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The PSD and SEPA: Strategic Impact

From the opening up of national payment transactions markets to increased competition from non-bank payment institutions, to the anticipated rise of new high-volume cross-border payments processors: the Payment Services Directive (2007/64/EC) (PSD) and the Single Euro Payments Area (SEPA) - for which the PSD forms the legal basis - will make firms think twice about their long-term payments strategy.

Insource or outsource?

Companies trading on a pan-European basis which use different banks in different countries for payments in euros may decide to take advantage of the opportunities afforded by SEPA to review and rationalise their banking relationships. They may want to seize the opportunity to benefit from lower transaction charges and quicker processing times by consolidating and standardising their payments processes into fewer accounts with only one or a few SEPA participant European banks. Many may decide to have only one bank account for euro payments.

What impact will this have on traditional banking models and strategy? Given the commoditisation and rationalisation likely to flow from PSD and SEPA implementation and the prospect of more intense inter-bank competition for payments business from corporates, the short-term need for banks to invest in developing new systems and processes simply to comply with the PSD and SEPA may yield to a tougher strategic repositioning.

In the medium to long term, post-implementation, is the margin from payment transaction fees for commoditised payment processing services likely to cover a bank's development, training and systems costs, particularly where euro payments are concerned? If not, should it outsource some or all currencies or payments products and focus instead on a more limited pool of specialist payment services? Or can it make a margin by leveraging existing infrastructure and expertise and insource some currencies or services while outsourcing others?

Or perhaps it can maximise profit extraction by gearing up current platforms and insourcing high volume payment processing services for most or all currencies and products. This may involve using a loss-leader such as legacy domestic payment products which are slowly being phased out in order to attract high enough volumes elsewhere to make a sufficient margin. Is it also worth incurring the necessary development costs in order to offer the full range of SEPA products? The strategic options for smaller, domestic banks are more limited: they are perhaps more likely to outsource commoditised SEPA payments to larger payments processors, providing opportunities for larger banks who have to provide the full range of services.

Threat from payment institutions?

One of the objectives of the PSD is to introduce Europe-wide competition into national payments markets. PSD-licensed UK non-bank payment institutions will be able to passport their services into other European payments markets in direct competition with both domestic banks and those operating on a pan-European level (although competition might arguably be fiercer if non-bank payment institutions were less severely regulated).

Key Issues

- **Insource or outsource?**
- **Threat from payment institutions?**
- **Payment institutions in your group?**
- **Is it safe for Europe to have just one PE-ACH?**
- **What is the future for small, local banks with no cross-border business?**
- **Operating a payment system?**

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Smaller payment service users with no need for the higher-end payment products or processes might be attracted by lower fees charged by non-bank PSD licence-holders with lower overheads for payments processing than domestic banks. But the authorisation requirements mean that it may take a few years before passported non-bank payment institutions build up enough market share to be perceived as a potential threat to banks with pan-European operations.

Also PSD Article 9 requires non-bank payment institutions engaged in other types of business activities to ring-fence or insure funds received from payment service users. PSD Article 17 applies to agents, branches or entities of payment institutions to which their activities are outsourced and requires their contact details and the identity of their directors and management (together with evidence that the latter are fit and proper persons) to be transmitted to the competent authorities in the home member state of the payment institution. They must also be informed of the internal control mechanisms to be used by the agents in order to comply with obligations relating to money laundering and terrorist financing under the Third Money Laundering Directive.

Payment institutions in your group?

Entities which have a large segment of their business involved in payments, such as supermarkets or utilities, may consider setting up a payment institution. Larger corporates may decide to set up and even passport their own PSD-licensed payment institutions. But perhaps the hidden question is whether entities in financial sector groups might need to become licensed as payment institutions. Challenging questions of interpretation arise on the scope of the PSD in relation to providers of investment and other financial services which involve the making of payments. Only "credit institutions" and electronic money institutions are outside the scope of the PSD. Should non-bank entities get licensed under the PSD?

What is the future for small, local banks with no cross-border business?

Costs of compliance with transparency and systems requirements

Most payment transactions within Europe are domestic. Titles III (*Transparency of conditions and information requirements for payment services*) and IV (*Rights and obligations relating to the provision and use of payment services*) of the PSD apply to payments effected by payers and recipients within the same country, in contrast with the focus of earlier European payments conduct of business legislation on cross-border payments. Contract terms may need to be revised if corporate business users do not elect to opt out of the Title III rules, which they are likely to do if their existing terms are better than those set out in the PSD.

Banks may need to change their systems and processes in order to comply with these requirements. Smaller and medium-sized banks may not have the resources to make the substantial investment in the technology and systems adjustments needed to compete with their multinational peers on a cross-border basis within the SEPA area. The cost of implementing SEPA, and hard on its heels the PSD, will be very substantial for many banks. Banks which have no significant cross-border payments activity will see little gain, and a lot of

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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cost and operational pain, in these changes. The only return on their investment in those systems changes which are necessary for PSD compliance purposes would seem to be loss of revenue and increased competition.

Pricing: domestic v cross-border payments

The recitals to the PSD make it clear that it is essential that payment service users know the real costs and charges of payment services so they can make a proper choice and do not have to deal with opaque pricing methods. Recipients should receive the full amount transferred by the sender of the remittance, eliminating the need to match odd amounts received to accounts receivable. Value dating, which can restrict the availability for use by a recipient of funds credited to its account, may no longer be used by banks as a means of profit extraction. Instead, same-day value payments are to facilitate pricing transparency and reconciliation by users and recipients. The intention is also to mitigate operational and counterparty risk.

The aim of EC Regulation No 2560/2001 on cross-border payments in euros was to reduce fees charged for cross-border payments so that they would equal those charged for domestic euro payments. Fees for cross-border payments made using SEPA instruments should also be the same as those charged for domestic transactions. The SEPA rulebook requires banks to inform payment beneficiaries of their service charges and increased competition between payment service providers is expected to reduce the cost of most transactions in Europe.

Competition from pan-European players

SEPA will not affect banks in the UK as much as those whose business is entirely based within the euro zone. The pan-European reach of the PSD and SEPA may come at the expense of smaller, domestic banks operating within the fragmented national payments infrastructure of one or two European jurisdictions. As domestic legal and structural barriers come down, local banks may face competition from the subsidiaries and branches of larger institutions moving into their markets, especially those with uniform SEPA-compliant products throughout Europe.

The pan-European players may perhaps more easily attract corporate clients with pan-European operations seeking cash management efficiencies and savings.

Banks may eventually seek to recoup elsewhere margins lost in a newly commoditised SEPA market, perhaps by creating higher-end bundled payment packages for larger corporate clients. Larger players operating cross-border may be more able to invest in the structuring of tailor-made, complex payments solutions and integrated products suited to the needs of these customers, which could involve taking on some outsourced payment-related functions.

Advantages of decentralised cash management

It is not all bad news for smaller, local banks. Currently businesses may seek banking arrangements so that they have a single euro account with one pan-European bank for all European collections. At present, such arrangements are difficult to create. In a pure SEPA environment businesses may no longer need to maintain relationships with different banks in

Is it safe for Europe to have just one PE-ACH?

- It is envisaged that, once SEPA achieves critical mass, the domestic euro payments of European member states are to be settled via a Pan-European Automated Clearing House (PE-ACH) system by 2010.
- Currently there is only one PE-ACH: the Euro Banking Association's STEP-2 system.
- Migration of SEPA credit transfers from the existing fragmented systems towards this pan-European clearing infrastructure, which will process both domestic and cross-border payments, is commencing.
- Some commentators consider that this arrangement may raise competition and systemic risk issues.
- How difficult would it be for another ACH to be set up and accepted by financial institutions as a real competitor to PE-ACH, with the potential for transaction and processing fees to be reduced further as a result? The dual obstacles of start-up costs and market acceptance would seem to make it difficult to achieve.
- In the event of operational or systems glitches, security breaches or even terrorist attack, is it really safe to have only one ACH for all euro payments in Europe?

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different member states, and the SEPA instruments may make cross-border euro zone treasury management products easier for small banks to provide. During the transition period, however, when both SEPA and non-SEPA compliant products are in use, clients may prefer to continue maintaining and operating decentralised accounts in each member state in which they trade.

The rationalisation of multiple national accounts into a single account may not be easy where the accounts are used for payment collection. Businesses may choose to stay with legacy products in a particular jurisdiction as long as possible if their terms (e.g. transaction processing timelines) are more beneficial than those of SEPA instruments. The cost of changing accounts and banking relationships may also have a deterrent effect.

Businesses may have other reasons for continuing to operate decentralised cash management arrangements with different local banks, including local regulatory and tax restrictions, a preference for maintaining relationships with particular banks for their expertise in a particular field, or their own customers' preference for paying into local accounts or using non-SEPA paper-based domestic instruments such as cheques.

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: Operational Impact* (February 2008)
- Clifford Chance briefing: *The PSD and SEPA: Customer Impact* (February 2008).

Operating a payment system?

- "Payment system" is defined in PSD Article 4 as "a funds transfer system with formal and standardised arrangements and common rules for the processing, clearing and/or settlement of payment transactions".
- PSD Article 28 (*Access to payment systems*) is intended to allow disintermediation, by permitting non-banks with the requisite authorisation or registration to gain direct access to payment systems without needing to use banks as intermediaries.
- Exclusions from the scope of this Article relate, among other things, to payment systems composed exclusively of payment service providers belonging to a group where one of the linked entities controls the others, or where a sole payment service provider acts for both payer and payee and is exclusively responsible for the management of the system and licenses other payment service providers to participate in it.
- But the breadth of the definition of "payment system", which does not fix the number of participants, might catch other unlikely candidates and bring them within the ambit of Article 28, unexpectedly forcing them to allow others access to what they had assumed was their own mini clearing arrangement.
- Banks will wish to consider whether they are operating or providing "payment systems" and have to provide open access.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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