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Review of the European Union’s proposal for a new directive on payment services (“PSD2”)

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The European Union is in the process of updating its regulatory regime for payment services to reflect the developing nature of the payment services market. The European Commission’s proposed revised Payment Services Directive (“PSD2”) will certainly broaden the net of regulation to cover a wider range of payments-related services. But questions remain about the scope and effect of the European regulatory regime that the PSD2 does not fully answer.

The first EU Payment Services Directive (“PSD”) was adopted in 2007 and became law in most EU member states in 2009. In July 2013, the European Commission published its proposal for PSD2, which it hopes will be adopted in early 2014 and implemented by member states by 2016.

In its current form, PSD2 will impact financial institutions already operating within the scope of the PSD, as well as the operators of e-commerce marketplaces, gift card and loyalty schemes, bill payment service providers, public communication networks, account access services, mobile wallets and anyone who receives payment by direct debit. This change in scope is the most obvious immediate impact of PSD2, but unless the EU alters its approach, it seems likely that PSD2 will not successfully resolve all of the residual problems in the existing payment services regulatory regime.

The intention behind the original PSD was to open up the markets for regulated payment services to new entrants, both by creating a new form of regulated financial institution (“payment institution”) and endorsing certain unregulated activities through specific exemptions. Importantly, the PSD substantially reduced the initial capital required to enter the regulated market. The first Electronic Money Directive (“EMD1”), introduced in 2000, required electronic money institutions (“EMIs”) to hold initial capital of €1 million. But in 2009, the PSD enabled payment institutions to launch other types of payment services with only €125,000 of initial capital (and later, in 2011, EMD2 reduced the initial capital for EMIs to €350,000). As a result, there are now over 200 payment institutions, 80% of which are based in the UK (as are the majority of e-money institutions).

However, the PSD does not accurately reflect the contractual, operational or technological reality of how some payment methods operate; certain exemptions are inconsistent; and its effect is uncertain in many respects. While the UK’s Financial Services Authority (now the Financial Conduct Authority, “FCA”) led the way in trying to clarify the application of the PSD, the “maximum harmonisation” requirement limited the ability for EU member states to resolve any problems in the course of transposing the PSD into national law.

Unfortunately, while PSD2 expands the regulatory sphere to encompass some additional payments-related services, the proposals do not resolve some of the more fundamental issues in the PSD and may otherwise operate as a barrier to further innovation and competition.

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Payment transaction: Perhaps the most fundamental problem in the PSD which has not been resolved in PSD2 lies in the definition of a "payment transaction":

> "an act, initiated by the payer or payee, of *placing*, *transferring* or *withdrawing* funds, irrespective of any underlying obligations between the payer and payee", where "payer" is essentially a person who initiates a payment request and a "payee" is the intended recipient of funds that are the subject of a payment transaction."

This fails to reflect how card payments work. The definition conflates the contractual reality and the flow of funds by assuming that the intended recipient of funds (*i.e*., the "payee") in a retail card transaction is the merchant. But a cardholder never intends to pay the merchant, even though using the debit or credit card discharges the cardholder's obligation to pay the merchant under the contract of sale. The cardholder only intends to pay his or her card issuer, either immediately (when using a debit card) or on the due date for payment of his or her monthly credit card statement. Similarly, when initiating a card transaction via the point of sale terminal or online gateway, the merchant only expects to be paid by its card "acquirer" (who literally buys each transaction). As a result, some acquirers consider that the PSD does not apply to their activities.

The FCA has explained how and why it considers the PSD *does* apply to card acquiring. But its reasoning is not consistent. In contrast, the FCA explains that bill payment services are out-of-scope of the PSD because the supplier who issued the bill is not the intended recipient of funds. Instead, the customer intends to pay the service provider, and that payment discharges the customer's obligation to pay the supplier. This is essentially what happens in a card payment scenario, as well as in other cases.

PSD2 does not resolve these problems. In fact, it directs EU member states to treat the bill payment scenario as money remittance unless the activity falls under another payment service.

Where payment is ancillary to a core business activity: In the notes to PSD2, the European Commission suggests that e-commerce platforms (undefined) have unfairly relied on being the agent of both consumer and merchant to remain outside the scope of the PSD (often called the "commercial agents exemption").

Assuming that "e-commerce platforms" is intended as a reference to retail marketplaces linking buyers and sellers of goods and services, it seems unlikely that the operators of such platforms are really engaged in the provision of payment services as a "business." The payment aspect is a small, ancillary step in a much wider set of operational activities that involve digital marketing, product search and display, order processing, customer support, delivery, order tracking and other related features. Such activities are already regulated under distance selling, trading standards and other sales regulations as well as data protection law. There are also many other types of online marketplaces where payment is but a small ancillary step in the overall service offered by the market facilitator. In such cases, payment to the operator also usually discharges the customer's debt to the merchant, as in the bill payment scenario.

Such treatment of e-commerce platforms is also inconsistent with the exemption for transactions involving the purchase of digital content on a telecommunication network, which PSD2 concedes are "ancillary services to electronic communications services (*i.e*. the core business of the operator concerned)." While this exemption is to be limited to €50 per transaction and a total of €200 per month, it has also been broadened to apply regardless of the device used for the purchase or consumption of the content. Why telecoms operators are accorded such special treatment is neither evident nor explained.

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Limited networks: The PSD exempts payment transactions based on payment instruments accepted only within the issuer's premises or certain limited networks. This applies to "closed loop" stored value and other instruments such as retail store cards, gift cards, fuel cards and loyalty programmes. Such instruments are also exempt from the definition of "electronic money" in the second electronic money directive ("EMD2") by reference to the PSD exemption.

While this exemption survives under PSD2, operators will be obliged to notify the regulator if the average of their transactions in the preceding 12 months exceeds €1 million per month. The regulator is then entitled to disagree that the exemption applies.

It is unclear on what basis a regulator might decide that a service which otherwise fell within limited network exemption below the threshold average of €1 million per month would no longer qualify if and when it reaches that threshold. There is no provision for an orderly transition to full authorisation or finding an authorised payment institution or PSD agent to operate the service in the event that the regulator were to disagree that the exemption applies. A closed loop stored value service would thereby cease to qualify for the exemption from the definition of "electronic money" under EMD2, which specifically imports the limited network exemption in the PSD. Accordingly, a service provider who was lawfully operating within the exemption below the volume threshold could suddenly find itself in breach of both PSD2 and EMD2.

Practically speaking, this could drive service providers of limited network payment schemes to err on the side of (i) applying for authorisation or becoming a PSD Agent; (ii) relying on an authorised firm to operate their schemes; or (iii) withdrawing their schemes altogether.

New "payment initiation services" and "account information services": In essence, these are services provided by "third party payment service providers" (or "TPPs") that only involve interfacing with a payment account, either to initiate payments or display account information. The activities of providing or maintaining a payment account, on the other hand, are the role of "account servicing payment service providers" (ASPs).

TPPs are considered "medium risk" for initial capital purposes (€50,000 is required), even though they are neither operating a payment account nor (one infers) handling funds. They are also subject to the full weight of the information and contractual requirements, and the obligation to contribute to losses arising from the parts of the transaction that are under their "control." It is not clear what constitutes "control" for these purposes.

It is also unclear how to distinguish the proposed new forms of regulated service from those offered under the exemption for technology service providers whose activities support payment transactions without them entering into possession of funds (*e.g.* "gateway" services that merely transfer payment data to and from payment service providers). It would also be important to consider whether such services would now be classified as exempt financial services for VAT purposes, if, indeed, payment services generally will continue to be, to the extent that they seem to merely involve the payment of debts.

At any rate, the initiation of payments and accessing payment accounts seem more akin to personal data services than payment services. Accordingly, the key operational risks would be more readily addressed under the data protection regime, under which official guidance and co-regulation is already being developed to govern data sharing and access to personal transaction data (see, for example, the UK ICO's "Data Sharing Code of Practice").

The concern must be that the regulatory costs and increased liability associated with payment initiation or account access features will constrain the potential for further innovation and competition in this area.

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Small payment institutions: PSD2 allows permits a reduced form of authorisation ("registration") for firms whose average transactions in the preceding 12 months exceed €1 million per month. No passport is available, and the various authorisation conditions and capital and safeguarding requirements can be waived. The current threshold is €3 million per month. So it would appear that any small payment institutions whose volumes exceed the new threshold would need to become authorised, thereby increasing the regulatory and capital burden for businesses that are still very small compared to incumbent competitors.

Safeguarding: The safeguarding requirements in PSD2 relate only to funds received from payment service users or through another payment service provider for the execution of "payment transactions". That is a narrower range of funds than perhaps one might think, especially given the problems with the definition of payment transactions discussed above.

In addition, a firm need only deposit funds payable to customers in a segregated bank account "by the end of the business day following the day when the funds have been received". The service provider must use an appropriate mechanism under national law to protect those funds from claims by its creditors. However, the timing raises the potential for funds to be deemed the service provider's "own funds" on receipt and either dissipated at that time or to gather in an "own funds" account if the service provider's business operations are interrupted for more than a day.

To avoid this, it is suggested that the definition of funds to be safeguarded should encompass any that the payment service provider intends to pay to its customers or their payment service providers, and that such funds should arrive into, and be disbursed from, segregated bank accounts that are bankruptcy-remote under the applicable national law. The service provider would still be entitled to deduct and pay to itself any agreed fees or charges.

MISCELLANEOUS ISSUES

There are numerous other issues to be addressed, but the following are more generally significant:

Is a service supplied on a cross-border basis or by exercise of the right of establishment? This is often unclear, particularly in relation to the use of agents based in other EEA states to facilitate purely online payment services. This structure was a fundamental building block of the single market, yet PSD2 gives the authorities another two years after implementation to clarify its regulatory treatment.

Surcharging: PSD2 bans surcharging for the use of payment cards, since interchange fees will be regulated (downward). The Commission explicitly intends this provision to make card payments more attractive. It remains to be seen whether this has the unintended effect of making it harder to market alternative payment methods.

Refunds for direct debits etc: It is unclear whether one or two conditions must be satisfied to claim a refund for a direct debit or other payee-initiated payment. Confusing limits and exceptions apply. These rules are also inconsistent with the cancellation rights for distance sales. For instance, distance marketing cancellation rights are limited to the first of "successive operations of the same nature" or a "series of separate operations of the same nature". Yet PSD2 would allow the consumer to reclaim subsequent instalments paid by direct debit, even if he or she is no longer entitled to cancel (or terminate) the contract under which instalments are due.

Security: PSD2 mandates the use of "strong customer authentication", as well as additional internal controls related to security and fraud. Payment service providers are also to be subject to the Network and Information Security Directive, including risk management and incident reporting obligations. It is important that mandating such approaches to information security does not slow the pace of innovation in the face of ever more sophisticated cybercrime.

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Calculating capital requirements: As under the PSD, the requirement in PSD2 to hold certain capital “at all times” is at odds with the annualised basis of calculating those requirements.

Force majeure: Typically, force majeure arises where a party is prevented from performing an obligation due to circumstances beyond that party’s “reasonable control”. However, Article 83 refers to consequences “which would have been unavoidable despite *all efforts* to the contrary…”. This arguably introduces a “best endeavours” obligation.

Complaints handling: The deadline for a firm to resolve a complaint is reduced from eight weeks to 15 to 30 business days, significantly accelerating the deadline for referrals to the Financial Ombudsman Service (in the UK), for which payment service providers pay a substantial fee.

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