Scope Insights

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While analysts are investors remain focused on bank M&A scenarios, CEO changes and other shiny objects, a tectonic shift is in motion that is likely to lead to an irreversible repositioning of Europe's banking and financial sector.

This shift is being brought about by fast advancing digitalisation, a process that has been in hyperdrive since the pandemic disrupted physical interaction, and by growing customer centricity in financial services.

But the more concrete catalyst has been the EU's Second Payment Services Directive (PSD2), adopted in 2015, transposed into national legislation at the beginning of 2018 under the new Law on Payment Services and Payment Systems, and after several delays, implemented in full as of this year.

The European Banking Authority (EBA) has now asked[1] national competent authorities (NCAs) to take the necessary actions to ensure that PSD2 is fully complied with, and that obstacles to implementation are removed.

Implementing PSD2 is a first and important step towards the open-banking and open-finance ecosystem that in my view represents the future of financial-services. PSD2 is arguably Europe's most important piece of non-prudential financial regulation for decades.

It directly challenges the traditional bank-customer value chain (which asymmetrically benefits the bank) by allowing the transfer of customer financial data ownership from banks to their business and individual clients via open application programming interfaces (APIs).

Customers can then freely choose between their existing bank or third-party providers (TPPs) – other banks or authorised non-banks – to carry out their payment instructions. TPPs' access to accounts (XS2A) occurs solely with customers' prior agreement, which in effect puts them, not their banks, in the driver's seat.

The implementation of PSD2 puts in play European banks' revenues related to payments and account services. A recent McKinsey report[2] estimates these as being no less than 35% of

[1]https://www.eba.europa.eu/eba-calls-national-authorities-take-supervisory-actions-removal-obstacles-account-access-under

[2]https://www.mckinsey.com/industries/financial-services/our-insights/the-future-of-european-payments-strategic-choices-for-banks

total bank revenues (vs. 51% from lending and 14% from other products). Laggards in the post-PSD2 shake-up could see their client base rarefy, their market position erode, and a stable and reliable source of earnings diminish.

The market needs to pay more attention

Sufficient reasons in my opinion for market participants to start paying proper attention to how European banks adjust to the post-PSD2 environment. Attention not only to how aware top management is to the new challenges, or how PSD2-compliant the bank is. There are good chances that banks will tick both boxes.

Rather to the specific strategy banks are adopting to win in the new game, and to the concrete steps they are taking or are planning to take around cloud-based platforms, big data management, use of artificial intelligence and robotics etc.

There is often a degree of inertia in how the market investigates new aspects of relevance. Which is why those banks with a clear vision of where they want to position themselves in the open-finance world and how to get there should bring up the topic themselves on analyst calls and meetings to try to educate their analysts and investors. For everyone's benefit.

PSD2 opens Pandora's Box: clouds and platforms

TPPs – account information service providers (AISPs) and payment initiation service providers (PISPs) – include bank-independent fintechs, merchants, big techs like Google or Amazon, and established businesses capturing payment flows like BP or Poste Italiane. As of September 2020, there were overall 410 licensed TPPs in the EU, up from 237 a year before. Which is a respectable 79% growth, fueled not only by the desire to take advantage of the market opening enabled by PDS2, but also by the massive pandemic-induced rush to digital.

Using "build, buy, or partner" avenues, Europe's large banks are preparing for the new world, at a different pace but aiming at the same goals. One central element of their strategies is migrating activities and operations to cloud-native platforms. The main business cloud providers – Amazon Web Services, Google Cloud, Microsoft Azure, and Alibaba Cloud – are actively courting the top names in European banking. One example is the just-announced partnership between BBVA and Google Cloud to enhance the open platform's security. Both big techs and specialised fintechs are partnering with incumbent banks to build open APIs.

There is also increased interest in independent open banking platforms like Tink, Mambu, or Nordic API Gateway (the latter with substantial investments from large Nordic banks). Some large banks have set up platforms that are open to other competitors, like ING's Yolt.

Smaller institutions are clearly in a more vulnerable position in terms of digital investment and know-how, so are aiming to set up partnerships to approach open finance. One example is the recently launched European Cloud User Coalition (ECUC), set up by several banks across the EU with the aim of broadening and facilitating cloud usage by a larger number of peers in various European countries.

In this respect, one visible systemic weakness is the absence of viable European cloud providers to compete against the US and Chinese giants. Both EU governments and banks have all the interest in the world to address this weakness in the not-too-distant future.

Implementation hiccups

PSD2 implementation was supposed to have started three years ago, but the deadline was pushed back to September 2019 to sort out the thorny issue of data security.

This was clarified by the EBA through a Regulatory Technical Standards (RTS) paper on strong customer authentication (SCA).

According to the SCA protocol, at least two of three categories are required: “what you know” (password or PIN), “what you own” (smartphone or physical token), and “what you are” (biometrics like face recognition or fingerprints).

In line with the degree of security provided, the tendency now is to move more towards ‘non-transmittable’ elements, such as biometrics, and rely less on static passwords or SMS that are more prone to cyberattacks. Indeed, cybersecurity firm Kaspersky recorded a tripling of distributed denial-of-service (DDoS) attacks over the 12-month period ending in mid-last year.

In light of the visibly weak degree of preparedness for PSD2 by September 2019, the compliance deadline was further pushed back to January 2021. To which a few supplementary months, to September 2021, were recently added to ease the SCA implementation pressure on pandemic-affected smaller merchants.

Another initial problem with implementation was the fact that PSD2 did not specify a specific standard format across the EU for setting up open APIs. There were several competing standards, although now those adopted by the so-called Berlin Group (a coalition of EU banks) seem to be prevailing, suggesting smoother sailing ahead.

Further afield, there are plans for a review this year of PSD2 that will focus mostly on lessons learned in recent years around security enhancements (strengthening payer’s protection, reducing the risk of ‘social engineering’ and ‘targeted phishing’ fraud) and, importantly, looking at better standardisation for APIs across the EU. One inherent challenge for regulators involved in these areas is keeping up with the fast advances in technology and rapidly changing industry standards.

Open Banking takes off in the UK

These teething problems were to some extent avoided in the UK, thanks to the Competition and Markets Authority’s (CMA) initiative to require a standardised and enhanced version of PSD2. Through its Open Banking initiative, the CMA requires the largest financial institutions operating in the UK – HSBC, Barclays, NatWest, Lloyds, Santander, Bank of Ireland, AIB, Danske and Nationwide Building Society (the so-called CMA Nine) to release data in a secure and standardised form so it can be shared seamlessly among authorised users.

The range of data to be released, again with the customer’s prior authorisation, goes beyond payment accounts, as is the case with PSD2.

Recent data from Finextra Research shows that as of January this year there were already 2.1 million active open-banking users in the UK, while the API call volume increased to six billion in 2020 (from only 67 million in 2018).

Beyond the CMA Nine, an increasing number of smaller financial institutions -- neobanks and nonbank fintechs – are joining the Open Banking initiative’s bandwagon. There is every reason to believe that open banking will end up being adopted by an increasingly large share of businesses and individuals. This clearly raises the stakes for financial institutions still on the sidelines.

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