Open Banking lessons from PSD2: From Compliance to Innovation
EXECUTIVE SUMMARY

PSD2 has been dogged by delays for multiple reasons but the original rationale – to improve competition and innovation – remains tantalisingly out of reach. To move beyond the first stage – compliance – to the second stage – innovation we need to learn the lessons of existing payment schemes to determine what works and what doesn’t. In particular we need to understand that more regulation is not going to improve the current patchy and incomplete implementations – we need to develop business models that ensure all parties, including the banks, are able to benefit from the enormous changes to the ecosystem and huge investments, that have already been made.

The future shape of payments – globally, not just in Europe – will look very different to that of the past. However, if we fail to recognise the reasons why today’s payment schemes exist, the benefits they bring and their value to all users, we will fail to develop anything that adds significant value on a systemic scale. Payments solutions offer huge value when there is a balance between regulation to protect consumers and market opportunity to encourage producers – PSD2 provides a framework for this but lacks the structure and business cases needed to take advantage of the opportunity it affords.

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What does PSD2 require?

At a high level PSD2 imposes two requirements on banks:

1. Banks must implement Strong Customer Authentication (SCA): a form of two-factor authentication on all payments, including electronic payments. There are limited exemptions to SCA when it does not need to be applied, but all payers will find that they, at some point, have to enter their payment credentials for a transaction.

2. Banks must implement APIs to allow authorised third-parties to request payments from accounts and access account information.

Both of these changes require huge investments by banks. They are designed to 1) make banks responsible for the security of payments and 2) allow third-parties to compete with banks through innovation.

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Has PSD2 worked?

PSD2 has worked to a limited extent. Delays have been granted by regulators because both SCA and API implementations have been problematic:

1. **Incompatibility with existing card payments** – internet-based card payments are poorly suited to SCA and the changes needed to ensure a smooth transition were more difficult than appreciated. A delay to implementing SCA was required in order to avoid a cliff-edge crisis with significant numbers of payments being declined or abandoned.

2. **Lack of standards** – simply regulating without introducing standards means that all 6,000+ European payment institutions are at liberty to develop their own SCA methods and APIs. For organisations wanting to use these services to innovate this makes implementation expensive and problematic.

3. **Failure to communicate with all parties** – banks and authorised third parties are regulated entities and need to conform to the regulations but merchants and consumers are also critical parts of the infrastructure and little or no attention has been paid to communicating with them.

4. **A lack of incentive for the banks** – banks will obey regulations, but as the issues above show, regulations only solve part of the problem. Forcing banks to implement hugely expensive changes for no business benefits only ensures compliance – which is a long way from helping to develop a viable, vibrant and useful new ecosystem.

At its heart PSD2 has failed to learn the lessons of existing payment schemes such as Visa, Mastercard or PayPal. These organisations exist to bring payees and payers together via their banks and do so using a combination of regulations, standards and detailed rules. PSD2 provides only the first of these and then relies on co-operation among parties to solve the other issues. This may happen, but given that there is little business upside and considerable downside for banks it seems unlikely to us that this will happen swiftly – if it ever happens at all.

From Past to Future

Card-based payments systems are a modern miracle – but they were designed to solve the payment problems of the past. International payment schemes have evolved to meet the need to allow account holders to pay at merchants that did not have a direct banking relationship with the account holder’s bank. The payment schemes provide the technology to allow both parties in the payment to have trust in the outcome.

Behind this sits a complex set of governance rules that are designed to ensure that all parties can be made good in a transaction, regardless of the myriad of things that can – and often do – go wrong. These rules, and the development and adherence to international standards are critical parts of a payment system, and point towards why the payment schemes aren’t going to disappear – they play a vital role in the payments ecosystem, which will not go away just because of the regulation of open banking.
However, the future lies with push payments – where the consumer instructs their bank to send money to the merchant of their choice. The internet allows point-to-point connections, potentially making the use of four-party payment scheme routing solutions superfluous – why go through multiple intermediaries when you can directly connect to the accountholder’s bank?

Meanwhile smartphones can replace cards, allowing accountholders to authenticate themselves to their bank to instruct it to push funds to the merchant, who never sees the accountholder’s details, removing whole swathes of insecurities. And because the accountholder authenticates directly to their bank there is far less likelihood of payer not present fraud occurring.

PSD2 API payments are regulated push payments – a natural way of paying for ecommerce transactions. By opening up payments to competition and simultaneously increasing the requirement for security around it, PSD2 could radically change the way that the entire payments ecosystem operates. However, while the ambition of the directive is laudable the progress to date has been difficult.

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**PULL PAYMENTS**

1) Card details (card number, etc)  
2) Card details, merchant details, payment details

**PUSH PAYMENTS**

1) Payment details, merchant details  
2) Accountholder instructs their bank to send payment to merchant  
3) Accountholder’s bank sends payment to merchant’s bank
Despite these issues PSD2 is opening doors and creating opportunities. In the UK, the most engaged market for APIs, there are over 500 authorised or soon-to-be organisations authorised to use the PSD2 APIs. Entrepreneurs see the possibilities, but remain frustrated by the issues outlined above. The opportunity is enormous, but given these issues, the question is how do we move from a minimally compliant infrastructure to one that provides the real benefits that PSD2 set out to achieve – to allow competition and innovation to flourish?

A Business Case for Banks

The answer, we believe, is obvious – it’s to create a business case for banks to develop effective new services. That can’t be achieved by more regulation, however attractive that may seem to third-parties frustrated by the slowness of change. Regulation is a blunt weapon to force change and will always have unintended consequences. Far better is to appeal to market forces and to help develop – or even mandate – a profitable role for banks in the new ecosystem.

This still means change, of course – we cannot innovate around payments without splitting payments from underlying core banking services. However, the regulated functions of banks under PSD2 open up some interesting possibilities:

- SCA creates the possibility of banks operating as providers of federated identity, providing identity and attribute assertion based on consumers authenticating. This is analogous to the bank-based identity solutions in the Nordics, where bank backed identity services are used to access a wide array of public and private services. Beyond this is the possibility of federated data sharing, using a variety of privacy methods, allowing banks to monetize data while protecting their accountholder’s privacy.

- PSD2 APIs are a zero value proposition for banks, but banks could also choose to develop standardised premium APIs that focus on ways of extending banks’ reach to avoid their key business areas – those which drive revenues – being disintermediated by third-parties. Most bank revenues do not come from payments but from loans, so the key focus for new APIs should be on innovative ways of offering lending to both consumers and commercial customers - for instance, through point of interaction lending, microloans, corporate liquidity management, instant factoring and extended risk management services.

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**PSD2**

- Banks are responsible for authentication of payments
- Regulates banks to implement SCA
- Banks act as curators of federated identity
- Incentivises banks to implement
- Banks are responsible for implementing access to accounts/payments
- Banks provide standardised premium lending APIs
Once banks have business reasons to engage and extend SCA and API capabilities then the underlying technology will receive the concentrated investment it requires. Regulation can only enforce minimal levels of compliance; it will be profits that drive innovation.

**Conclusions**

PSD2 is not dead, although it isn’t entirely alive yet. Regulators and market participants need to look at the lessons of the existing payment schemes and address the missing governance issues in PSD2. There is a glaring opportunity for parties to step in and fill this gap – on a geographical, sector specific or regional basis. Without this, however, adoption of PSD2 payments will be an unnecessarily slow process.

The key to injecting vitality into the system is to give banks a reason to engage as active participants, rather than them regarding it purely as a compliance issue. Simply introducing more regulation won’t help, but helping to create business propositions to help generate real profits, will.

Consult Hyperion are specialists in the technology and business processes behind payments, and we believe that the opportunities for all participants in the payments ecosystem are enormous – as long as the lessons are learned. We can support the regulated parties – banks and authorised third parties – with the planning and innovation needed to move forward and the non-regulated parties – merchants and Internet Gateways with specialist consultancy into the risk management and business opportunities they need to both comply and develop their businesses.

Above all, we believe that there are significant opportunities for innovative organisations looking to take a scheme role using PSD2 APIs. As an organisation with 30 years of experience in helping to develop payments schemes Consult Hyperion are ideally placed to help such far-sighted organisations take their first steps into a new – and better – payments future.