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The PSD and SEPA: Operational Impact

From ISO 20022 XML to D+1: the Payment Services Directive (2007/64/EC) (PSD) and the Single Euro Payments Area (SEPA) - for which the PSD forms the legal basis - will focus attention on firms' operational and compliance risk management.

Operational impact of time limits and refund rights

Refund rights

The PSD endeavours to set out clear rules on refunds for unauthorised and defectively executed transactions. Notification to the payment service provider within 13 months after the debit date triggers an automatic refund right.

A payer's payment service provider must refund immediately the amount of an unauthorised payment transaction and, where applicable, restore the debited payment account to the state in which it would otherwise have been.

PSD Articles 62 and 63 set out rules for full refunds for payment transactions initiated by a payee if the authorisation did not specify the exact amount of the payment transaction and its amount exceeded the amount the payer could reasonably have expected, taking into account his previous spending pattern. The payer can request the refund for a period of 8 weeks from the date on which the funds were debited; within 10 business days of receiving such a request, the payment service provider must either refund the full amount of the payment transaction or justify its refusal to do so.

PSD Article 75 provides, in relation to non-execution or defective execution, that where the payment order is initiated by the payer, the payer's payment service provider is liable for the correct execution of the payment transaction and must without undue delay refund to the payer the transaction amount and, where applicable, restore the debited payment account to the state in which it would otherwise have been.

Article 77 provides that where liability under Article 75 is attributable to another payment service provider or to an intermediary, that person must compensate the first payment service provider for any losses incurred or sums paid under Article 75. "Further financial compensation" may be determined in accordance with the agreements between payment service providers and intermediaries.

Operational impact

Banks will thus need to consider the credit risk management issues deriving from their potential cross-border refund exposure to other banks with lower credit ratings in other jurisdictions. They will also want to factor in the potential foreign exchange risk where refund exposure relates to an account denominated in a different currency from the denomination of the account to which the defectively executed payment transaction was due to be credited (e.g. where the payment was to be made by debiting a sterling account in order to credit an account denominated in euros).

Banks will also want to consider carefully the various time limits imposed by the PSD (see box entitled *Execution and value dating timelines*) when determining

Key Issues

Operational impact of time limits and refund rights

IT and data processing

Execution and value dating timelines

Calculating capital requirements for operational risk

Compliance risk confounded by interplay between Directives

Operational impact of fraud risk

Operational impact of interoperability for card payments

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the calculation of funds tied up in compliance with regulatory capital requirements for operational risk (see box entitled *Calculating capital requirements for operational risk*) plus their potential liability in respect of refunds and under the Article 77 inter-bank right of recourse.

They will need to factor these time, cost and funding constraints and obligations in to their operational risk management processes and liquidity models.

It may also be that some inter-bank market conventions in certain funding markets relating to business days and payment times will not match the time restrictions on payment execution and the business day definition imposed by the PSD, where the relevant payment transactions involve the provision of a payment service as a regular occupation or business activity under the PSD and as listed in its Annex. Mismatches will need to be anticipated and dealt with up front so as not to trigger refund or recourse rights or break funding indemnities.

However the 13 month limit in PSD Article 58 on notification to payment service providers of unauthorised or incorrectly executed payment transactions giving rise to a claim at least brings a deadline and some certainty for hard-pressed compliance managers (unless the payment service provider originally failed to make available the relevant Title III information for that transaction).

IT and data processing

Banks and businesses will feel the impact of the changes wrought by PSD and SEPA in the areas of IT and data processing. If SEPA instruments are to achieve critical mass and the domestic payments of member states are to be settled via a Pan-European Automated Clearing House (PE-ACH) system by 2010 and domestic credit transfers, direct debits and card systems are to be switched off in a new, fully integrated market, both banks and their corporate customers need to start reviewing their IT systems and internal processes and identifying any changes required in order for them to become fully PSD and SEPA-compliant.

Customers will not be able both to send and receive SEPA credit transfers until enough banks have updated their technology platforms and processes. The standardised formats for SEPA direct debits and credit transfers require the use of certain uniform content (eg IBANs and BICs) and software (ISO 20022 XML standards) in order for businesses to connect to their banks' systems and accept SEPA transactions. Non SEPA-compliant payment orders will be returned to the sender or processed manually.

XML ISO 20022

Banks may need to invest in new software for data communication, as all interbank messaging required by the European Payments Council (EPC) for SEPA processes is based on the XML ISO 20022 standard. They may also need to convert data from business customers who use non-XML formats into XML, although corporates transmitting bulk payment data to their banks may be happy to invest in new SEPA-compliant software. Corporates are not obliged to move to the ISO 20022 XML format, but legacy payment formats may no longer continue to be supported by banks and software

PSD

- European member states must implement the PSD by 1 November 2009.
- The European Commission proposed the PSD in December 2005 in an attempt to harmonise the fragmented nature of national payment infrastructures and their supporting laws.
- The PSD aims for transparency of information and charges, certainty of transaction execution, clarity on rights and liabilities of payment service providers and users, consumer protection and the opening up of national payment transactions markets to competition from non-bank payment institutions.
- The main impact of the PSD relates to its scope. To date, European legislation protecting consumers in the payments world has focused on cross-border payments. Payment service providers are already required to comply with pricing rules, execution time limits and obligations to provide payment service users with certain information. The PSD extends these conduct of business obligations to cover purely domestic (including non-euro) payments.

SEPA

- The PSD forms the legal basis for the proposed Single Euro Payments Area (SEPA), an integrated payment services market for transactions in euros across the EEA and Switzerland being created at the initiative of the European banking industry, represented by the European Payments Council (EPC).
- The first SEPA products are available from January 2008 and the aim is to build up a critical mass of users by the end of 2010.
- The SEPA project sets out interbank rules and standards for payments in euros using direct debit and credit transfer schemes and provides a framework for the clearing and settlement infrastructures which provide operational processing services for euro payments.
- Once SEPA instruments and processes achieve critical mass, it is intended that any payment in euros within the SEPA region would be effected as quickly and securely as payments within domestic markets are today, using uniform terms and standards.
- SEPA-compliant standardised transactions processes will enable euro remittances to be effected under the same terms within the SEPA region. Such commoditised payment services will in turn enable more efficient pricing.

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suppliers in the medium term and a move to the new uniform format may save technology support costs.

Payment message content

SEPA also introduces uniformity of content for each SEPA payment message, which may necessitate investment by banks in new software applications to check the content before each message is sent. For example, the new format limits the payment description field to 140 characters.

Routing tables

In order to be able to use the new messaging for SEPA processes based on the XML ISO 20022 standard, banks will need "routing tables". These use software which interprets payment messaging instructions by mapping them across to a database of bank and payment institution identifiers in order to ensure the proper routing of payment orders. The databases underlying routing tables will need constant maintenance in order to ensure that they contain up to date routing codes, contact and account details for banks and payment institutions and other data needed for the accurate routing of payment messages.

Switch to SEPA compliant interface

Corporates with statement reconciliation and invoicing accounting packages will need to review their systems.

Businesses should consider calibrating the data formats used to generate payment files (as well as file content) from their treasury and cash management systems with those of SEPA-compliant banks and thus reduce the number of bank-specific and instrument-specific interfaces they share. Businesses also need to consider carefully the timing of any switch to SEPA compliance: if their customers and suppliers change to SEPA before they do, their reconciliation process and supply chain may be adversely affected.

Advance messaging

Ancillary data management issues for businesses and their relationship banks include the introduction of advance messaging warning of payments which are already inside the D+3 payment execution pipeline (see box entitled *Execution and value dating timelines*): currently a beneficiary bank may have little warning that a payment is coming through. While the PSD's emphasis on transparency of terms will assist payment tracking and process-driven (as opposed to manual) reconciliation of invoices for users, SEPA compliant processes will facilitate electronic payment tracking.

Running parallel systems

Banks need to invest in system design and start testing SEPA-compliant instruments. Costs incurred in purchasing and migrating technology platforms and processes and training users on new systems will be increased by the necessity for existing domestic systems and current payment products to be run in parallel with SEPA products until the latter achieve critical mass, a situation not helped by the loss of revenue which is anticipated to result from lower charges deriving from PSD and SEPA implementation. Banks may need to offset these costs

Execution and value dating timelines

- The elimination of value dating will allow payees to use monies credited to their account immediately.
- D+1 is the new maximum execution deadline by which payment service providers must execute electronic payment transactions: by the business day after the date on which the payment instructions were received by the payment service provider.
- Parties may, however, agree on a deadline of D+3 for transfers until 2012 and D+1 thereafter.
- Controversy surrounds the new D+1 obligation for the following reasons:
  - Existing payments infrastructures may not be able to process payments with this degree of rapidity
  - Because cross-currency payments are within the PSD's scope, it could be difficult to reconcile D+1 with the standard foreign exchange transaction which settles on T+2, for example if the payment instruction is received very late in the day
  - Payment service providers believe that time should be measured from the moment when the instruction is accepted, not received, for processing.
- These deadlines will impact on bank liquidity risk management and cashflow: banks will need to factor these more restrictive time limits in to their liquidity and cashflow models and allow for the fact that they have less time available in which to use payment transaction cashflows for profit extraction purposes.

Calculating capital requirements for operational risk

- The Banking Consolidation Directive (2006/48/EC) (BCD) sets out minimum own funds requirements for operational risk in accordance with the Approaches set out in BCD Articles 103, 104 and 105.
- "Operational risk" is defined in the BCD as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.
- Under the Standardised Approach, the capital requirement for operational risk is the average over three years of the risk-weighted relevant indicators calculated each year across the business lines listed in BCD Annex X Part 2 Table 2. For the business line "Payment and settlement", including the activities "Money transmission services" and "Issuing and administering means of payment", the percentage is specified as 18 %.
- Banks will need to factor this in to their regulatory capital and liquidity models.

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by attracting higher payment volumes and maximising process efficiencies.

Banks may need to rewrite their current software or invest in conversion software which facilitates an interface between the two systems by converting data formats from the SEPA platform to the domestic platform for a particular member state (and vice versa) and supports a gradual migration to a uniform SEPA environment as the volume of SEPA and non-SEPA payments changes over the next couple of years. This is because most existing high volume payment systems do not use XML ISO 20022. SEPA XML documents will need to be validated and accessed by both new and existing applications. Banks may also have internal applications and databases which run using different software and which will need SEPA XML converted to a non-XML format. In addition, while SEPA clearance terms differ from those of domestic payments, transactions will need to be routed into different clearance infrastructures.

The lack of a deadline for the discontinuance of legacy domestic payment instruments and services in the euro zone once a full range of SEPA-compliant products is on offer may affect the take-up of SEPA instruments, which may in turn delay the critical mass of SEPA payments anticipated by the end of 2010. The extended parallel running of SEPA and non-SEPA products may lead to delays in banks switching off domestic legacy systems and an increase in costs due to the necessary extension of marketing programmes for SEPA products.

Operational impact of fraud risk

PSD Title IV Chapter 2 sets out operational requirements relating to the authorisation of payment transactions. These are intended to assist in fraud prevention, and include requirements relating to the personalised security features of payment instruments, the blocking of their use and notification of theft or loss. Controversial provisions leave payment service providers bearing the brunt of the losses arising from theft, loss or misappropriation and the burden of showing that the transaction was authenticated properly where authorisation is disputed.

Article 79 permits the processing of personal data by payment systems and payment service providers when this is necessary to safeguard the prevention, investigation and detection of payment fraud.

Operational impact of interoperability for card payments

The SEPA Cards Framework is intended to give European customers the facility to use cards for payments and cash withdrawals in euros throughout the SEPA region.

Interoperability is integral to the Framework and entails allowing a card to be accepted on any terminal, a processor to authorise and process any transaction regardless of the card or terminal that generated it and any card-based transaction to be cleared and settled independently from the scheme under whose rules it has been accepted. Interoperability would entail the alignment of different national card schemes, the adjustment of current arrangements to achieve separation of scheme and processing and the adoption of common card standards.

The European Central Bank's 2004 *Third Progress Report: Towards a Single Euro Payments Area* stated "Interoperability among card schemes will need to be achieved so that

Compliance risk confounded by interplay between Directives

- The scope of the PSD ostensibly overlaps with areas covered by other European Directives, making compliance risk management a more difficult task, including:
    - the Consumer Credit Directive
    - the Third Money Laundering Directive
    - Regulation 2560/2001/EC on cross-border payments in euro
    - Regulation (EC) 1781/2006 on information on the payer accompanying transfers of funds
    - the E-commerce Directive (2000/31)
    - the Distance Selling Directive (97/7/EC)
    - the Distance Marketing of Financial Services Directive (2002/65/EC)
    - Directive 2004/39/EC on Markets in Financial Instruments (MiFID)
    - EC Directive 93/13 on Unfair Contract Terms
    - the Unfair Commercial Practices Directive (2005/29/EC).
- The interplay between the Directives covers areas such as:
    - territorial scope
    - type of payments and businesses caught
    - home-host supervision
    - definition of "durable medium"/electronic terms of business.

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cardholders who request it will be able to use their cards in the same way nationally and within the SEPA well in advance of the 2010 deadline… The card industry has to make progress in interoperability in order to meet the SEPA objectives. Cardholders should be able to use their card in the euro area even if the issuing bank and the acquiring bank are based in different countries…. To a large extent, international card schemes already establish the bridge between countries. However, they do this in a similar way within the euro area and outside, i.e. with a relatively high interchange fee which leads banks to levy higher fees on the merchants for cross-border transactions. This result is inconsistent with the SEPA…"

Neelie Kroes, European Commissioner for Competition Policy, has expressed concern that implementation of the SEPA Cards Framework will entail the replacement of lower cost national card schemes by fewer, more expensive cross-border schemes. She has cited uncertainty in relation to the lack of detailed rules and standards for the Framework, which she says has led market participants to interpret it so that a card scheme would only be SEPA compliant if it covered all 31 states of the SEPA territory. She has welcomed clarification from the EPC that there is no such requirement and interprets this as meaning that domestic card schemes in Europe can continue to compete with international schemes, with banks making their own choice of which to join. She has also stated that the Framework needs to address the issue of access to and interoperability with non-bank payment schemes in order to promote competition in the payments market.

Want to know more?

You may find the following of interest:

- Clifford Chance briefing: *Payment Services Directive I: New Year Resolutions* (January 2008)
- Clifford Chance briefing: *The PSD and SEPA: Strategic Impact* (February 2008)
- Clifford Chance briefing: *The PSD and SEPA: Customer Impact* (February 2008).

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