

If there is a hot topic in the payments space, the European Payment Services Directive (PSD) is it. The directive has a consumer protection element, contained in a requirement for transparent terms that allows consumers to compare services. It sets out the balance of liabilities between banks and their customers, though in some areas its legal requirements are similar to existing industry best practice, such as the UK Banking Code. It promotes both competition and modernisation of the payments infrastructure with a view to faster payment times.

The PSD also provides the legal underpinning for SEPA. So does it simply do too much? With 60 pages and 100 articles, arguably, yes – though there are significant omissions. Ruth Wandhöfer, payments industry and strategy vice president, EMEA, cash management, Citi Global Transaction Banking, points out that the PSD does not control transactions that have one payment leg outside the 30 markets it covers. European Commission (EC) recommendations have encouraged some member states to implement “leg out” provisions voluntarily, although to do so risks compromising the PSD’s coherence as single-market legislation.

If the flaws are evident, the directive is a done deal. “It’s natural to complain, but I don’t find it particularly useful,” says Björn Flismark, senior vice president, market and infrastructure, Global



Damage limitation

The Payment Services Directive (PSD) requires banks to undermine their own business advantage. So do they know when they are beat – or will they take on non-bank upstarts? Shayla Walmsley reports.

Transaction Services, SEB. “We need to see it within the context of creating a single euro market. You can complain that it’s too much, but we’re spending money by not doing it. There are currently inefficiencies within the system that the PSD will reduce. That’s to the benefit of

consumers and banks in the longer term.” If the PSD is flawed, it is also mandatory, with implementation into national legislation scheduled for November 2009. “With SEPA, banks have a two-to-three-year implementation timeframe. With the PSD, if you don’t comply on 1

November 2009, you're breaking the law. I hope banks understand the difference, but it's worth pointing out," says Flismark. "Multi-country banks expect banks in other countries to play by the same rules. They would find it difficult if the law were applied in some countries and not others." Although it's a "maximum harmonisation" directive – meaning that in theory member states cannot gold-plate it by exceeding its strictures in national legislation – it leaves 23 areas open to national derogations and variations. That creates a risk of market fragmentation as a result of diverging national interpretations.

Erik van Winkel, a manager at EDC who sits on the industry expert group that negotiates with regulators and the EC on PSD implementation, says: "It may be that payment institutions will choose markets with more liberal interpretations of the PSD." He compares it to the 2000 Electronic Money Directive (EMD), which had "the same-type principles", and which favoured markets such as the UK. Of 20 institutions authorised under the EMD, 14 are UK-based.

In any case, the full force of the PSD may take some time to filter down. The aim to achieve T+1 by 2012 is arguably little short of wishful thinking. In any case, according to Bob Lyddon, consultant, IBOS Association, banks will "prioritise" when it comes to compliance. He cites the burden of proof for non-

resolution. "Banks will have to retain and retrieve information on payments they make, and have it readily available. They're not ready for it. It will take them time to get it into place but they won't lose their license over it. They will prioritise complaint areas and compile information where customers are most likely to complain." Some analysts claim to see a 'boiling frog' scenario, with banks waiting...and waiting. Asked whether he was less pessimistic than in April, when a Logica study of 22 banks revealed more than 75% would not start work on PSD implementation until 2009, Simon Bailey, payments director at Logica, says: "Pessimistic isn't the word; I'm realistic. There's a heck of a lot of work going on, but it's far from concluded."

Feisty new entrants

The PSD has not occurred in a vacuum. "The PSD is one of a set of key market changes – including SEPA and advances in technology – which collectively are expected to have a radical impact on the payments environment," says Simon Newstead, head, financial institutions advisory group, Global Transaction Services, RBS. Coming on the back of other initiatives, notably SEPA, there is a chance that the PSD could disrupt the payments industry in ways that may benefit customers and consumers, but which threatens what has hitherto been effectively a bank preserve. One of its potentially most significant impacts is the prohibition against

discrimination between different types of payments provider, between banks and payments institutions (PIs). In some markets, notably the UK, banks already have non-bank competition. What is new is that the PSD will encourage payments institutions to passport – in other words to offer services outside their domestic market. The question is how far, and how fast, those services will expand. The one advantage payments institutions have over banks, cost-wise, is the fact that they're unfettered by legacy systems.

One of the pressure points for payments banks faced with PSD compliance will be the cost of change. Deutsche Bank, for example, has spent USD 40 million to USD 50 million on its payments and messaging infrastructure over the past three years. "Until now, banks have owned the infrastructure because ownership is embedded in how payments are managed," says VocaLink chief commercial officer Martin Wilson. "In recent years there has been a gradual realisation among enlightened banks that they don't need to own the infrastructure to get the benefit. Smaller banks could use it to compete. It breaks through a psychological barrier between risk control and ownership."

PIs are as well positioned to innovate, according to Rajesh Mehta, head, treasury and trade solutions, EMEA, Citi Global Transaction Services. "The more enlightened banks don't dismiss



the innovation such institutions can engender; anything else would be complacent. But there are banks out there who believe payments institutions will operate in only a small segment of the market.” There are other trends, too, that favour PIs’ competitive advantage. Some observers claim, in addition to the trend towards e-payments, there is also a trend towards micro payments. The result is disintermediation, with payments disaggregated into their granular parts. If they do launch a challenge to banks’ dominance of the European payments business, PIs will target the choice segments. “Banks have international systems and offer a broad range of instruments. Payment institutions will either start from scratch or target specific, niche segments,” says van Winkel. “They will have advanced technology; they will incur lower regulatory compliance costs; and they’ll target less burdensome target segments. Banks may end up with a broader range of payments products, most of which aren’t profitable.”

In reality, many bankers are openly sceptical that new PIs could occupy payments space previously owned by banks. Some cite PIs’ distribution disadvantage – though, as Mehta points out, if banks are relying on their branch real estate, they will miss the “tremendous shift” to e-payments. The fact that the PSD tries to bring remitters into regulation is “unlikely to change the competition balance too dramatically”, according to Wandhöfer. Yet she does not rule out

Ruth Wandhöfer, Citi

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corporates filing for a licence to become ‘hybrid’ businesses – say, a mobile telco adding payment services to its core airtime business. “Overall, the fact that the conduct of business rules are fairly detailed, strict and numerous, could still constitute some degree of caution to file for a licence, even though the capital requirements that need to be set aside are very little,” she says.

It may be about competition, but competition could be best served by co-operation or even co-option, with banks teaming up with PIs. The danger for banks taking shares in these institutions is that they could damage their relationship with their customers in the process – that, rather than exploiting the cross-selling opportunity that includes, they will

exchange a customer relationship for a mere shareholding. Other potential forms of co-operation include banks spinning off their own payments institutions, if staying in the space is too costly, or if their pan-European skills are less than optimal. PIs could even acquire small banks. “It’s difficult to make detailed predictions, but they could try to capture the full banking relationship with customers or they could go with niche and stay as PIs,” says van Winkel.

What the prospect of new entrants should teach banks is that, as an industry, they have no special title to the payments business. Everyone may need banking services, but do they necessarily need banks? “The gauntlet has been thrown down to banks,” says Wilson of Vocalink, which in May signed a processing deal with Sweden’s BGC that marks the first time a national payments scheme has been outsourced to a non-domestic provider. “The PSD will free up the market to competition, and competition brings innovation. Banks could see it as a threat or an opportunity to respond.”

Beyond compliance

Either way, banks have barely begun to count the cost of the PSD, according to Harold Young, head, payments, cash management, Global Transaction Banking, Deutsche Bank. He cites estimates that banks operating in Europe have already spent half a billion US dollars on

SEPA; add to this the reduction of pricing to the rate of domestic payments, which has “driven huge holes” in revenues. “The cost of complying with the PSD on top of that will be profound,” he says. Young cites estimates that the revenue pool could shrink from USD 44 billion to USD 18 billion. This is not just about technology – or, more precisely, the impact will be about more than an increase in IT costs for banks.

For banks to gain scale in the new milieu, they need to re-focus away from merely regulatory compliance and towards customer value. “Banks in Europe have always been reacting to the next big infrastructure or regulatory change – from the introduction of the euro onwards,” says Mehta. “Change currency, and they had to change their systems; then SEPA, and they had to change them again. The implication is that, if banks aren't consciously focused, they won't innovate (*see i2i page 16*), because they'll be reacting with mandatory re-tweaks to external stimuli, rather than being driven by customer value.”

Refusing to concede that payments is a commoditised business, Young claims the future for banks left in the payments space lies in value-added services. He cites “dynamic control” services that allow customers to specify the time and conditions of execution, for example, tying it to the account position. He also claims the payments business could be carved up between five or six banks as the others, fazed by marginally



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profitable economics, opt to outsource. But which banks will they be? There is no consensus around Young's view that “only scale providers will survive”. In fact, Joergen Jensen, director, corporate solutions, Wall Street Systems, claims the PSD will give mid-sized banks an opportunity to compete with large ones. “Before, mid-sized banks weren't present in all EU countries. Now banks can process payments whether they're Dutch or French – they don't need a local presence. Not all will, of course. Some will outsource direct debits to larger banks because they won't generate

revenues as they have in the past. But with the right systems they can compete.” Logica's Bailey agrees. “Consolidation among payments banks is already underway. It's a big problem for big payments banks because it involves a costly change process. At the top end, it's another trigger for them to rethink whether they want to operate in the payments space. A number of banks with some scale are beginning to rethink their position. They've gone to the Board, told them what it will cost and that, for that investment, they'll get exactly what they've got now. The Board will say no.” //