides opportunities for all parties, among which the traditional ones.

Main Objectives of PSD2
• Contribute to a further integrated and efficient European payments market
• Improve the level playing field for payment services providers (including new players)
• Ensure a high level of consumer protection and payments security
• Encourage lower prices for payments
• Facilitate the emergence of common technical standards and interoperability

Background

In PSD1's Footsteps

Notwithstanding a noticeable progress in incorporating retail payments in the EU into the current legislative framework, the revised version of the PSD1 is an important step forward in contributing to a further integrated and efficient European payments market, by including new elements and improvements. With various yet important areas – such as card, internet and mobile payments still being fragmented along national borders, the Commission, the European Parliament and the Council of Ministers intend to subject 'all payment providers active in the EU to supervision and appropriate rules'. Top priorities now are 'to improve consumer protection against fraud, possible abuses and payment incidents, such as disputed transactions' [1] through implementing stronger and compulsory customer authentication for online payments. On top of that, the payments industry is made more contestable by encouraging competition and lowering entry barriers for new entrants. Accordingly, innovative mobile and internet payments can become prominent in Europe's level playing field. PSD2 also equates an encouragement of lower prices for payments and a facilitation of common technical standards emergence and interoperability.

On the 8th of October 2015, The European Parliament adopted the revised Directive on Payment Services. PSD2 will accordingly be formally adopted by the EU Council of Ministers in the near future. The Directive must first be published in the Official Journal of the EU and from that date, Member States will have two years to translate the necessary changes for compliance into their national laws.

Key Changes

Third Party Payment Service Providers (TPPs)

PSD1 was adopted in 2007 but ever since, new services have emerged in the industry of internet payments where e-merchants are offered payment solutions without opening an account with third party providers. Under PSD2, traditional financial institutions are classified as 'Account Servicing Payment Service Providers' (ASPSP) whereas those without a banking license are the so called 'Third Party Payment Service Providers'. The latter category, arguably the most significant amendment introduced by PSD2, encompasses two types of services; Third Party Account Information Service Providers (AISP[2]) and Third Party Payment Initiation Service Providers (PISP). A TPP does not hold a payment account and does not enter into possession of the funds being transferred. Including TPPs into the directive is 'aimed at promoting innovation and low cost electronic payment solutions while ensuring that security and data protection are not compromised'[3].

According to the proposed directives, AISPs have to be given access to account information – provided permission is granted by the account holder. Subsequent to banks releasing this information, it can be used for AISPs innovative services. Typically, these systems collect and consolidate information on the different bank accounts of a customer in a single space and allow

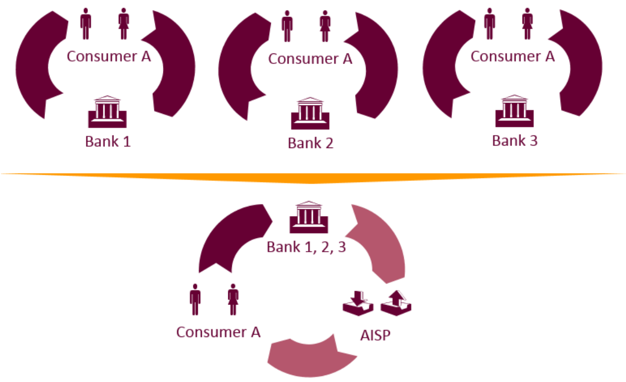
[1] Commissioner Hill welcomes agreement on the revised Payment Services Directive, European Commisson, May 5th, 2015

[2] Also called Account Information Aggregators

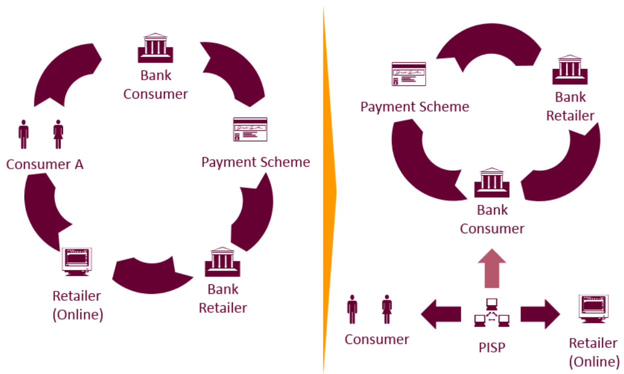
[3] The long awaited arrival of PSD2: a summary of some of the key provisions and issues, European Payments Council Newsletter, October 30th, 2013

them to have a global overview of their financial situation and even make payments from their various bank accounts.

PISPs, on the other hand, will be allowed to initiate payments commissioned by the account owner and thus facilitate the use of online banking to make internet payments. Their task consists of transmitting a customer's security code to their bank, together with the credit transfer and to notify the seller the transaction has been initiated. The TPPs are subjected to the same rules as the traditional payment service providers i.e. registration, licensing and supervision. Security around online payments under PSD2 applies to all payment service providers.



AISP VISUALISATION BEFORE AND AFTER PSD2, 2015 SIA PARTNERS



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Multilateral Interchange Fees (MIFs)

Despite previous regulations, the European cards market remains fragmented and interchange fees are widely varying. On the 24th of July, the Commission adopted a legislative package proposing PSD2 and a Regulation on Multilateral Interchange Fees. In order to establish a level playing field, an interbank fee cap was included in the MIFs proposal – the so called Multilateral Interchange Fee. These can be defined as the fees agreed between the acquiring payment service provider and the issuing payment service provider, for each sales transaction made. According to this regulation, the charge can be a maximum amount of 0,2% and 0,3% for a debit- and credit card-transaction respectively.

>> for a more **detailed reading on the "interchange fee"** topic, please see Sia Partners' **blogpost "The New EU Interchange Fees Regulation"**

Piece of the Pie for Everyone

Economic and Societal Benefits

In response to the conceivably rising distrust of confidentiality, liability and security of the aforementioned TPPs transactions, PSD2 will cover these at EU level. Consequently, an increased competition in the electronic payments market will provide more and better choices between different types of payment services and service providers. The maximum MIFs indirectly give rise to a low cost methods of card payments, domestically as well as cross-border, through a reduction of the charges paid. In particular those who currently pay high fees will benefit from it in the future. That way, according to estimates made by the European Commission, consumers will save 730 million euros annually which contributes to an increased customer experience. Furthermore, this promotion of diversity in payment method providers, stimulates innovation and competition, eventually resulting in lower consumer prices. Even though retail prices are influenced by many factors, it is possible that the cost-savings obtained by retailers are passed on to consumers through lower retail prices. On top of that, the regulation's indirect promotion of card acceptance and usage contributes to the fight against tax evasion and the black economy. Lastly, a better protection against fraud and other abuses is guaranteed by the introduction of improved security measures.

Retailers

The reduction of MIFs is only obligatory between acquiring and issuing payment providers, making it crucial for both offline and online retailers to optimise their payment processes and renegotiate their contracts. In the wake of maximum interchange fees, the cost of card payment

transactions for online as well as offline retailers thus can indirectly decline considerably. Taken together with the aim of a level playing field on the payment service market, which will result in a diversity of payments methods, this can increase the reach online retailers have, with a higher revenue in return. Caution is needed when payment options become disproportionate; convincing both customers and retailers to use a certain payment system could become a hard task. The choice of an acquiring bank outside their own Member-State will now also be possible at a regulated price, giving (large) merchants the opportunity to benefit from investing in cross-border relationships. However, competitive pressure will drive domestic acquirers to a convergence of fees in the longer run. Small retailers benefit directly from the floor on interchange fees since they had a lower ability in negotiating.

Consumer Rights

With respect to consumer rights, the Payment Services Directive as currently in effect was implemented with the aim of having EU wide rules to increase consumer rights, clearer information on payments, faster payments, refund rights and increased competition. PSD2 will continue to be of particular relevance for consumer rights through a number of extra regulations. First of all, the prevailing rule on refund right for consumers is that they are unconditional. This also applies to the case of a disputed payment transaction, unless the contract has been fulfilled and the good or service has been consumed. The obligation for banks to answer complaints within 15 business days in written form, will put consumers in a stronger position in case of disputes. Whereas the current PSD regulations only cover transfers within the borders of Europe and are limited to currencies of the Member States, PSD2 enhances consumer rights regarding transfers and money remittances outside of Europe and paying in non-EU currencies[4]. Finally, competent authorities to handle complaints of payment services users and complaints procedures are put in place.

TPPs

Up to now the payments market was characterized by difficulties to enter and barriers to offer services on a large scale and across the different Member States for TPPs. By including them in PSD2, barriers get broken down and difficulties eliminated. Intrinsically, more customers will be reached by new entrants and new markets – with cheaper solutions. The bigger opportunities for TPPs lie in those markets and countries where card payments are the rule rather than the exception, and where online retailers are in the search of new alternatives.

Traditional Banks

One could argue that traditional banks will suffer from regulations due to losses related to the cap on interchange fees – but that would be taking a blinkered view of the matter. The capped fees are likely to result in an increased card payment usage by customers and acceptance by retailers. Consequently, the losses can be partially counterbalanced by an expanded volume of transactions and savings on cash handling. Since there will be less cash circulating, fewer costs will result from ATM withdrawals and more interchange fees will appear in return.

With TPP services on the rise and their inclusion in PSD2 – a fortiori – banks run the risk of being increasingly disintermediated and losing transactions to these parties. Fundamental here is that banks should regard the PSD2 regulations as an opportunity rather than a threat; collaboration with TPPs, FinTech companies and customers to create e.g. an app store can avoid the wedge between customers and banks to be driven any further. This comes together with the advantages of customer loyalty without the disadvantages of development and innovative maintenance. Another way to deal with the issue is to establish TPP services themselves. Those banks that see the business opportunities behind the regulations and compliance measures, are most likely to succeed and keep up with the customer experience needs.

Conclusion

The new payments regulation is all about opening up the bank with technology and consequently, will have a huge business model impact. PSD2 has a crucial role to play in the increase of transaction volumes and the maximization of customer value.

[4] Payments within the European Economic Area (EAA) in currencies of the Member States and other currencies (e.g. USD), or one-leg-out payments in all currencies, with one service provider located outside the EAA.

The moral of the story here is that every party affected by it – and traditional banks in particular, should be open to the wealth of business opportunities it brings along. More specifically, collaboration is key to enlarge the benefits of each party and to secure financial institutions' position and relevance to customers. There should be no winning or losing but all stakeholders should work on a partnership-based model and mind-set – and if banks need to open up in the light of PSD2, then a timely act of doing so could guarantee a strong position in payments in the future.

The banking sector needs to adapt and change its mind-set – Sia Partners can help organizations rethink customer relationships and revenue models, as well as provide a pertinent understanding of the new regulations and its plausible implications. Moreover, it can reassess business processes, product development and competitive threats of new entrants.

Benefits				
Economic / Society	**Retailers (renegotiating)**	**Consumer Rights**	**TPPs**	**Traditional Banks**
• Increased competition • Low cost use of card payment • Increased customer experience • Diversity of and innovative payment methods • Lower consumer prices • Fight against tax evasion and black economy • Protection against fraud	• Capped fees Card payment cost decline • Level playing field • Increased reach • Higher revenue • Cross border relationships	• Unconditional refund right • Stronger position disputes • Transfers and money remittances outside Europe • Payments in non-EU currencies	• Elimination barriers to entry • Increased customer reach • Cheaper solutions	• Increased card payments transaction volume • Savings on cash handling • Collaboration opportunities • Resulting consumer loyalty

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About Sia Partners

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