PSD2 and the impact on the Financial Services industry

FISER CONSULTING
FINANCIAL SERVICES

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Executive Summary

Technological changes are not new to the Financial Services industry, but they have certainly grown in volume as well as complexity in recent years. FiSer Consulting understands the impacts and challenges which impact the core functions and infrastructure of banks. We are heavily engaged with our clients on all aspects affecting their business and remain a tried and trusted leading and support advisor.

One such technological change relates to the new Payments Services Directive (PSD2) which is a fundamental game changer for the financial services industry, where the lack of action by individual participants will result in the major risk of losing customers and revenue and may take many years to recover from a proactive approach to this new directive.

In this paper, we will outline how the Directive has evolved from its initial format, what it means for the industry, the strategic options for all financial institutions, the challenges, opportunities and implications and its impact on the operating models which financial institutions currently have in place.

Separately, we will detail the services that FiSer Consulting provide and how we can help you best respond in a proactive manner to this major technology driven regulation.

The Evolution of PSD

In 2007 the Payment Services Directive (PSD) was accepted as a law for regulating the payments industry and to protect and control safer consumer payment services in Europe. The principal objective was to facilitate valuable, protective and accessible cross-border payments as a universal payment option amongst Member States of the European Union.

The PSD directive has established beneficial well-defined boundaries for the payment services. The law benefited the European economy by making it easily accessible for new market entrants and payment institutions, while also promoting competition and creating payment choices for consumers. The directive has simplified payment processing and payments by efficient structures, innovation and reduced costs. Last but not least, the PSD provided a platform for the Single Euro Payments Area, also known as SEPA.

The PSD not only created transparency and benefits for financial institutions, but also for consumers. The law informed consumers about execution time and fees, strengthened refund rights and clarified the liability of consumers and payment institutions. A very distinct characteristic of the PSD is its ability to make payments easy and quick throughout all the European Member States: payments could be credited to the receiver's payment account within just a couple of days.

Despite the PSD's ability to create transparency and opportunities for both financial institutions and consumers in the payments and service industry, the European Commission decided to propose a second iteration to the PSD legislation called PSD2.

In 2013 major changes started occurring in the financial services sector. These predominantly technological changes are the reason behind the PSD2 directive. The continuous changing technologies require a rock-solid law that unifies and strengthens payment services, and strictly regulates security and fosters competition and innovation.

PSD2 refines certain provisions of the old directive and seeks to achieve the following:

- Standardise and make card, internet, and mobile payments interoperable
- Reduce the entry barriers
- Consolidate emerging types of payment services
- Align charging and steering practices across the EU
- Ensure consistent application of the directive across the EU

Enhancements on PSD

Coverage: One-leg transactions whereby one of the PSP's is based in the EU. All EU currencies will be covered.

Changes in exemptions: PSD2 proposes to change the scope of certain exemptions and their interpretation in order to enhance consumer protection. This brings more firms on to their radar and provides a level playing field to all stakeholders.

Transparency: Before the transaction is initiated, all terms and conditions of the services are to be disclosed mandatorily.

Safeguarding requirements: The directive introduces measures for payment institutions to safeguard the funds they receive as payments. Provisions include keeping funds separately and insuring the amounts with non-group institutions.

Registration and licensing: PSD2 lays down detailed procedures for registration, licensing, and financial and operational controls such as statutory audit of annual accounts, reporting requirements for PSP's.

Charges: PSD allowed merchants to request a charge from payers, offer them a reduction, or encourage them to use the most efficient payment method, with the qualifier that member states may limit such surcharging in their territories. PSD2 seeks to address this by prohibiting surcharging altogether. Benefits passed on to customers.

Electronic access point within EBA: The new framework calls for the establishment of a web portal serving as a unique electronic access point with the EBA to connect all national registers. This will provide for enhanced transparency of authorised and registered payment institutions and enhance cooperation among competing authorities.

PSPs' and payer's liability for unauthorised payment transactions: Where transactions are unauthorized, PSD2 suggests changes to liability rules to enhance consumer protection.

Small payment institutions: PSD2 seeks to redefine the transaction amount threshold for identification of small payment institutions (PSPs handling small value transactions). This is to avoid unnecessary regulatory burden for very small institutions, while ensuring adequate protection to users of payment services.

Security measures: The proposed rule addresses the various aspects of security and authentication in accordance with the EC's directive of the European Parliament and the

Council on Network and Information Security. This is to ensure a high level of network and information security across the EU.

Third party service providers offering payment services: PSD2 seeks to bring third party service providers, especially those offering online banking-based payment services, under the scope of the regulation. TPPs will now be required to get licensed or registered, and supervised as payment institutions, before being allowed to provide payment services.

Out-of-court complaint and reparation procedures: The requirements for out-of-court complaints and reparation procedures and penalties have also been revised. When a payment service user complains, PSPs are now required to reply in writing and address all concerns within 15 business days of complaint.

Sanctions: PSD2 requires member states to align administrative sanctions, ensure that appropriate measures and sanctions are available for beaches, and are duly applied.

Preparing for PSD2 - Financial Services industry impact

PSD2 should be viewed as a foundation to drive innovation, enhance competition, increase transparency and encourage deeper customer engagement. To that end the directive is certainly not restricted to just banks and impacts non-banking financial institutions and technology firms.

Two key provisions, namely account information service and multi factor authentication will require banks to:

- Restructure the underlying technology landscape by consolidating and modernising legacy infrastructure
- Build additional IT infrastructure and access channels
- Restructure and realign core and surrounding systems
- Overhaul business processes
- Develop new APIs and/or products
- Redefine banker-customer relationships and revenue models
- Develop additional security layers' services.

Given that banks will need to create an API framework to prevent disintermediation, and be a partner in their customers' growth, it is essential to:

- Design a standards-based API strategy
- Examine the maturity levels of core payment systems
- Modernise underlying payment platforms to align with the defined strategy
- Build new apps as required
- Reengineer business processes to support the various provisions

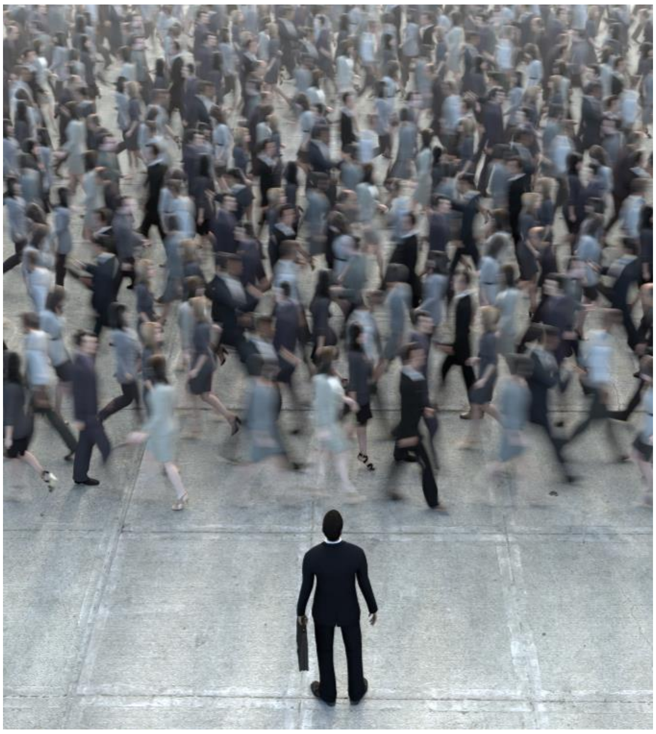
Resistance to replacing antiquated technologies or legacy platforms will impede the smooth transition to an open bank and create integration challenges in partner ecosystems.
However, banks should refrain from implementing a minimally functional API as a tactical fix to connect payment initiating channels with underlying systems. The intent should be to use APIs to connect to anything and everything, both within and outside the bank. It is therefore a structural change that will impel banks to develop a strategic response and reinvent themselves as API-driven entities to align with the open world.

Strategic options for banks

Two key strategic choices present itself to banks when they deep dive in to determining what it wants to be to its customer:

1. Where should the bank position itself in the payments value chain? Banks either focus solely on providing account access and let others offer compelling payment and account information services to their existing customers. Alternatively, such banks develop these new applications themselves and compete directly for customer relevance and ownership in the TPP domain.

2. What should the breadth of the transaction services portfolio be? Banks either offer a limited portfolio of payment and information services (through APIs conform XS2A requirements) or extend to also cater for other types of transactions. These are essentially transactions which are beyond payments e.g. advanced payment and information services, digital identity services and API based lending and risk management services.



Four strategic options can be taken:

Option 1: Comply
Minimal action is required. The bank focuses on PSD2 compliance and opens up through APIs, and thereby conforming to XS2A requirement. This is the most limited extent possible to enable TPPs to execute payment initiation and account information services.

Option 2: Expand
Ensures PSD2 compliance, while banks also focus on developing and exposing services through APIs. These services go beyond basic payment and account information services. Banks will place themselves in a position to seize new revenue stream opportunities by monetising APIs beyond the services compelled by PSD2. API based services leveraging account information and digital identity are interesting areas to explore, providing potential new revenue sources for banks.

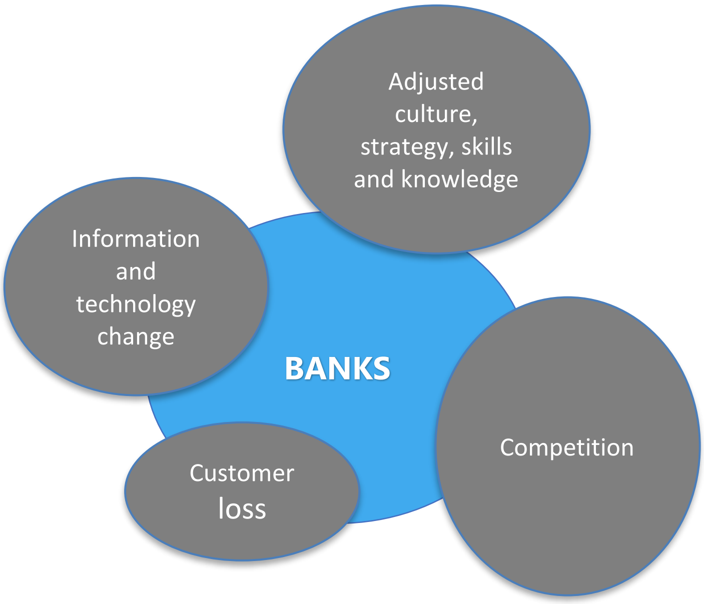
Option 3: Compete
Very similar to the Comply option. However, banks also add an offensive strategy by offering payment initiation and AIS, leveraging the reach to other banks they will obtain by becoming a TPP themselves.

Option 4: Transform
This option combines all three other options: banks focus on pursuing a 'bank as a platform' strategy to enable third parties to build applications and services around the financial institution. This must be based on open APIs. Banks become complete digital players, competing and collaborating for customer relevance and ownership.

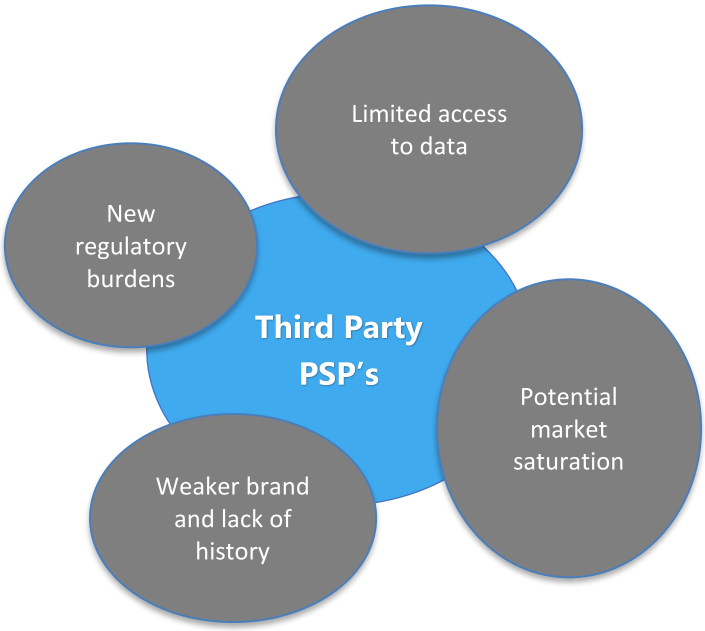
Fundamental to making such a decision on which option is most appropriate, is the focus of bank's leaders on adequate and timely decision making regarding its future strategic value chain position and the products it will be offering.

Challenges & Opportunities

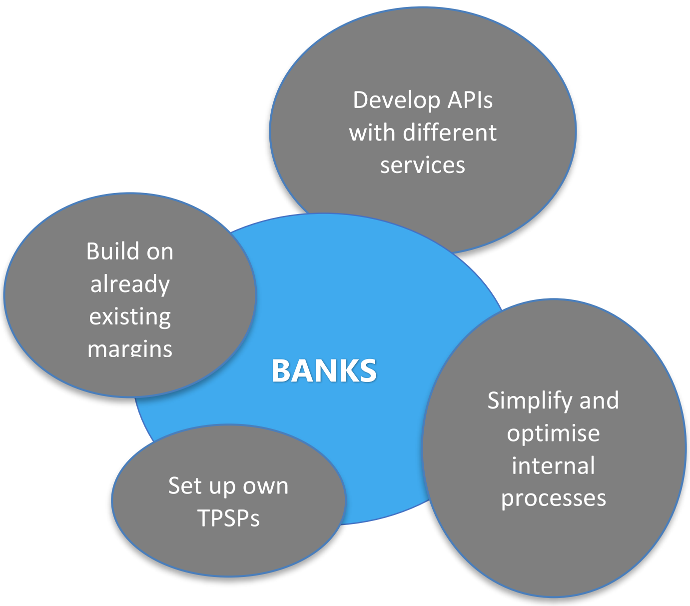
Challenges to banks



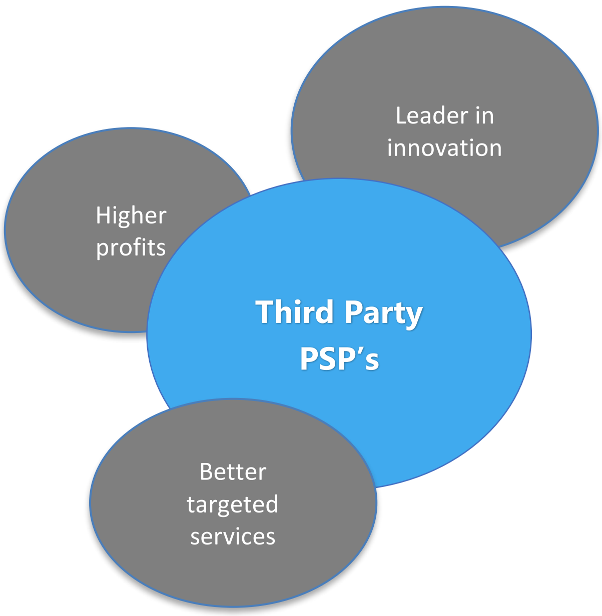
Challenges for PSPS



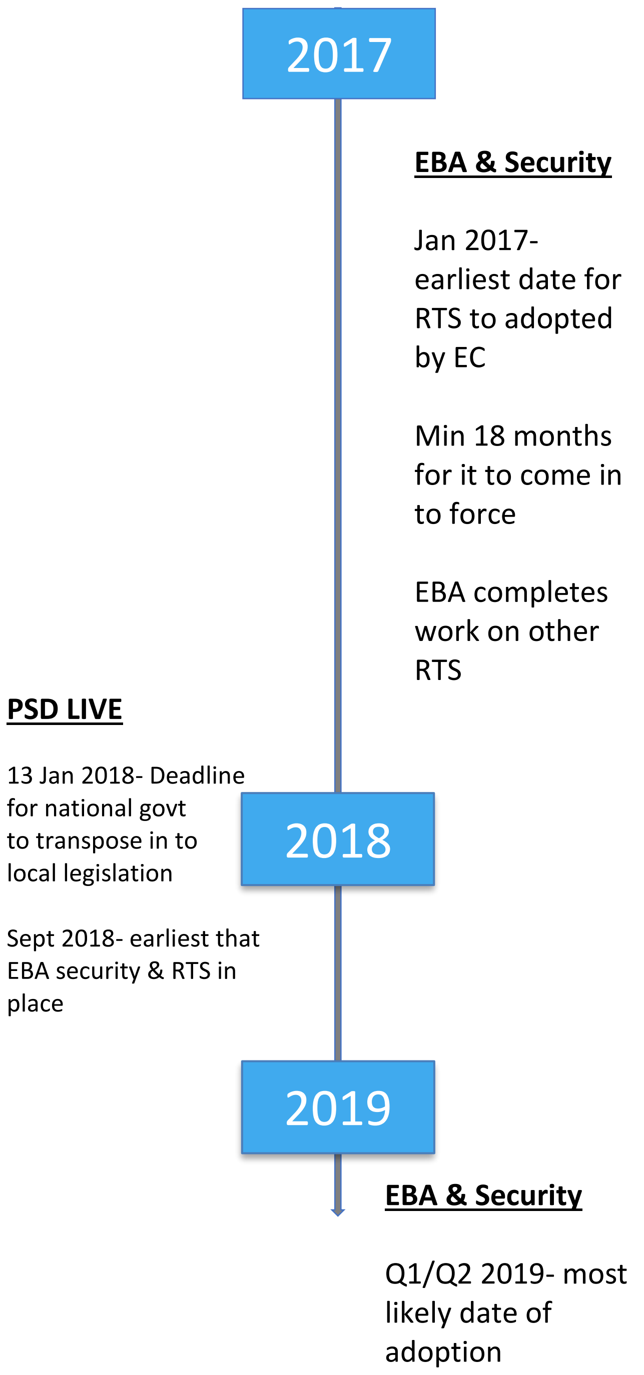
Opportunities for banks



Opportunities for PSPS



Current timeframes



The draft Regulatory Technical Standards will be published by the EBA in January 2017. The standards will then be adopted by the EC, after which there will be a transition period of 18 months before the standards come into force across the EU. This means that the technical standards will not yet be in force in January 2018, the date at which all EU countries and institutions must be compliant with PSD2.

Implementation challenges

Legacy infrastructure: One of the key challenges that banks and financial institutions will need to address, in order to allow access to their payment systems, relates to legacy platforms and architectures. The inflexibility of legacy infrastructure and core banking platforms will severely limit banks' capabilities to provide the required access in a secure and robust manner.

Security: One of the prime concerns of banks and financial institutions would be to ensure the security of customers' data and complete protection of their identity. This becomes even more important now with the new EU Data Protection Act which will be coming in to play. Banks and payment providers will need to identify the way in which customer data and identity can be protected whilst sharing customer account information.

Liability: Opening access to information and introducing new players such as TPPs had a knock on impact allocating and managing liabilities. PSD2 puts the onus on the bank that maintains the customer account to implement adequate security mechanisms to protect the identity of the customer. The provisions in the latest draft of PSD2 imply that the account servicing payment service provider (bank maintaining the customer account) has to compensate the payer (customer) in case of an unauthorised payment, despite the involvement of a PSP. Though PSD2 acknowledges that the TPP could be held liable to compensate the bank that holds the account, liability allocation under the new regime will prove to be a major concern for banks and payment firms. Banks and financial institutions will therefore need to study liability scenarios and prepare accordingly.

Effective governance and management: PSD2 impacts multiple stakeholders and consequently, there is a lack of clarity on ownership, which makes it difficult to define governance structures. Banks and financial institutions will need to resolve this issue, as effective governance and management of services are key to building an open API environment. One way to achieve this is to classify all services in the existing portfolio into core, commodity, and differentiated categories.

So what next:

- Industry need not wait for the regulations to be final. The simple fact is that the directive will happen and the technology selection and implementation can happen now.
- The scope should not be limited to PSD2. Parties need to be open and creative in what APIs and services to enable for third party developers and partners to find new business models and mutual benefits.
- Experiment with a lean approach with smart technology to see what sticks and works.

Operating Model Implications

Depending on each banks strategic response to the new opportunities enabled by PSD2, the impacts on operating models will vary by scale.

In some cases entirely new platforms, roles and capabilities will emerge within the bank, while in others existing capabilities will gain rising importance and complexity.

Examples of such new roles are as follows:

Head of Ecosystem and Partners

In an expanded ecosystem, banks will need to negotiate new relationships and interactions with third party providers to drive mutual benefit for all parties involved. An ecosystem and partnership platform will need to be created.

This will provide ongoing oversight of the relationship between the bank and its network of external partners i.e. partner assessment, governance, lifecycle management.

Head of API Management

As banks open up their APIs and allow TPPs to use their data, products and services, they will need to put in place infrastructure and roles to manage all their APIs in a secure and reliable manner while dealing with the legacy and complexities of existing IT platforms.

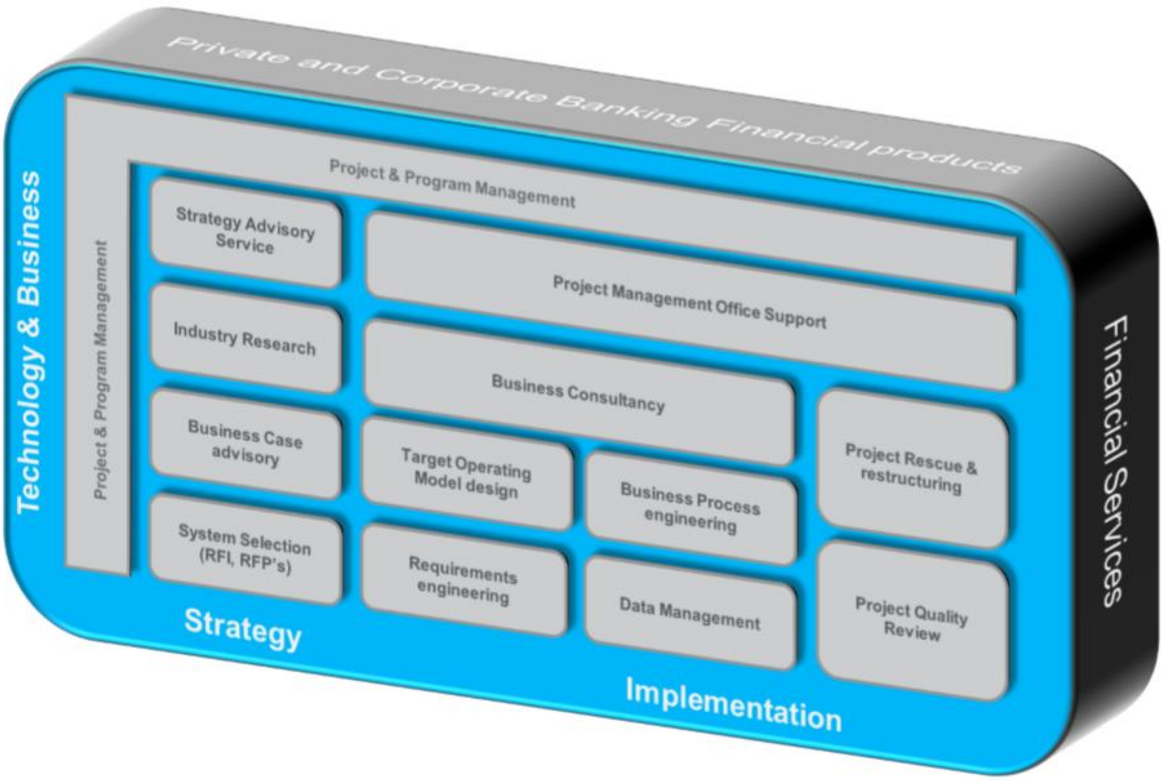
Head of Data Security and IT

A bank anchored on a digital ecosystem will now rely heavily on customer data and insight. This will include both internal data as well as new customer data owned by third parties. As the quantities of this data increase so will the requirements around safeguarding of such information. The bank will therefore need to ensure that adequate controls are in place to verify the identity of the customer or TPP seeking access to bank's APIs or customer data.

Head of Loyalty

The main ambition of the new directive is to allow for more competition and innovation in the EU payments market. In this newly created environment, banks will need to mitigate the risk of losing customers and hence a customer loyalty programme needs to be part of the overall approach in order to ensure retaining competitiveness.

Our Services and how we can help



FiSer Consulting can assist you in the transformation process of the following areas:

❖ **Business Consultancy, Requirement Engineering & Business Process Engineering**

Due to our exclusive focus on Financial Services, our consultants have a strong content background which covers the Payments area. A strong background and extensive knowledge of the organisation and processes, our consultants can assist you with:

- Interpretation and approach to the new EBA RTS
- Design of infrastructure and risk controls to support PSD2
- Changes with operating models
- Assisting with developing an API plan and strategy which includes assistance with technology selection and implementation

❖ **Business Case Advisory**

With a major change to your technology infrastructure as well as far reaching implications for the entire business, our consultants can formulate and develop a solid Business Case which will cover:

- A description of the business challenge
- An assessment of the potential benefits and costs of the PSD2 investment
- An assessment of the risks that may arise during the implementation/change program
- Recommendations on a preferred course of action
- Description of the implementation approach

- **Project & Program Management**

  The implementation of PSD2 covers changes that effect many stakeholders of the organisation. Significant changes in the way of dealing with customers and other market participants ask for investments supporting advanced IT infrastructure and innovative technology. Our Project & Program Management capability can help you structure and manage a variety of stakeholders across your business. Our project & program managers combine multiple years of experience with in-depth knowledge of the Payments industry.

- **Project Management Support**

  Aligned with our Project & Program Management capability, the PSD2 implementation requires detailed and frequent risk & issue, planning & dependency management as well as internal status reporting. Our Project Management Officers, with proven experience within the Financial Services industry, assist the organisation in these challenging activities.

- **Data Management**

  FiSer consultants can support your needs to have data managed correctly as well as having the necessary security safeguards in place. Our service would facilitate the implementation of the according and necessary required changes.

Glossary of terms

Terms	Definition
AIS	Account Information Service
AISP	Account Information Service Provider
API	Application Programming Interface
EBA	European Banking Authority
EC	European Commission
IT	Information Technology
PSD	Payment Services Directive
PSP	Payment Service Provider
RTS	Regulatory Technical Standards
SEPA	Single Euro Payments Area
TPP	Third Party Provider
XS2A	Access to Account

Next steps

For further information on PSD2 and where FiSer Consulting can assist you, please contact:

FiSer Consulting | Mischa Wesdorp - Managing Partner

Mischa brings over 14 years' experience in the Global Financial Services Industry where he has been employed mostly by large international Dutch based banks. In his career, Mischa acquired an all-round understanding of Risk, Lending and Payments. He is specialised in Operational Risk and Payments related projects.

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FiSer Consulting | Dirk Worm - Managing Partner

Dirk has over 20 years of experience in the Investment Banking and Corporate & Commercial Banking industries. Dirk's consulting skills lie in risk management, front office transaction management and the implementation of asset & liability management. Furthermore, Dirk has a comprehensive understanding of the implementation of regulatory processes, including Basel II, III, MiFID and EMIR.

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