

PSD2: WILL IT BE A GAME-CHANGER?

Speech by Job Swank, Executive Director of De Nederlandsche Bank at ESB's Conversation with Regulators on Innovation in Payment Services, 18 January 2018 in The Hague

1. Introduction

- Ladies and gentlemen, I'm grateful to the organizers of this conference for inviting me here. This Conversation with Regulators is the last in a series of events on innovation in payment services, organized by ESB. For those of you who can read Dutch, I highly recommend the dossier *Innovatie in Betalen*, issued by ESB in September. It has much more to offer than you will hear from me today.
- Today's topic is PSD2. PSD2 is a European directive, to be implemented through national legislation. And PSD2 is about payments. To most people, these topics – legislation and payments – are extremely boring, a necessary evil. Probably not to you. Otherwise, you wouldn't be here, but you are certainly a minority.
- But life will change for the better, at least according to innovators, fintechs and other market suppliers. Customers can be disencumbered from the tedious activity of making a payment. They may enter a shop or webshop, pick whatever they want and have the shopkeeper take care of the payment ... which will be the end of civilization as we know it. Or perhaps even more sophisticated: refrigerators, printers and other home appliances can order their own refill ... and arrange for the payment without intervention of the consumer. A bank customer may receive an offer from a mortgage broker, perfectly geared toward her financial position and spending pattern ... before she even considers buying a house.
- This is not the future, this is now. Those services – if that's the proper term to use – are technologically feasible and supplied as we speak. So, the question is not whether or when we will enter into a new era (we already have), but rather on what scale. This very much depends on the receptiveness of the public at large and on the reactions of regulators and supervisors to the new possibilities.

- PSD2 is the response of the regulators. It is a response that facilitates innovation. It compels banks, payment institutions and other players to prepare for an era in which financial services are mainly delivered through smartphones, tablets and other electronic devices.
- DNB welcomes PSD2 and the associated innovations. Still, a number of issues are pending. Customer privacy is the most salient one, but there are more challenges: on the demand side, on the supply side and with the regulators. The rest of my talk is organized along this triplet: demand, supply and regulation. I do not have definite answers to all pressing questions related to PSD2. What I'll try to do, is give you a concise impression of issues that need further attention in the near future.

2. PSD2 and the demand side: consumers and retailers

- Let's start with some basics. What is PSD2? PSD2 is the legal framework for retail payments in the European Union. The radical new element of PSD2 is attractive for some, and frightening for others. That is: a bank is obliged to give so-called service providers online access to the account of a customer ... if – and only if – the customer consents. This is an important proviso. The service providers exist in two types: the ones that initiate payments and the ones that extract and exploit information from bank accounts. Such data – on all kinds of transactions – contain commercial value. The collected information can also be redirected to the bank customer as a housekeeping book. Both types of service providers will be regulated under PSD2.
- What is the intrinsic demand for innovative payment services? The novelty of PSD2 is primarily concerned with payments connected with e-commerce. Two facts. First, those payments are still a small portion of the market. Right now, only 2 percent of total payments in the Netherlands. Second, there are already several ways to pay online: through credit cards, by PayPal and, in the Netherlands, through iDEAL. What else would you need to become a happy payer? I hasten to say that this question may be rather silly. The story goes that Henry Ford once sighed: *“If I had asked my customers what they wanted, they would have said ... faster horses”*. Paying online in the Netherlands is quite easy, also compared to other countries. Moreover, already next year, the ideal of 24/7 instant payments will be realized for mobile and internet payments. But judging from the excitement in the industry, plenty of new P2P applications are likely to be within reach.

- What are retailers interested in, as for payment methods? Reach, user convenience, conversion time and – last but not least – cost. Larger retailers may have an incentive to offer payment initiation services themselves, hence bypassing their banks and avoiding bank fees. From this angle, PSD2 may certainly become a game changer.
- The future need for account information services is also difficult to assess, at least where consumers are concerned. Account information services can emerge as smartphone apps that give the customer an up-to-date overview of her payments and financial position. This may be quite useful to analyze one’s expenditures, when a financial advice is needed, or some financial product. I assume that most people acknowledge the benefits of such a service, especially if information from several accounts is combined. But this is probably just the beginning of the further use of payment data. While the exploitation of account information is extensively regulated, it is a very delicate matter. I will not go into the possibilities and horror stories connected with the commercial use of payment data (incidentally, the industry prefers the term “customer intelligence”). But let me elaborate a bit on two contradictory attitudes with the general public when it comes to privacy.
- In 2014, ING announced it considered to use payment data of its clients for commercial purposes. You may remember that this caused a national outcry on privacy. So fierce that soon after the announcement, ING decided to abandon its plan. A recent survey by Carin van der Cruijssen, a researcher at DNB, confirms that the Dutch public is very reluctant to share their payment data with third parties, even for innovative services. An effective way for banks to lose client confidence is to publicly hint at selling customer data to other firms. At the same time, most people are frightfully willing – or unconscious – in allowing internet firms like Google to tap and exploit their search activities on the Web.
- Of course, the European legislator has been fully aware of the privacy concerns. PSD2 provides for a number of requirements regarding the use of data and data protection. In addition, the General Data Protection Regulation (GDPR) will become applicable soon. But certain issues on privacy are still pending, mainly due to possible contradictions between PSD2 and the GDPR concerning consent [[, which is the legal basis for the provision of payment services and the use of account information](#)]. More work is needed on this score by prudential and privacy supervisors. In the Netherlands, this requires close cooperation between the Dutch Data Protection Authority and DNB.

PSD2 and the supply side

- Payments business is a network industry. The entrance of new users – be it consumers or retailers – increases the value of the network for all players. There are substantial economies of scale, due to network externalities and also because setting up a payment infrastructure requires large amounts of investment. This infrastructure is traditionally offered by banks. However, the network effects may raise entry barriers on the supply side, as well as lock-in effects on the demand side. These, in turn, may become obstacles to innovation and competition. One way to overcome such obstacles is to separate the provision of payment services from the infrastructure. This is exactly what PSD2 intends to achieve to stimulate competition and innovation. Banks maintaining the infrastructure, new players providing new services.
- But this solution gives rise to new concerns. The first is the risk of fragmentation. The potential benefits of PSD2 might be frustrated if banks and payment service providers would communicate by a wide diversity of technical interfaces. Common standards help to create a critical mass and to incite new players to enter the market. Standardization is not provided for by PSD2 or its lower regulations. For good reasons, as regulations should be technologically neutral and principle-based. Thus far, principles on standardization could not be agreed in the Euro Retail Payments Board either, due to conflicts of interest between banks and the new payment service providers [screen scraping, among other things]. So, the question remains how standardization can be achieved without creating one dominant force. I will come back to this shortly. The answer may be further cooperation between banks and the new service providers to come to standards that will be broadly accepted in the market. As long as competition is not hindered, of course. That is the real challenge.
- The second, related, concern is the potential role of BigTech. PSD2 makes it easy and attractive for BigTech companies like Google and Apple to enter the European market as payment service providers. If these companies were given a license, they would get access to the accounts of bank clients and acquire the right to use payment data, provided that the customer consents. Like other service providers, they will have to comply with PSD2 and the General Data Protection Regulation. But BigTech companies have a clear competitive advantage when it comes to global brand awareness, international reach and financial resources. Hence, they may oust smaller players and obtain a dominant market position.

“Winner takes all”. This is probably not the best outcome for Europe and certainly not in the spirit of PSD2. The big – unanswered – question is, then, how to avoid it.

- How should small players get the chance to develop. Loosely speaking, PSD2 gives them the right to access bank accounts; again, if the customer consents. But this is only their legal position. Can they survive if BigTech penetrates into the market? Will they be squeezed, then, between the incumbent banks and the new big players? Not necessarily! There is an increasing tendency for banks and fintech companies to work together. Banks provide a large customer base, capital and regulatory experience. The fintechs, in turn, offer specialist expertise and agility in product development. For them, the proverb “If you can’t join them, beat them” seems to apply.
- Another concern or challenge is: what does PSD2 imply for the business models of banks? Banks provide and maintain the infrastructure, which the new players can use freely to supply their services. Banks cannot charge for the access, for information requests or for the use of their infrastructure. So, banks may need to review and adapt their business models. Fortunately, PSD2 also provides banks with new business opportunities. They can decide to become payment initiation service provider or account information service provider and offer their customers the new services themselves. They can reorganize themselves, create agile teams of young and creative people to develop innovative tools, based on access to the account. This is already happening. And, of course, they can closely cooperate with fintech companies.

3. PSD2 and the payment system

- It is also important to look at the system as a whole. This is where DNB comes in. DNB is entrusted with the prudential supervision of banks and payment service providers settled in the Netherlands. DNB is also the central bank. In that capacity, it is legally mandated to promote a sound functioning of the payment system.
- PSD2 gives financial supervisors a prominent role in maintaining the security of payments in the EU. PSD2 not only creates business opportunities, it may also change banks’ risk profiles. Operational risk in particular is likely to increase. This includes cybersecurity, digital fraud and the risk of mismanagement of personal data and privacy. New service providers are also exposed to these risks. Banks, in addition, may have to adapt their business models, which creates a strategic risk. On the other hand, individual banks

prosper to the extent that they can exploit the new opportunities that PSD2 offers. Supervisors and central banks will have to monitor these new risks and developments, both for individual banks and from a system perspective. This is not something new. But the playing field may become in a constant state of flux over the next decade, posing new challenges to the authorities.

- As a central bank, DNB welcomes PSD2 and the associated innovations. By increasing competition, PSD2 can make the payment system more efficient. There are at least three unresolved issues, though, which will come to the fore sooner or later. First, banks are expected to maintain the infrastructure for payments, which the new players can access for free. Then, the strategic question arises whether there will be sufficient incentives for banks to invest further in the infrastructure. Second, the payment system as a whole may become more complex and more fragmented, due to a lack of standards. Is this a problem that needs intervention by the competent authorities or can it be solved by the industry itself? It may serve as a warning here that, until now, European stakeholders have not been able to develop a standard interface for access to bank accounts. Third, if BigTech penetrates into the European market, who should organize the countervailing power to prevent market dominance. And how could this be done?

4. Concluding remarks

- Let me conclude. PSD2 compels the payment industry to head for a new digital era. This may have major strategic consequences for online payments. In my address, I have raised a series of questions on privacy, on the potential role of BigTech and on the conceivable prospect of a fragmented payment system. While DNB welcomes PSD2, these questions deserve ample further reflection in the coming years.
- I thank you for your attention.