PSD2 broadens competitive landscape for European banks in the digital age

The revised Payment Services Directive (PSD2) will add a new and important angle to the competitive landscape for EU banks in the digital age: regulation-sanctioned open banking platforms that will challenge the traditional bank-customer value chain. The Directive has been in effect since early last year, but its final compliance deadline is less than two months away. Based on its depth and breadth, it has no equivalents elsewhere in the world.

Financial regulation, whether prudential or conduct-related, tends to be restrictive in that it raises entry barriers into the banking sector. PSD2 is the opposite; lowering entry barriers by aiming to offer cheaper and faster alternatives as well as enhanced security to consumers and businesses. In this regard, it is not dissimilar to other end-user-enabling EU regulations, like GDPR or MiFID2.

The way banks approach the pitfalls and opportunities of PSD2 – defensively or pro-actively – can shed light on their strategic foresight and future positioning in the open digital ecosystem. The drawback is that not enough banks outside the Nordic region are specific enough on this topic in their communications with investors. First, because just as they do with the other regulatory norms, banks are looking at PSD2 mostly from a compliance angle rather than as a business opportunity.

Second, because market participants, in aggregate, do not seem to be that focused on the likely impact of PSD2 and open banking on EU banks' business models and future profitability. The subject is rarely on the menu during analyst calls with banks. But investors ignore this aspect at their peril: the implementation of PSD2 is mandatory across the EU and in the not-too-distant future it will likely alter the playing field for banks. Not all banks are taking this risk fully on board.

What is PSD2 and why is it important?

The first Payment Services Directive (PSD1), effective in 2007, provided a legal framework to the-then new European Single Payments Area (SEPA). More than a decade later, PSD2 has advanced this framework into the digital age, aiming for cashless transactions and, importantly, broadening its scope beyond the banking sector. Specifically, it opens the door for consumers and businesses across the EU/EEA to use non-bank third-party providers (TPPs), such as fintechs or other digital platforms, to handle their finances via online and mobile channels.

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Author

Sam Theodore
+44 776 932 1043
s.theodore@scopeinsights.com

Investor Relations

Debbie Hartley
+44 20 3871 2872
d.hartley@scopegroup.com

Media

André Fischer
+49 30 27891 147
a.fischer@scopegroup.com

Scope Insights

Suite 204
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Scope Group
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

www.scopegroup.com

Bloomberg: SCOP

Under the new framework, banks will have to give TPPs access to their customer accounts (subject to customer agreement) through open application programming interfaces (APIs). Among other things, PSD2 makes customer transactions – payments and money transfers – more secure via strong customer authentication (SCA). At least two of the following three categories are required for SCA: knowledge (password or PIN), possession (phone or physical token), and inherence (fingerprints or face recognition).

PSD2 requires banks to set up open APIs but does not specify a standard format across the EU to allow access to accounts (XS2A). Currently there are several standards, such as Open Banking (UK), NextGenPSD2 (a coalition of EU banks called the Berlin Group) or STET (France).

The final deadline for banks to comply with the SCA requirements, as well as adopting an open API format, is 14 September 2019. In preparation, an interim mid-March deadline required banks to set up a testing sandbox environment for APIs, as a dry run for TPPs before they can access real customer data. A week after that deadline, it was reported that some 40% of EU banks were still non-compliant. This suggests that not all banks may be ready for the final deadline in September either. There is, however, only limited information coming from banks on their readiness. This is far from ideal.

PSD2 introduces two types of TPPs: account information service providers (AISPs) and payment initiation service providers (PISP). The former let participating customers see all information from different bank accounts in one place – online or via an app. The latter allow customers to pay directly from any of their bank accounts without using a credit or debit card. Both types of TPPs are licensed and regulated as financial firms (e.g. in the UK by the FCA) and require the explicit consent of the respective payment service users (PSUs). The EBA has established a central register of participating entities in the EU/EEA according to PSD2 requirements, which it updates regularly.

Challenges are growing for banks, especially second-tier entities

For years now and not related to PSD2, non-bank participants from fintechs to big tech have increasingly invaded the banks' turf. This has been challenging banks' business models – which are based largely on cross-selling to locked-in customers – as well as their earnings structure. The stakes in Europe are high, because unlike the US the European markets still remain largely bank-intermediated. And nowhere higher than for the multitude of second and third-tier banks which have fewer options to diversify their earnings sources.

In some ways PSD2 is pouring gas on the fire, because it has brought a regulatory imprimatur to the ongoing digital disruption risk threatening the banking sector. In essence, PSD2 will change the payments value-chain by opening the field to TPPs. On the revenue side, payment-related fees amount for a considerable share of retail banking earnings – between 10% and 20%. This slice of revenues, which is relatively sticky and not highly linked to balance-sheet risk, will be under increasing threat once TPPs start taking payment and money-transfer fees and spreads away from the banks.

PSD2 will likely have the highest impact on bank revenues generated from consumers and SMEs: mortgages, credit cards, business loans, savings, insurance, and wealth management. These happen to be the sectors where most European banks are particularly active. Again, the challenge is highest for the smaller, undiversified entities. But not only for them. Case in point, the biggest providers of credit cards in Europe, by volume, are the large French and UK banks. Revenues from the card business could be particularly vulnerable over time as customer payments bypass it. The risk for the large EU groups is not very significant at this stage, as the gains of open banking in the market will take years. But it is not inconsequential, especially if not addressed in time.

Banks' cost structures could also be affected in a post-PSD2 environment, given the growing IT expenses related to setting up APIs and providing customer security and compliance under the new regulation. To top it all, PSD2 will not allow a bank to charge a TPP more for using its infrastructure than it would normally charge its own customer.

Beyond the challenge on revenues, perhaps more importantly the value of customer transactions data being available on banks' open APIs to TPPs cannot be under-estimated. The more customer transactions go through TPPs, the more the user's bank will be left with the tasks of account maintenance (client money remaining with the bank), providing SCA, or assuring compliance duties such as KYC. These are middle and back-office areas, with more lucrative revenue generators potentially going to PISPs and AISPs.

This is not the most likely scenario, as banks cannot be expected to stand pat and do nothing. But the fact that too many banks are not yet pro-actively engaged in the PSD2 process is not reassuring.

Winners and losers in a PSD2 environment

When faced with a new piece of regulation, the natural reaction of banks is to focus on compliance. This has been the case with both prudential and conduct regulations, especially during the crisis and post-crisis years. Banks and market observers agree that regulatory compliance remains a top risk: being non-compliant is usually bad news.

But in the case of PSD2, a lot more than merely complying with the new rules is at stake for banks. Through the requirement to set up open APIs, the door to new competitors like TPPs is open irrespective of PSD2 compliance status. PSD2 lets TPPs operate across the EU as long as they are licensed by their home regulator. The new regulation needs to be viewed by banks less as an existential challenge and more as an opportunity for digital growth.

Nordic banks have communicated on PSD2 opportunities for several years now and have taken steps to build, buy, or associate with open platforms. Helping to some extent is the fact that they operate in relatively small national banking markets with a culture of more consensual competition (vs. more knives-out competition in other markets). And especially with a large share of digital-minded customers.

By definition, seeing PSD2 as an opportunity has to translate into more significant IT investments for the digital age. In this respect, there remains a considerable degree of opacity and uncertainty, especially among Europe's second-tier banks. With some exceptions, it is not clear at all how they will react and operate in a post-PSD2 environment and how competitive they will be able to remain once the trend towards open banking takes off in earnest.

The game is still for banks to lose

On the other hand, the degree to which transaction flows will move to open APIs and into the hands of fintechs and other TPPs will be in function of evolving customer behaviour. Which, in general, with a large dose of inherent customer inertia in place – especially outside the larger cities – evolves much slower and more gradually than the disruptive capacity of new technologies allows for.

Besides, it is very likely that in a post-PSD2 environment there will be instances of fintechs and other TPPs which will run afoul of public trust and regulatory norms, especially if they try to build too quickly business volumes and revenues. Perhaps more so than the average bank, which, with the traumatic crisis experience behind it, would be more predictably tied to accepted rules, regulations and business practices.

But this does not mean that a bank can consider itself comfortably sheltered in its comfort zone, based just on past customer loyalties.

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Scope Insights GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

Disclaimer

Managing Director: Florian Schoeller
Commercial Register: District Court Berlin-Charlottenburg HRB 202433 B