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Briefing Note
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Payment Services Directive

Consumer protection is at the heart of Europe's Payment Services Directive but its rules could have major strategic significance throughout the financial services sector, as journalist Chuck Grieve learned from Clifford Chance experts.

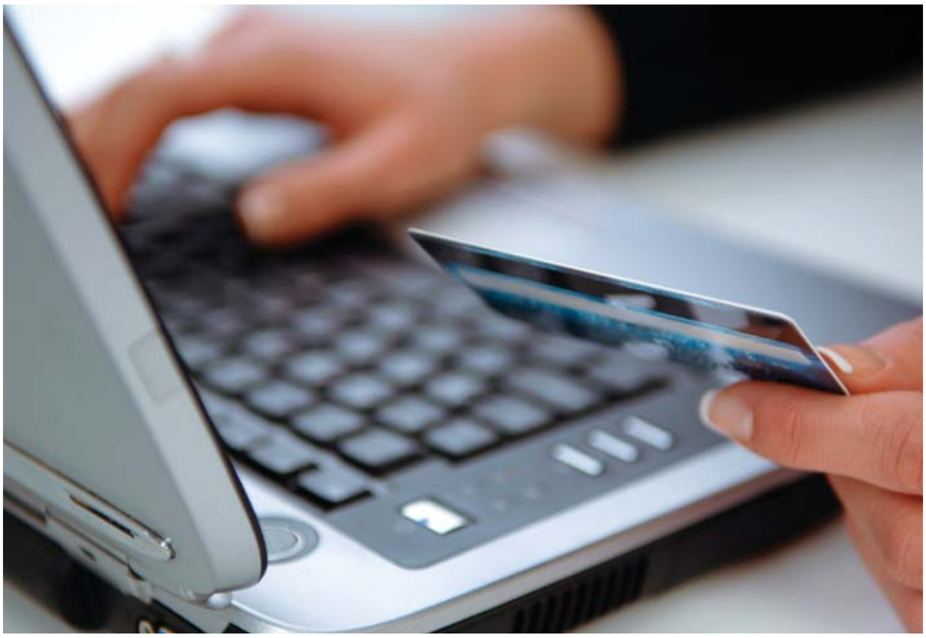
The Payment Services Directive (PSD) is the European Commission's answer to a burgeoning business in money handling. This business touches us all: when we shop online, pay by Oyster card for Tube travel, type in a PIN number over the phone. Yet for all its speed and convenience, this business is outside the scope of the financial watchdog.

The PSD would change that, says Dermot Turing, partner in Clifford Chance's International Financial Institutions and Markets group in London. Its purpose is to expand the regulatory net to cover organisations which operate on the fringes of the financial services industry without licences.

Examples of such organisations are not hard to find, especially when things go wrong. Dermot cited Farepak, the Christmas hamper and savings club whose widely publicised collapse in December 2006 cost thousands of relatively poor people their annual savings. "Farepak was an unregulated entity," he says. "It surprised many people that organisations like Farepak that handle money and payments could exist outside the sphere of scrutiny of the FSA."

This situation, among others, did not escape the notice of the European Commission in its work on improving conditions for the single market. It proposed the PSD in December 2005 to harmonise infrastructures for payment and their supporting laws. By their nature these laws are fragmented, leading to problems of unnecessary cost and poor service with cross-border electronic payments that are incompatible with the single market. The directive gives EU member states until 1 November 2009 for implementation.

Dermot dismissed as "street rumour" the suggestion that the PSD is essential to help banks deliver SEPA, the single euro payments area. "This is a myth – the PSD is not primarily about SEPA, it is about expanding the scope of regulation." The PSD applies to all payments in member states' currencies.



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“You might think that where the directive applies should be defined by where the payer and payee, not the PSPs, are located. It is a dematerialised service. How do you allocate jurisdiction for regulatory purposes to something completely dematerialised?”

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Bank-like rules

The directive will require providers of payment services to abide by bank-like regulatory rules covering such areas as regulatory capital, governance, systems and controls, restrictions on outsourcing and requirement for statutory audit. “It has the look and feel of traditional banking or broker dealer regulation about it – which is exactly what the European Commission is trying to do,” says Dermot.

The PSD identifies three categories of payment service providers (PSPs) – banks, electronic money institutions and payment institutions – and seeks to have them all under regulatory authority with licences and conduct of business rules. Those which will need the "new species" of regulatory licence are businesses which provide payment services but are neither banks nor electronic money institutions.

Payment services, in the eyes of the European Commission, include accounts which allow case withdrawals or fund transfers, payment by credit card, money remittances and payment transactions authorised by telecoms, digital or IT devices.

“What comprises a payment account is one of the controversial, unanswered questions under the PSD,” says Dermot. “We can be fairly certain a current account in a bank is one. But what about a mortgage account from which you can make occasional payments, or other kinds of accounts whose dominant purpose is not making payments but which allow disbursements or cash withdrawals?”

In the case of electronic payments, in which transaction consent is given by a telecoms or IT device, the directive makes an important distinction between the payment intermediary and service provider. “Imagine if – when – your Blackberry has Oyster card functionality built in,” says Dermot. “You expose the Blackberry to a transport network reader so you can get onto the Tube. In this case, the Blackberry service provider is acting only as an intermediary, processing the payment to enable you to use London public transport.

“Contrast that with using your Blackberry to watch football on the train. The service you are paying for is delivered into the Blackberry itself, making the Blackberry service provider both intermediary in the payment process and the vehicle for delivering the service.”

A list of exempted payments and services further complicates what is already a complex situation.

‘One leg out’ exemption

Internationally, jurisdiction issues abound. The intriguingly named ‘one leg out’ exemption rules that both PSPs must be within the EU for the directive to apply. “This is peculiar,” says Dermot. “You might think that where the directive applies should be defined by where the payer and payee, not the PSPs, are located. It raises the question of where you think a payment service is provided. It is a dematerialised service. How do you allocate jurisdiction for regulatory purposes to something completely dematerialised?”

That is one difficult unanswered geographical question raised by the PSD. Another is determining which regulator will supervise the activity. Does, for example, a UK bank providing payment services in Germany to German customers come under UK or German rules? Despite the PSD being a ‘maximum harmonisation’ directive, interpretations will differ on some points. “The possibility of dual or even multiple regulation is a real one,” says Dermot.

Another area of potential concern surrounds payment systems. While the PSD obliges payment systems providers to give unrestricted access to newly-licensed payment institutions, the definition of a payment system is unclear and complicated by exemptions. But in the end, “if you are operating a payment system you are going to have to comply,” says Dermot.

An unusual provision is intermediary liability. The PSD “actually imposes an obligation on member states to create statutory liability,” says Dermot. As well as laying out responsibilities if a payment transaction goes wrong, it establishes a right of a PSP to reimbursement from an intermediary. “It says if I had to pay out because my customer has complained, but I think somebody else was actually the cause of my loss, I have a right to be reimbursed by that other entity,” Dermot says.

"I have never seen that in a directive before. Does it mean there will be mandatory rules that have effect regardless of what's agreed in contracts? The question is being raised in some member states. That law potentially undermines the legal validity of things like limitations on liability, caps on liability, exclusions and so forth."

Stimulate transparency

Simon Crown, senior associate in Clifford Chance's International Financial Institutions and Markets group in London, says the PSD's conduct of business rules are designed to stimulate transparency and to adjust the rights and obligations between PSPs and users.

"The consumer protection thinking behind the directive becomes apparent with the conduct of business rules," says Simon. "The more information given to consumers of PSPs by the providers of those services, the more competitive the market becomes."

The rules can be disapplied by agreement if the user of the payment services is not an individual consumer. However, member states have the option to extend the transparency rules to micro-enterprises – companies with fewer than 10 employees and turnover of less than €2m. "The Treasury, in its consultation paper, indicated that it is minded to apply this to micro-enterprises," says Simon, noting that this would mean that any repapering exercise may need to be conducted by a bank's business banking division as well as its retail division.

The directive makes a distinction between one-off payments and those requiring a framework contract. Fewer requirements surround the former in Brussels' attempt not to hamper development of quick payment services, such as the Oyster card swipe payments. Low value transactions are similarly subject to a lighter regulatory touch.

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In its rules on speed of execution, the directive requires payments in euro and other EU currencies to be three days after transaction until 2012, thereafter reduced to one day. This "should not be a problem in the UK because of the recently introduced Faster Payments initiative," says Simon. However, there are implications for banks' operational float if the standards are not uniformly applied.

Shape of the industry

The wider implications of the PSD – the "joker in the pack" – are how it will affect individual business strategy and the shape of the industry, says Dermot Turing. For a start, can you afford to continue in payments?

While UK consumers traditionally have enjoyed free payment services as part of the package of a total banking service, it is not necessarily the right model any more in the face of the costs of compliance. This raises questions of outsourcing and the viability of selling or buying into a system with another bank or solution provider outside the financial sector.

That choice will be influenced by other regulatory drivers; the Basel II operational risk capital requirements, for example, could influence insourcing and outsourcing choice, as could the Markets in Financial Instruments Directive (MiFID).

"This whole pricing issue is interesting," says Dermot. The model will have to change to reflect other factors such as your ability to continue to hold float, faster payments and so forth, how that business is funded.

As intriguing are the possible effects on the financial sector of the introduction of regulated payment institutions. "If you were a payment institution and had to get a financial services licence, why would you stop at just doing payment services?" says Dermot. "Why wouldn't you add more full-portfolio financial services to your licence and broaden your offering with a more attractive range of products for your customer? Where does that leave you in the competitive environment with mainstream financial services providers like banks?"

One area that is definitely 'on the move' is mobile payments. "Mobile service providers will probably be among payment institution licensees," he says. "Will they then be tempted to move from e-payments and m-payments into full-scale financial services?"

"It might be useful for financial institutions to consider whether it would be beneficial to have a PI licence themselves."

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Simon Crown, senior associate, Financial Institutions and Markets Group

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