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Transaction Services Newsletter
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Transaction Services Newsletter

Payments

The morning after

Those who work in the Transaction Services sector know that some lucky colleagues get to spend a week in some exciting city during September when they can party, party, party. At least, that's how it seems if you got left behind. This annual gathering of payments, securities, trade and software people is called Sibos (the SWIFT international banking operations symposium, if we have it right), an impressive four-day conference where there are approximately 200 seminars, 200 exhibitors, 7000 delegates, and one terrific party at the end of the proceedings. After all that, heads might hurt, particularly on the morning after the Sibos closing party.

> "Some regulators have concluded that it is not permitted to "earmark" funds which are to be transferred."

Perhaps, but at the 2011 Sibos in Toronto, there was a good deal of focus on regulatory issues affecting payments, and that was not really putting many people in a dancing mood. One regulatory development which comes into force on 1 January 2012 is the deferred effect of article 69 of the Payment Services Directive. This provides that a payer's payment service provider must ensure that a payment is credited to the payee's payment service provider's account by the end of the next business day after the point in time of receipt of the payment instruction. In other words, next year you have to get the money to the recipient's bank by the day after you get the transfer instructions. And this provision – known as the requirement to execute on D+1 – is causing a few headaches.

Hangover

The principal area of difficulty is with deferred-execution payment instructions. Article 64(2) of the PSD allows a payment service provider to agree with its customer to delay the execution of payment instructions to a particular future date – for example, to pay rent at the end of the month. So far, so good. But there are some regulators in the EU, notably the FSA, who have concluded that when a customer gives deferred-execution instructions it is not permitted to "earmark" the funds which are to be transferred. When a bank "earmarks" funds in an account, it is essentially blocking them for further use by the client, although the client will continue to receive interest on the funds (where applicable) because they have not actually been transferred yet.

The logic behind the idea that earmarking is not allowed for deferred-execution transactions is as follows:

"Where 'earmarking' of funds takes place, so that the funds remain in the customer's account for value-dating purposes but are unavailable for the customer to spend, the point in time of receipt for the purposes of calculating the execution time must be the point at which the funds become unavailable to the customer." [FSA approach document, August 2011]

This means that banks which accept deferred-execution instructions may take a degree of credit risk on their customers. For example, if a bank commits itself irrevocably to make a credit transfer on the (future) execution date, which may happen if the bank puts in payment instructions into an inter-bank clearing and settlement system, then the customer may have withdrawn

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the funds in its account before the actual execution date arrives. If the bank has no choice about the timing of its commitment, the bank will wish to consider carefully whether it is willing to offer the payment service concerned. An example is the UK's BACS system, an ACH for batch low-value payments processing such as payroll obligations, which (even in 2012) will have a three-day processing cycle, obliging some users to commit to make payments substantially in advance of the execution date. Payment service providers using BACS can continue to do so in 2012, as the UK Payments Council has confirmed in its June 2011 paper on Industry Best Practice, but the UKPC stops short of saying that earmarking at the moment of commitment is allowed.

"There is a danger, that the D+1 timeframe applies to some R-transactions."

Teetotal transactions

In some cases, deferred execution will not cause a problem. An example is where a customer gives an on-line credit transfer instruction on a Friday evening and then wants to make an ATM withdrawal over the weekend. If the two debits exceed the customer's Friday afternoon balance, the bank may want to disallow the ATM withdrawal. Can the bank "earmark" the funds which are committed to the on-line credit transfer, even though the transfer will not be executed until the clearing systems open on Monday?

Here the answer is yes, because the PSD is framed in terms of "business days", so that the on-line credit transfer instruction is indeed going to be executed within the D+1 timeframe. But if the credit transfer had a deferred execution date attached, earmarking would not be allowed, at least in those countries which follow the approach taken by the FSA.

Another example of transactions where no D+1 hangover applies is cash movements associated with securities processing. In various securities contexts a payment is committed several days in advance of the actual transfer: for example where an agent bank provides a settlement service relating to stock-exchange trades where the trade is done on day T and settlement occurs on day T+3 or T+2. In these cases the PSD does not apply, because article 3(i) of the PSD exempts payment transactions related to securities asset servicing from its scope, so the bank is free to earmark the funds if it wishes to do so.

Changing your mind: R and D

Sometimes you have second thoughts about noisy revelry, or even about payments, and wish to revoke or reject a payment. There are a number of processes, commonly called R-transactions, which are designed to allow payment service providers to do this. (The SEPA payment schemes rulebooks have Rejects, Refusals, Returns, Reversals, Recalls and Refunds.) R-transactions can also get tangled up in the D+1 rule: some R-transactions may have to be processed within a D+1 timeframe.

This might seem surprising because most people would think that R-transactions are simply a continuation of, or adjunct to, the original payment instruction, and that there is no real meaning to the "point in time of receipt" when you are looking at an R-transaction. However, the European Commission seems to think that some R-transactions should be treated as completely separate payment transactions in its answers to numerous FAQs about the PSD. There is a danger, then, that the Commission and the courts will think that the D+1 timeframe applies to some R-transactions as well as the main payment transaction.

Where this seems to leave payment service providers who wish to offer their clients R-transaction services is that they may be subject to the very tight D+1 processing timetable set out under PSD article 69, at least for some types of R-transaction. It may be prudent to agree with clients that these transactions will be treated as deferred-execution transactions, but of course the "no earmarking" rule might apply in countries which follow the interpretation adopted by the FSA.

Good party? Time for the bill. And the road home

When a party degenerates into a discussion about payment timetables and people are using more algebra than real language, you know it is time to go home. Banks are working hard to comply with the implementation of D+1; unfortunately the ramifications may (as explained above) require some adaptation or augmentation of client documentation for some services as well as operational change. There are also further changes coming up: much of the discussion at Sibos was about the forthcoming SEPA Regulation, which will not only set end-dates for the process of migrating national euro-denominated payment schemes to the pan-European SEPA schemes, but also supplement the PSD in various ways which could require yet more changes to client documentation and will certainly involve more operational upheaval. Further down the road is a review of the PSD, and the implementation of Basel III. All this is going to cost money, and payment service providers will need to factor the possible impact into their strategic thinking as well as IT planning and client relationship management.

FSA approach document:
http://www.fsa.gov.uk/pubs/other/PSD_approach_latest.pdf

UKPC paper:
http://www.paymentscouncil.org.uk/files/payments_council/guidance_document_2011_v2.pdf

Commission's FAQ on PSD:
http://ec.europa.eu/internal_market/payments/docs/framework/transposition/faq_en.pdf

Freezing of Accounts

Frozen food

The European Commission wants to help hungry creditors get judgments paid by freezing amounts in "bank accounts." In July the Commission issued a proposal for an EU-wide European Account Preservation Order (EAPO). If a bank is notified of one of these, the bank will be obliged to ensure that the "amount" specified in the order is not transferred, disposed of or withdrawn from the accounts designated in the EAPO. The consequences may be unwelcome for banks providing custody and cash accounts.

The variety of produce available in a frozen food store is surprising; the Commission's account-freezer proposal has noted this, and given it very wide scope. A frozen "bank account" includes custody accounts and indeed any other account containing financial instruments as defined in MiFID – which would encompass derivatives accounts, and even potentially accounts provided for holding units in investment funds – as well as the expected cash accounts. And banks appear not to be able to exercise rights in priority to the EAPO unless, in the Member State where the account is located, the law gives seniority to another interest. This approach seems to work in cases involving security interests over accounts containing assets, but is harder to apply to cash accounts where the bank is primarily aiming for a right of set-off. But even if the general principle of preserving the ranking of rights is clear in each Member State, the Member State concerned has to notify the Commission of prior-ranking instruments, which calls into question what priority would be given in a case where there is no notification.

Frozen food can be distasteful

Banks may find they have little appetite for the proposed Regulation, given they will bear the brunt of implementing EAPOs, and will have to get used to the form and content of an EU-wide form of attachment to sit alongside more familiar local forms. There is also a handful of operational and legal implications for banks in implementing the rules of the Regulation, assuming it is adopted in its current form.

"The freezing must take place "immediately" upon receipt."

- A claimant requesting an EAPO will have to supply "all information" to enable the bank to identify the account-holder and the affected accounts. But a minimum level of information to be given is prescribed by the proposed Regulation, and a new process is proposed under which Member States will have to obtain the minimum information for claimants who do not have it. So banks may have to be able to act only if the minimum amount of information is given, and it appears that banks may have to comply with an information request under the Regulation despite other regulatory and contractual duties concerning confidentiality.

"A frozen "bank account" includes custody accounts."

- The process for receipt of EAPOs by banks is not spelt out in detail, so it may be sufficient for claimants to serve an EAPO on the head office or some other office of the bank and leave it to the bank to sort it out. The problem is that the freezing must take place "immediately" upon receipt except where service takes place outside business hours, and within three working days of receipt, the bank has to inform the competent authority and the claimant to what extent funds in the account have been preserved.
- Joint, nominee and trust accounts cause particular problems with attachment orders. Member State rules about attaching these types of account will continue to apply, but here the relevant legal system is the "national law governing the account". This may be a different system of law from the law of the "location" of the account, particularly in the case of an international bank providing multi-country services to clients.
- EAPOs might be denominated in a different currency from the account. The bank has to convert the amount using the "official" exchange rate. Even if that is operationally easy, it is bound to be more complicated when the assets in the account are securities which themselves may be valued in a variety of currencies.
- Freezing of fluctuating balances is a difficult issue. If a client has a lower balance than needed to satisfy the EAPO on the date of service, but the client receives more funds subsequently, does the bank have to freeze the after-acquired funds? Furthermore, can a client withdraw assets which were surplus assets on the date of receipt of the EAPO, when the frozen assets have deteriorated in value subsequently?
- Some amounts are exempt from attachment under an EAPO, and the rules about exemptions will be set separately by each Member State. A uniform EU-wide procedure for implementing EAPOs is not going to be feasible for international banks.

What's the next course?

There is the usual process of cooking which is needed to bring a European legislative proposal to the table. The expected timetable for the proposed Regulation is rather vague, but usually a Regulation takes at least a year between being initiated by the Commission and being finalised and published in the Official EU Journal. Once it is final and published in the Official Journal it will be in force immediately as binding law in the Member States… but not necessarily all Member States.

Not all Member States need to eat up this frozen feast. Three Member States (the UK, Ireland and Denmark) must positively resolve to opt in if the proposed Regulation is to be binding in these countries. The UK has carried out a fast-food consultation on whether this kind of diet could damage your health; but in the rest of Europe it is going to happen, at least in some form.

EAPO Legislative proposal

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0445:FIN:EN:PDF

UK Government consultation

http://www.justice.gov.uk/downloads/consultations/eu-cross-border-debt-recovery-consultation.pdf

Clifford Chance briefing

http://www.cliffordchance.com/publicationviews/publications/2011/08/european_asset_protectionordersthegoodth.html

General Market Developments

1. Attacks on messaging

The European Court of Justice has ruled that VAT is payable on messaging services such as that provided by SWIFT. Previously it was thought that these services counted as part of the VAT-exempt banking services. The ruling was given on 28 July; the case is called *Nordea Pankki Suomi* (*Taxation*); and it is reported at [2011] EUECJ C-350/10.

Payment Services and Cash Management - Market Developments

1. e-Payments

It seems odd that e-Payments should generate controversy: almost everyone accepts that secure, easy-to-use on-line payment methods need development. But the technical and commercial issues are complex, and the regulators are active. In a headline-grabbing move, the European Commission has opened a formal investigation into the European Payments Council's e-Payment initiative. The Australian Securities and Investments Commission (ASIC) has published a new ePayments Code, which provides a best practice consumer protection regime for electronic payment products. And a group of merchants has issued 10 recommendations on how e-Payments should be shaped in Europe.

Commission initiative

http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1076&format=HTML&aged=0&language=EN&guiLanguage=en

e-Merchants' recommendations

http://www.e-commercesummit.com/images/stories/presentations/e-payments_merchant_intiative_final.pdf

ASIC code:

http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ePayments-code-published-20-September-2011.pdf/$file/ePayments-code-published-20-September-2011.pdf

2. SEPA migration end-date

While the proposed EU Regulation relating to SEPA (and which, incidentally, will change various operational processes in relation to payments which have only a limited relationship to SEPA) rumbles along on its legislative course, the Euro Banking Association has produced a helpful leaflet on some of its implications.

EBA leaflet:

https://www.abe-eba.eu/Repository.aspx?ID=558c6499-adf5-4b1e-bcbc-2595cefbe412

3. PSD approaches

You probably thought it had approached, done its evil stuff, and moved on. Nevertheless, the UK's Financial Services Authority has re-issued its document called "Our approach" on the UK Payment Services Regulations, which is, in effect, its regulatory rulebook. Meanwhile, better late than never, the last member state to transpose the PSD has at last done so: Poland managed to get to it in September.

FSA approach document:

http://www.fsa.gov.uk/pubs/other/PSD_approach_latest.pdf

4. Stub snub

The attempt by the UK payments industry to stub out cheques forever has officially failed. The UK Payments Council responded to public pressure, channelled through the UK Parliament, to retain centralised clearing of cheques. The UKPC is studying whether it can close the UK's unique guarantee scheme for cheques.

UK Payments Council statement

http://www.paymentscouncil.org.uk/media_centre/press_releases/-/page/1599

House of Commons Treasury Committee report

http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1147/1147.pdf

Securities Services - Market Developments

1. Missed the target

Target2-Securities has been postponed, it was announced at Sibos. At a conference in early October the European Central Bank invited delegates to consider what the world would be like when T2S is up and running – in 2020. The original target date was 2014: the actual start date will be somewhere in between.

ECB programme plan and conference details:
http://www.ecb.eu/paym/t2s/progplan/html/index.en.html

http://www.ecb.eu/paym/t2s/pdf/T2S_Conference_Programme.pdf

2. Securities Law

Sceptics think that a long-awaited directive, being considered by the European Commission as a necessary step in harmonising the legal implications of ownership of securities by holding them in an account with a custodian or broker, may never happen. The European Parliament has issued a pair of helpful papers which sweep away some of the confusion around this topic. As to the timing of a directive … that's almost as difficult a subject.

European Parliament papers:
http://www.europarl.europa.eu/activities/committees/studies/download.do?language=en&file=41311#search=%20securities%20

http://www.europarl.europa.eu/activities/committees/studies/download.do?language=en&file=37268#search=%20securities%20

3. Client Assets

The UK's Financial Services Authority has proposed to refine its proposal to limit the ability to take liens and security interests over client securities held in custody. The FSA is consulting until 28 October on clarifications which would ensure that firms can allow security interests to subsist over omnibus accounts containing several clients' assets. In Handbook Notice 113, the FSA extended the transitional period leading up to the change, to enable firms to have more time to adjust to whatever the post-consultation regime will be. So (broadly speaking) the rules currently in force do not have to be applied until March 2012: check the Handbook Notice for the full detail.

Consultation paper CP11/15:
http://www.fsa.gov.uk/pubs/cp/cp11_15.pdf

Handbook Notice:
http://www.fsa.gov.uk/pubs/handbook/hb_notice113.pdf

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