

## Payments Services Directive: Complexities on the Road to Harmonisation

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In this Insight issue, Tanya and Volker pool their considerable knowledge and experience to discuss the impact, opportunities and challenges within SEPA zone countries presented by the implementation of the Payment Services Directive (PSD). They also explore the impact of the PSD on global markets including the Americas and Asia Pacific.

This article reviews some of the potential impacts and challenges of the Payments Services Directive (PSD or the Directive). The PSD came into European Law in December 2007, with a goal to harmonise national legislation around payment services, remove legal barriers to entry and to allow new, non-bank entrants into the payments industry. As a key component of the Single Euro Payment Area (SEPA) strategy, the PSD is designed to promote more consistent and competitive payments services across the European Union (EU). The PSD is important because it (1) is highly likely to impact existing payment service providers in Europe; (2) creates a new type of payment service provider – the Payment Institution (PI); and (3) may impact the evolution of payments services in other global markets such as Latin America and Asia Pacific.

Regulators and market players anticipate a number of benefits and strategic opportunities will arise from the introduction of the PSD into the payments landscape<sup>1</sup>, including:

- Increased consumer choice as a result of greater competition between service providers
- The introduction of new payment institutions into the payment arena
- Improved efficiency of cross border transactions
- More effective consumer protection regardless of where the consumer is based (as long as they are transacting within the SEPA zone)
- Greater potential for cross market customer acquisition
- Increased innovation and product development throughout the payments industry

By November 2009, the PSD must be passed into law at the national level throughout the EU. Each EU member state has the right to assign whichever regulator or competent authority it defines as the most appropriate to oversee the implementation of the PSD and ensure a successful introduction of the PSD principles into operational practices at the national level.

The PSD is intended to provide clear implementation guidelines to national regulators and competent authorities but there remains substantial latitude for regulators to interpret the key principles differently from country to country. While the fundamental goal of the PSD is to promote harmonisation at an EU

<sup>1</sup> EDC response to HM Treasury consultation document March 2008

*Substantial latitude remains within the PSD for regulators to interpret the key principles differently from country to country.*

level, each regulator has a duty to apply the PSD principles consistently with its responsibilities within the European Union and at a national level. Because of the degree of latitude within the PSD guidelines, it will be challenging for regulators to ensure that business innovation is encouraged, local payment providers are supported, appropriate levels of consumer protection is provided, and the payment services industry remains profitable, all in a manner that is consistent with national objectives across the EU and SEPA market.

EDC is working closely with stakeholders to assist in the translation of PSD guidelines into operational reality. EDC is providing its clients with information and advice to enable them to leverage the ongoing opportunities for new products and technologies in Europe that are arising as a result of this transition.

As the transition evolves, there will be significant room for different interpretations of the PSD guidelines such as which payment providers and Financial Institutions are covered by the PSD and how an organisation will be treated which transacts both within and outside the European zone.

For example, under the guidelines, the PSD provides for three types of payment providers: retail banks and credit institutions; e-money issuers<sup>2</sup> ; and Payment Institutions (PIs - a new category). PIs are defined as providers of payment services that:

- (1) Are not currently classified as banks/credit institutions or e-money institutions
- (2) Must be authorised (or registered with one of the competent authorities in the EU) dependent on a number of key criteria (yet to be finalised)
- (3) Take possession of funds
- (4) Provide a service beyond just the selling of their own goods.

An open network or scheme does not need to become a Payment Institution if they act only as a pathway for payment services rather than provide direct payment accounts (take possession of funds). The introduction of this new category of Payment Institution is likely to enhance the level of innovation and the creation of new payment products and services. New entrants will be able to enter the payments value chain, furthering the objectives of increased competition and consumer choice. Merchants authorised as Payment Institutions will be able to directly provide payment services and payment transaction processors will be able to compete directly with Financial Institutions.

The introduction of the Payment Institution category will create considerable challenges for local regulators in terms of classifying organisations. We have included below four examples of these challenges.

**1. Who will be required to be authorised as a PI, and what services will they be allowed to provide<sup>3</sup>?** The Directive seeks to clarify some of these questions by defining payment service activities as “services enabling cash to be placed on a payment account as well as all the operations required for operating a payment account”<sup>4</sup>. Payment products have evolved substantially over the last 10 years and whilst it is clear that a PI includes bank operated current accounts, credit institutions, and e-money accounts, it is less explicit as to whether other types of services that may be categorised as PIs (such as prepaid accounts or online e-wallets) are covered by this legislation and whether those with some

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<sup>2</sup> As provided for under the 2000 Electronic Money Directive

<sup>3</sup> Payment Institutions (PI) will only need to be authorised if they transact more than €3m per month or intend to passport their services outside their home state. Below this level PIs must notify the relevant competent body in order to become a “registered” Payment Institution.

<sup>4</sup> PSD Annex

*Lack of clarity remains about who will be required to be authorised as a Payment Institution, and what services will they be allowed to provide.*

additional features are “in” or “out” of the PSD scope. It has been stated that the payment for prepaid airtime, utility bills at a third party intermediary or the cash payment for utilities at a third party is excluded from the PSD. However, some models of bill payment services will be captured by the PSD because the payment service provider enables the execution of payment transactions through a payment card or similar device. This leaves room for interpretation by bill payment providers as to whether they are included in the PSD. Further issues are likely to arise from the lack of clarity around whether PIs will be able to provide credit and to what extent this may be exportable to other EU countries as national credit legislations will still apply and vary significantly from country to country. EDC is involved in helping both the regulators interpret the PSD to ensure “harmonisation” and payment providers to understand the PSD so they are in a better position to respond to regulatory questions and interpretation.

The examples above demonstrate why it is important that the PSD is clearly and consistently passed into law in each Member state in order to ensure that the principle of harmonisation and standardisation to create a “level playing field” is achieved. This will need to include rules on how to identify whether certain players/activities in the payments value chain are included or excluded from the PSD and ensuring these rules are clearly and consistently interpreted in each Member state. EDC is involved in helping both the regulators interpret the PSD to ensure “harmonisation” and the payment providers to understand the PSD so they are in a better position to respond to regulatory questions and interpretation.

**2. How is the PSD aligned with other existing legislation, such as the Electronic Money Directive (EMD<sup>5</sup>)?** Initial capital requirements for PIs have been grouped within the Directive, ranging from €20,000 for a money remitter to €50,000 for a mobile phone payment service provider and €125,000 for a complex payments service. These requirements are lower than those defined within the EMD and the domestic banking codes of EU Members. Many electronic money issuers currently regulated under the EMD anticipate some alignment of the EMD with the PSD in terms of issuing conditions and capital requirements, as the disparity between the two Directives is an area of concern. Without appropriate alignment, questions arise for some institutions. Does it still make economic sense to apply for an e-money license? Should an existing e-money licence holder apply to become a Payment Institution instead and how would such “license transfer” be managed and accommodated? Without alignment of the EMD with the PSD, risk arises that payment innovation may slow as firms wait for the PSD licensing regime to be implemented. Many believe this to be a less burdensome regulatory framework.

**3. Another area within the PSD that may create difficulty is the definition of ongoing capital requirements for PIs.** These are to be calculated using one of three different methods defined in the PSD. As there is no guidance by the competent authority regulating PIs for a single method to be applied, a risk remains that the choice of method will not be consistent across Europe. If this would occur, a level playing field would not be achieved and discrimination may result between local and foreign players. EDC has built an analytic tool to assist clients to perform a feasibility analysis on a variety of possible business scenarios to assist them with determining the appropriate structure of the business within each of the PSD methods. This tool highlights that the outcome of the calculations vary significantly between business types and structures and that the selection of a method by a “local regulator” may determine the type of organisation that will seek to be licensed within that regime. The three methods are detailed within the analytic tool, and roughly align to the following description:

*Without clear implementation plans, risk arises that payment innovation may slow as firms wait for the PSD licensing regime to be clearly defined.*

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<sup>5</sup> Issuers of prepaid cards regulated under the Electronic Money Directive will also be caught under the PSD

- **Method A:** Based on fixed overheads
- **Method B:** Based on payment volumes
- **Method C:** Based on income

Clearly, because of different business models within the payments sector, one method will not be appropriate for all institutions covered by the PSD in each Member state and the onus is on the Member state to choose the one which is more appropriate for the domestic market. The question at a local level is whether the competent authority will select the capital requirement method to act as a barrier to entry or as a means to attract new payment institutions. Scope for either approach exists.

**4. Local regulators are able to impose a plus or minus 20% variance to the ongoing capital requirements based on an assessment of risk management processes. But how will appropriate levels of risk be determined – and how can this be implemented consistently across Europe?** This potentially subjective variance alongside the ability for local regulators to select the method to determine ongoing capital requirements may further confuse payment providers. In addition, it may lead to competent bodies selecting an approach for providers within a market that results in a relatively low risk categorisation.

As seen from the above examples, the PSD raises a number of issues that need to be satisfactorily resolved if it is to achieve its goals – issues related to classification of PIs, their initial capitalisation, what they are allowed (and not allowed) to do, etc. The resolution of these issues will be important to organisations that might benefit from becoming PIs as well as those that have to compete with newly created PIs.

All organisations (European and non-European) would benefit from having a clear, structured understanding of the PSD related issues and how it may impact their organisations.

From a European perspective, EDC is in consultation with a number of Financial Institutions, payment providers and domestic regulators across Europe and actively participates in working forums in France, Netherlands and Germany to assist in the development of an approach which will facilitate the successful implementation of the PSD. In addition, EDC has recently responded to the HM Treasury PSD consultation document highlighting areas for consideration during the transposition of the Directive into a pragmatic and simple legal framework for the UK.

From a non-European perspective, it is important for payment providers within the global payment landscape to keep an eye on the implementation of the PSD in Europe. Although the PSD is directed at Europe, the PSD may have a substantial impact on a global scale as other markets look to the PSD migration and the impact (positive or negative) it has on payments competition and efficiency across multiple countries. If the European Union achieves their objective to increase innovation and harmonisation, other global sub-regions may respond through the creation of their own payment zones. Regions within Central and South America as well as Asia and the Commonwealth of Independent States (CIS) are keeping a close eye on the progression of the SEPA zone with a possible view to assessing the possibility of bringing change to their own domestic and regional payment landscapes.

There are many operational, technical and implementation hurdles to overcome prior to the 2009 implementation of the PSD at a national level, of which this article has only highlighted several. For the PSD to be successful, domestic regulators and competent authorities must continue to work closely with key stakeholders in the payments value chain, including Financial Institutions, payment providers and schemes. This will help ensure that any existing ambiguity

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between member state regulations is removed and that the objectives of harmonisation, innovation, transparency and standardisation are achieved to the benefit of all stakeholders across Europe.

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**About Edgar, Dunn & Company**

*Edgar, Dunn & Company (EDC) is an independent global financial services and payments consultancy. Founded in 1978, the firm is widely regarded as a trusted advisor to its clients, providing a full range of strategy consulting services, expertise and market insight. Global capabilities include in-depth industry and consumer benchmarking, strategy, risk management, marketing, profitability improvement, operations, and new products and technologies.*

*With offices in Atlanta, Frankfurt, London, San Francisco, Singapore and Sydney, EDC serves clients in over 30 countries on six continents. More information can be found at [www.edgardunn.com](http://www.edgardunn.com).*

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