The European regulatory agenda on payments is driving major industry change

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On 24 July, the European Commission published long-awaited proposals on the payments market in Europe, consisting of three elements: a revised Payment Services Directive (PSD), a regulation on Multilateral Interchange Fees (MIF) and a communication on SEPA governance.

These sit alongside other regulations including transparency of information for Anti-Money Laundering (AML) and sanctions, the proposal for a directive on the transparency and comparability of payment account fees, payment account switching and access to basic payment accounts. This broad regulatory agenda continues to provide compliance challenges for the financial services sector and impact increasingly on corporates and consumers.

Revision of the Payment Services Directive (PSD2)

The original Payment Services Directive (2007) established a legal and regulatory framework for Payment Service Providers (PSPs) and opened up the market to some non-bank PSPs. The revised PSD2 has been extended to include Third Party Payment Providers (TPPs) in its scope. This will increase competition in the payments market, creating opportunities for innovation, particularly for the offering of services focused on efficiency and reduced cost and making use of technological advances.

Some of the key changes that are proposed in PSD2 are:

Extensions in scope

The Commission proposes to extend the scope of the PSD to require compliance with transparency requirements and the provision of information where 'one leg out' transactions occur, namely transactions where money is being sent out of or into Europe.

Additionally, as a consequence of the dramatic increase in mobile banking and unregulated payment solutions, third-party providers of payment initiation services (which typically operate between the merchant and the purchaser's bank) and account information platforms will be required to be authorised under PSD2 as payment institutions.

Prohibition on surcharges

Currently, under the PSD, different regimes are in place across the European member states in relation to surcharging. Some member states allow surcharges on certain payment methods to enable the funnelling of the payer by the PSP towards the use of the most efficient payment systems. PSD2 will harmonise the surcharge practice by applying a prohibition on surcharging to consumer credit and debit cards under the four-party model. A small proportion of card transactions will not be subject to the regulation (e.g. corporate cards), and surcharging will still be possible by the payee for these transactions, as long as they do not exceed the cost borne by the payee in accepting the payment method chosen by the payer.

Third-party access to payment systems

The PSD has also been extended to cover all e-transactions made through IT devices, e.g. mobile, internet, etc. TPPs will now be able to initiate payments on behalf of consumers. In reality this is a major change to payment industry operating models, as it requires banks to allow TPPs access to their payment infrastructures where the consumer has provided consent and the TPP adheres to necessary security requirements.

Transparency

Under PSD2, transparency and information requirement provisions will increase in scope to also apply to payments made to third parties where only one of the PSPs is located within the EU.

Security

New rules for improving payment security over the internet are also included under PSD2. This requires PSPs and TPPs to ensure that they support two-factor authentication for card-not-present transactions and will adhere to the more detailed security requirements to be published by the European Banking Authority (EBA). An assessment of the operational and security risks at stake and the measures taken will need to be done on a yearly basis.

Single Euro Payments Area (SEPA)

The harmonisation of the euro payments market has been in the offing for a long time and will result in many benefits and efficiencies for companies with material euro flows. To achieve this, SEPA provides a single set of euro payment instruments—credit transfers, direct debits and card payments.

The deadline for SEPA is February 2014 for eurozone countries and October 2016 for non-euro countries. All euro payments will be made via a common payments framework (ISO 20022 XML) using standard bank account details including International Bank Account Number (IBAN), rather than the existing different domestic arrangements in each country. In effect, this will remove the distinction between domestic and cross-border euro payments within SEPA and will replace the country's incumbent local credit transfer and direct debit processes.

Many companies are still a long way from completing their convergence processes. The latest migration report from the European Central Bank (October 2013) shows a near-60% migration rate for the SEPA credit transfer system, but only 7% for the SEPA direct debit scheme, indicating that most companies will be completing their initiatives in extremely close proximity to the February 2014 deadline.

Regulation on interchange fees

The European Commission's first draft of its proposal on Multilateral Interchange Fees (MIFs) (fees paid by banks to each other for each card payment) outlines changes that the Commission suggests will remove important barriers between national payment markets, reduce fees and prevent surcharges being applied to customers, thereby encouraging the emergence of new players.

"A level playing field will be created for payment services providers, new players will be able to enter the market and offer innovative services, retailers will make big savings by paying lower fees to their banks, and consumers will benefit through lower retail prices."
Joaquín Almunia, Vice President, European Commission

The proposal suggests a prohibition on surcharging and imposes a cap on interchange fees of 0.2% for debit cards and 0.3% for credit cards (except for three-party schemes such as AMEX and commercial cards). The cap will initially apply to cross-border payment transactions from when the interchange fee regulation is implemented and 22 months later to domestic transactions. A further aim of the changes is to give merchants the freedom of choice to steer consumers away from more expensive cards.

The Commission expects the result to be cost savings for merchants and, due to the prohibition on surcharging, cheaper goods and services for consumers. The proposals will require significant changes to be made to existing payment service providers' business terms and procedures. Banks may want to look at other potential revenue streams in lieu of interchange fees.

Directive to prevent the use of the financial system for money laundering or terrorism financing

This 2006 regulation regarding information on the payer accompanying transfers of funds was updated in 2013. It increases the scope, and therefore, the effectiveness of legislation combating money laundering and terrorism financing.

The legislation requires companies to maintain records as to the identity of ultimate beneficial owners and provides increased clarity and transparency on customer due diligence rules. It also extends the definition of Politically Exposed Persons (PEPs) to include domestic PEPs.

The scope of the legislation has also been broadened to include gambling and specific provisions on tax and extends to all persons dealing in goods or services for cash payments of €7,500 or more (the previous threshold was €15,000).

Conclusion

Changes in payments regulations will produce both winners and losers, as institutions adapt their current compliance offerings with differing levels of success. The various financial consequences of non-compliance, coupled with high levels of scrutiny by both the media and regulators, mean the penalties for failing to adapt to the changes may be considerable. Further regulation is coming, and it is important for businesses to be adept and agile in their response to the payments compliance challenge.

Challenges

- The level of change from PSD2 (and the previous PSD) impacts the products, operations and customer areas of organisations, and will need support from risk and compliance departments
- Assessing the impact of IT changes that will be required by PSD2 to ensure the new requirements are adhered to, such as third-party access to payment systems
- Ensuring systems are compliant with new security requirements under PSD2
- Changes for PSD2 and SEPA are likely to require large scale customer communications and amendments to terms and conditions
- Regulations can be difficult to interpret and implement, often requiring complex or near real-time reporting structures
- Completion of SEPA migration for the February 2014 and October 2016 deadlines and assessment/ leveraging benefits from the regulation, as opposed to just attaining compliance
- Caps on interchange fees will challenge business models for issuers and acquirers
- New requirements for screening customers must be analysed and their impact assessed

Recommendations

- Ensure an early gap analysis is performed against all product sets to determine the impact and prioritise change activity, providing sufficient time for any IT changes required
- Ensure relevant departments such as risk, legal and compliance are engaged early in the process
- Review existing security mechanisms and supporting processes against the security standards to be published by the EBA and ensure full adherence to the requirements for two-factor authentication for card-not-present transactions
- Review and update relevant control frameworks to embed new controls that will address regulatory requirements
- Supporting MI will need to be defined and developed to allow compliance to be evidenced to regulators
- A centralised governance process is important to ensure consistency of response across all business areas that are affected
- Complete SEPA migration, including conversion to IBAN and IBAN-only payment requests
- Assess benefits that can be derived from SEPA, such as cost savings through standardised operating models, organisation, centralised and shared IT capabilities within Europe
- Issuers and acquirers will need to review business models including potentially increased card fees and market segmentation given proposed caps on interchange fees
- Ensure compliance with new screening requirements and understand the impact in terms of resource requirements to perform and manage additional screening and consider automation to reduce false positives