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IN AN INSTANT –

On the review of the PSD2 and the payments industry revolution

Until in the first decade of the millennium, payments was the most unappealing division young students with banking career ambitions could think of. Standard procedures, steady income and comparatively low risks are attributes in demand today but that were considered boring then. Two financial crises and a gigantic technology leap later, payments has become a contested market where the players have become brands like PayPal, Apple, Google, Amazon etc. We asked **Thibault Gobert, Head of Liquidity Pool at Spectrum Markets**, and expert in the field of the downstream processes of transaction lifecycles about the concept of 'open finance' and amendments to the PSD2 Directive.

Thibault, what gave rise to big tech becoming leaders in the payment industry?

One might be tempted to suggest that customers have turned away from banks as a result of the financial crisis. This is not just disproved by the fact that most banks, though long suffering from low-interest rates, didn't lose much more than their proprietary business. It also fails to consider another phenomenon which started with the population born between the eighties and nineties, aka Generation Y. While even older people have become accustomed to the use of technology, this generation is considered the first to have grown up in a digital environment. The results with relevance for our topic were manifold. While the internet brought services to the fingertips of all of us, this group of young consumers never felt the need, for example, to enter a bank branch to open an account, withdraw money or make a bank transfer.

Consequently, where there is no human interaction involved, there won't be anything such as a commitment to the provider of the service, i.e., where the consumer recognises a better service or more attractive conditions, he or she will change faster than someone who feels a personal bond. Obviously, the internet makes such change even easier as it doesn't require picking up the phone or even leaving the house to enter into a new contractual agreement for whatever service. Finally, it is no accident that the first companies to indulge this new consumer behaviour have today entered into, or better, conquered the payments business.

Why are banks struggling to catch up with tech companies in the payments sector?

For decades, banks were used to being the one-stop-shop for their clients across all financial services. As long as a financial institution was able to provide all these services competitively, the client stayed in the institution's ecosystem. When this era ended quite suddenly, this did not just turn out to be a problem for their attitude towards competition. While this challenge has been overcome, a much more burdensome problem persists until today. Banks' IT and process landscapes struggle with modern payment procedures and, in a mutually-depending manner, this is aggravated by regulatory obligations.

Are you referring to the PSD2, the European payment services directive?

First of all, there is the minimum reserves requirement for banks which puts providers that also hold the payment the initiator account in a weaker position compared to those that just process payments. In addition, it is a big difference whether initiator and recipient of a payment are registered with the same payment platform, as is the case for payments via PayPal, Amazon etc., or whether the transaction participants are within systems of different banks. Let's take SEPA Instant Payments as an example,i.e., real-time money transfers.

In the case of a real-time transfer the bank of the payment initiator must perform various legal checks prior to forwarding the payment message to a clearing house. If the initiator account check is successful, it will be debited and a connection to a clearing institution is established via a communication system such as SWIFT or EBICS . The payment message will then be transferred and the connection will be terminated. Similar granular control and administration steps are carried out by the clearing entity and by the receiving bank before crediting the account of the payment recipient. A confirmation whether the transaction was successful or not has to go all the way back.

In order to establish such a clearing and settlement process in a compatible way, banks must participate in the same clearing system. If this is EBA clearing, then clearing and settlement are separate processes, increasing the number of messages and thus complexity and costs. Plus, clearing cannot be processed directly against central bank money, which means that the minimum reserve for the customer deposits of the recipient bank, which has increased as a result of the payment, must be balanced. If the European Central Bank's (ECB) TARGET Instant Payment Settlement system (TIPS) is employed, clearing and settlement are not separate. The minimum reserve balancing is done automatically via an account held with the central bank. This process is still complex and the technical platform and process design is the property of the ECB. In any case, banks must fall back on infrastructures which are lagging behind modern payment infrastructures that are being used in trade commerce. And the PSD2 you've mentioned hasn't solved this.

Can you elaborate on the PSD2 and why it falls short of addressing these issues?

PSD, in its first version, was adopted in 2007 in order to make cross-border payments easier and safer; remember how long and costly bank transfers between member states had been before. The revision of this directive, the PSD2, mainly aimed to consider new types of payment services, such as payment initiation services and their providers, subjecting them to regulation. Those new providers are categorised as Third Party Payment Service Providers (TPPs) offering specific payment solutions. These are divided into Payment Initiation Service Providers (PISPs) and Account Information Service Providers (AISPs).

PISPs are intermediaries between the consumer's (payer) bank account and a seller's bank account. Once they are given authorisation by the payer, the PISP can access the payer's bank account automatically. Obviously, there is a confirmation step every time the payer buys something online. AISPs let consumers see all their payment account information from different bank accounts in one place online or via a mobile app including spending analysis tools. The most important changes introduced by the PSD2 are Third party Access to Accounts (XS2A), Prohibited surcharging and Enforced two factor authentication.

Through XS2A, banks have been forced to give TTPs access to customer accounts subject to the customer's prior consent. The problem is that neither PSD2 nor the guidelines of the ECB specify these APIs. The lack of harmonisation of technical standards is a risk to integration and competition and, not least, consumer protection.

There's a review of the PSD2 under way…

…The European Commission launched a public consultation in May on the PSD2 and open finance, assessing the effectiveness, efficiency, costs and benefits, coherence and added value for the European Union of the PSD2. The review process will measure the impact of strong customer authentication on the extent of payment fraud in the EU and, will infer to what extent additional measures should be considered to fight new types of fraud, especially regarding instant payments. It will look at existing legal limits for contactless payments to strike the right balance between customer convenience and preventing fraud risks. It will assess risks arising from unregulated services such as technical services provided on top of regulated payment or e-money services. Furthermore, it will align the PSD2 and the Electronic Money Directive (EMD2) by including the issuance of e-money as a payment service in the PSD2 and assess whether the transparency of cross-border transactions needs to be improved.

Accompanying the public consultation are a call for evidence on an evaluation and an impact assessment relating to its review of the PSD2 and a call for evidence on an impact assessment regarding the policy options relating to an "Open finance framework – enabling data sharing and third party access in the financial sector" initiative planned by the Commission by early 2023.

What is your conclusion?

The PSD2 has been a game-changer in the European financial industry and the ongoing review process will certainly address important shortcomings of the directive in its current form. The challenge is to ensure that further regulation does not create the fragmentation it was aiming to prevent in the first place. This challenge is increased by the pace of technological progress in that processes that shall be governed by to-be-drafted legislation will have become obsolete by the time the legislation applies. In order to cope with the pace of technological change and ever-developing regulatory frameworks, the successful players will be those that consider themselves technology companies.

Thank you very much!

Thibault Gobert, is Head of Liquidity Pool at Spectrum Markets, a pan-European trading venue for securitised derivatives aimed at financial institutions and their retail investors. Since May 2022, financial institutions connected to Spectrum can offer their retail clients long and short leveraged exposure to bitcoin and Ethereum as underlying markets.

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