



PSD2 AND CMA

What European Open Banking Laws Mean for U.S. Financial Institutions—and Industry Innovation

Christopher D. Ford

Partner, Consumer Financial Services

202.661.2294 | fordc@ballardspahr.com

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By: Christopher D. Ford


In 2015, the EU adopted the revised Payment Services Directive (PSD2) and the U.K. followed suit in 2016 with the Competition and Markets Authority Open Banking mandate (CMA). While these standards do not apply in the United States, they could have significant impact on American payments systems and banking.

The standards were enacted to implement open banking in Europe. With a goal of driving innovation in the banking industry, open banking generally requires the traditional leaders among banking institutions to share customer financial information with specified third-party providers (TPPs)—provided the customer consents. But the new laws likely will have the unintended side effect of weakening the closely guarded relationships these incumbent financial institutions have with their customers. Fintech companies that offer innovative products and services to consumers are likely to benefit, because they could leverage customer financial information to help them lure customers from less data-savvy incumbents.

Data is a priceless asset. Financial institutions have always closely managed the customer relationship, and their ability to control their customers' financial information was one of their most powerful tools. Now, armed with specific insight into customer preferences, innovative TPPs could design new products and services in competition with incumbent financial institutions.

European regulators hope that open banking will spark innovation and greater customer choice, benefiting customers' finances and boosting efficiency in the financial services sector. Banks continue to be less enthusiastic, viewing the laws as a threat to their primary position with the customer—and their profit margins. Some, however, have begun to innovate. For example, one large European financial institution used these regulations as an opportunity to create a platform that serves as a development portal for Fintechs, retailers, and other companies to enhance their offerings for payments and other financial products. That European financial institution hopes the portal will help it maintain its primary position with customers by putting it in the middle of the digital financial ecosystem.

The second major part of PSD2 and CMA is the requirement for Strong Customer Authentication (SCA) for transactions in which both the card issuer and the acquiring bank are located in the European Economic Area, comprising EU countries plus Iceland, Liechtenstein, and Norway. SCA aimed to reduce incidents of fraud in



card-not-present transactions and ensure that payments across the EU are secure, easy, and efficient. With some exceptions, SCA requires that any transaction authentication have two of the three forms of identification: password, device-based, or biometric.

While participants in the payments ecosystem have long understood the need for effective authentication methods, technology has outpaced the methodologies. Prior authentication methods were designed for a browser-based system rather than mobile-based apps. Use of these protocols, although necessary, has been clunky and has tarnished the customer experience on mobile devices, resulting in higher abandonment rates at checkout. The protocols required by PSD2 are intended to make multifactor authentication user-friendly on mobile devices while improving the security of transactions.


Although the initial deadline for companies to comply with the SCA requirement was September 14, 2019, many affected companies could not comply (already struggling to meet their GDPR requirements), and as a result the European Banking Authority, on October 16, 2019, granted an extension to comply to December 31, 2020, and required companies to meet interim milestones along the way.

U.S. Impacts

While a similar U.S. law is unlikely to be enacted, PSD2 and CMA likely will cause a domestic ripple effect. Market forces and consumer demand—not legislation—may cause American companies to adopt similar practices. While not historically as strong as in Europe, U.S. appetite for faster and more direct payments is growing. This may indicate that consumers are becoming indifferent about the entity that delivers their financial services—as long as that entity can deliver the desired functionality with the required security. For some time, we have seen partner entities in co-branded card relationships (i.e., the merchant) give the impression that it was the issuer of the card, although the card must be issued by a financial institution. In these cases, the merchant is willing to assume the role of the trusted financial institution, a position long-held by banks. Perhaps these merchants are tapping into the same philosophy as the European regulators—as long as financial products and services come with adequate security, customers will accept products and services from non-banks.

If these merchants are right, U.S. demand for non-bank financial products and services will grow. Studies in Great Britain show more technology has led to latent demand for new financial solutions, as the majority of users prefer using digital solutions, including mobile apps, for banking functions such as domestic payments/transfers, balance checking, international payments/transfers, and credit card applications. Following this logic, providers of digital solutions, whether through traditional banking institutions or Fintechs, will be better off than providers that are slow to meet consumers' demand for innovation. The same latent demand for new financial solutions exists in the United States, and incumbent financial institutions will need to adapt even in the absence of U.S. regulations. To keep up with customer demand, incumbents will be faced with two choices: build the technology themselves or buy or license it from someone else. Incumbents that do nothing likely will be left behind in the battle for customer loyalty.

An even stronger case may be made for U.S. adoption of SCA. Simply stated, fraudsters will seek the path of least resistance. If European standards are making it harder to commit fraud in Europe, fraudsters will look for another large economy to attack, and a lot of that fraud activity will shift to the U.S. market. That will force American companies to adopt more stringent anti-fraud standards.



So what does this mean for the legal community? As with all things these days, focus on privacy and data security will be paramount when sensitive customer information is involved. Regarding SCA, we expect that, as merchants begin to demand stronger authentication measures, providers in the ecosystem will provide customer-friendly technical alternatives. This should create significant contractual activity between merchants and processors/acquirers. In addition, as Fintechs develop new solutions to address stronger authentication factors, we expect to see an uptick in technology licensing, partnering agreements, and even M&A activity for companies that want to invest in these technologies. It also is likely that fraud-detection companies will stay busy as fraudsters attempt to outpace security technology. To this end, artificial intelligence solutions will continue to flood the market.

Even the most nimble of large financial institutions will struggle to keep up with Fintech innovation. This could lead to increased deal activity among financial institutions, processors, and Fintechs to accommodate market forces that demand faster and more transparent financial transactions and the ability to let customers control their financial data and choices. Financial institutions may attempt to take the approach of acting as a central platform on which the other entities will develop and offer solutions. Either way, as the marketplace evolves to absorb technological advances and meet customer needs, transaction activity among interested parties will increase.

The growth of these relationships might not be easy. Incumbent financial institutions are fighting to hold onto their customer relationships as third parties try to lure customers away. While market forces may force them to enter into partnering arrangements in order to meet consumer demand, many of these are likely to be awkward relationships of necessity rather than desire.

In the end, the European regulators may be prescient in their efforts to spur innovation through open banking standards like PSD2 and CMA, and the ripple effects are likely to extend across the pond. Financial institutions and third-party providers that position themselves properly—by remaining nimble regardless of size and open to innovation when it improves customer experience—may discover a lucrative world of new opportunity.

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OUR LOCATIONS

ATLANTA

999 Peachtree St., NE, Suite 1000
Atlanta, GA 30309-3915
678.420.9300

LAS VEGAS

One Summerlin
1980 Festival Plaza Drive, Suite 900
Las Vegas, NV 89135-2658
702.471.7000

PHILADELPHIA

1735 Market St., 51st Floor
Philadelphia, PA 19103-7599
215.665.8500

BALTIMORE

300 E. Lombard St., 18th Floor
Baltimore, MD 21202-3268
410.528.5600

LOS ANGELES

2029 Century Park E., Suite 800
Los Angeles, CA 90067-2909
424.204.4400

PHOENIX

1 E. Washington St., Suite 2300
Phoenix, AZ 85004-2555
602.798.5400

BOULDER

5480 Valmont Road, Suite 200
Boulder, CO 80301-2369
303.379.2275

MINNEAPOLIS

2000 IDS Center
80 South 8th St.
Minneapolis, MN 55402-2113
612.371.3211

SALT LAKE CITY

One Utah Center, Suite 800
201 S. Main St.
Salt Lake City, UT 84111-2221
801.531.3000

DELAWARE

919 N. Market St., 11th Floor
Wilmington, DE 19801-3034
302.252.4465

NEW JERSEY

210 Lake Drive E., Suite 200
Cherry Hill, NJ 08002-1163
856.761.3400

SIOUX FALLS

101 South Reid St., Suite 302
Sioux Falls, SD 57103
605.978.5200

DENVER

1225 17th St., Suite 2300
Denver, CO 80202-5596
303.292.2400

NEW YORK

1675 Broadway, 19th Floor
New York, NY 10019-5820
212.223.0200

WASHINGTON, DC

1909 K St., NW, 12th Floor
Washington, DC 20006-1157
202.661.2200

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