Implementation of the Payment Services Directive:

a consultation document

December 2007

HM TREASURY

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ISBN 978-1-84532-378-3

PU458

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Executive Summary

With the aim of achieving a Single Market in retail payment services, the European Commission adopted a legislative proposal for a Payment Services Directive (PSD) on 1 December 2005. Political agreement between the Council and the European Parliament was reached in April 2007, and the Directive was adopted on 13 November 2007 and published in the Official Journal of the EU on 5 December 2007. The PSD must be implemented into national law by 1 November 2009. The main aim of the Directive is to improve the competitiveness of the European Union by integrating national payments markets and providing support for the European payments industry to build the infrastructure necessary for a single payments market.

This consultation document sets out how the Government proposes to implement the Directive in an effective, proportionate, and risk-based manner. It discusses the Government's proposed approach to implementing each Title of the Directive. It also explains where the Government has flexibility in implementation and presents the options available. In particular, it includes a discussion of the following issues:

- the scope of firms which will be subject to the requirements of the Directive;
- the application of safeguarding requirements to different types of business;
- the conditions for waiving the application of the prudential authorisation requirements;
- the waiving of some of the conduct of business conditions in Titles III and Title IV for low-value payment instruments and electronic money; and
- the potential changes to payer liability for unauthorised use of payment instruments.

The Government invites responses to the consultation questions posed in each chapter. Respondents are free to frame their responses and input as they see fit. Chapter 1 explains how to contact us and at Annex A summarises the consultation questions posed. At Annex B is an initial impact assessment of five key policy options on which the Government invites comments and input from stakeholders; in particular, in relation to estimates of the costs and benefits. The impact assessment should be read in conjunction with the consultation document.

The consultation period begins with the publication of this document, and will run for 12 weeks plus an additional week for the winter break. Please ensure that responses reach us by 18th March 2008. Following the closure of the consultation period, the Government will put forward its preferred approach and will consult further on the legislative changes involved by summer 2008.

The final text of the Payments Service Directive can be found at: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2007/l_319/l_31920071205en00010036.pdf

1 INTRODUCTION

BACKGROUND AND GOALS OF CONSULTATION DOCUMENT

1.1 Efficient, competitive and innovative payment services, supported by open and secure payment systems, are of vital importance to the functioning of modern economies. In 2006, the average total daily value passing through UK retail payment systems was around £5.2 trillion[1].

1.2 In many European Union (EU) Member States, the banking sector has traditionally been the main provider of payment services, with legal and technical barriers preventing non-credit or e-money institutions (i.e. firms that are neither credit nor e-money institutions) from entering and competing in the domestic payment services market. To date, payment services and systems across the EU have largely been designed to serve the needs of national markets, with different national standards and consumer protection requirements. The fragmentation of the European payment market is believed to have hampered cross-border competition between payment service providers, with limited incentives for developing an efficient pan-European payments infrastructure.

1.3 The Lisbon European Council of March 2000 endorsed a set of 42 measures to complete the Single Market in financial services, including the creation of a more integrated Single Market in retail payment services. These measures aim to:

- reduce transaction costs;
- provide firms with improved opportunities to access markets and conduct business across the EU; and
- ensure that retail customers can choose between a range of efficient, innovative and competitively-priced products.

1.4 To achieve a Single Market in retail payment services, the European Commission adopted a legislative proposal for a Payment Services Directive (PSD) on 1 December 2005. Political agreement between the Council and the European Parliament was reached in April 2007, and the Directive was adopted on 13 November 2007 and published in the Official Journal of the EU on 5 December 2007.

1.5 The PSD stipulates that Member States must implement its provisions into national law by 1 November 2009. This policy consultation document sets out the Government's proposed approach towards implementation in the UK. It should be noted that the interpretation of the Directive set out in this document constitutes our initial view, and will be informed by both this consultation and further detailed analysis, and will also be subject to discussion in the course of European Commission-led transposition work with Member State governments. HM Treasury would be grateful for responses to the questions posed in this document, and any other comments of relevance to implementation.

[1] *Payment systems oversight report 2006* (issue no. 3), Bank of England, 2007

1.6 This Chapter of the consultation document sets out:

I. the rationale for and objectives of the PSD;

II. a summary of stakeholder reactions to the Treasury's previous consultation on the PSD negotiations;

III. the aims of the present consultation;

IV. an outline of the Government's overarching approach to implementation;

V. the implementation timeline;

VI. the relevance of the Directive to devolved administrations;

VII. how to respond to this consultation; and

VIII. confidentiality in responding.

I. RATIONALE AND OBJECTIVES OF THE PSD

1.7 In preparing its proposal for a Directive, the European Commission identified a number of concerns relating to European payment systems which it considered were adversely affecting EU competitiveness:

- EU electronic payment systems were fragmented along national lines. Providers and users were subject to different service standards, limiting opportunities for economies of scale;
- significant price differentials among payment services across the EU, reflecting varying efficiency and quality levels among national payment systems. Such inefficiencies, which included slow execution times for payments in some countries, were deemed to be impacting negatively on business and creating uncertainty for customers; and
- the level of competition between payment service providers in some countries was deemed to be unsatisfactory, with a low level of market entry, and barriers to access for new providers.

1.8 To address these issues the Commission proposed the PSD, the core objective of which is to enhance competition, efficiency and innovation in the European payments market, balanced with ensuring customer protection. The Directive has two main components:

- **a prudential authorisation regime for non-credit or electronic money** (e-**money) institutions, known under the PSD as "payment institutions**", and referred to as such throughout this document. Payment institutions which obtain authorisation in one EU Member State will be able to "passport" their business and operate in other Member States without having to adhere to further licensing requirements in other Member States. Smaller providers operating beneath a certain threshold will need to be registered under the PSD (Title II of the PSD);
- **harmonised conduct of business rules** covering information requirements, rights and obligations for payment providers and end-users. These rules will apply to all payment service providers, including credit institutions, electronic money issuers and payment institutions, and include provisions that are expected to support the SEPA initiative (Titles III and IV of the PSD).

1.9 The Directive also contains a provision (Article 28) stipulating that rules governing access to payment systems should be non-discriminatory. This is aimed at enabling payment service providers to access and compete effectively in EU payment systems, and should also support further competition among payment service providers more generally.

1.10 The PSD is broadly a maximum harmonisation Directive. This means that national implementing legislation must not exceed or fall short of its provisions unless expressly permitted by the Directive.

II. REACTIONS TO THE PREVIOUS CONSULTATION

1.11 On 3 July 2006, during the negotiation phase of work on the PSD, HM Treasury published a consultation document and an initial Regulatory Impact Assessment (RIA)[2]. A summary of responses to the consultation document and a revised RIA were published in December 2006.

1.12 The purpose of the 2006 consultation was to seek views on the Commission's proposal for a Directive, and inform HM Treasury's approach to the negotiations. Respondents represented a broad range of payment service providers and users, including credit institutions, e-money issuers, mobile phone operators, bill payment service providers, credit unions, credit card issuers, independent ATM operators and a variety of trade associations, as well as consumer groups and regulators.

1.13 Respondents were broadly supportive of the overarching aims of the Directive, i.e. to open up competition in the EU payments market, increase transparency and ensure consumer protection. There was general recognition that the Directive could help create a dynamic internal market in payments, provided that the rules were proportionate, risk-based, and workable. With respect to the initial RIA, the vast majority of respondents agreed with the Government's support for the overall thrust of the Commission's proposal, while suggesting specific areas where the Directive could be changed to maximise benefits to UK payment service providers and consumers and to minimise regulatory burdens. The comments received mainly addressed:

- the proportionality of the authorisation regime for payment institutions;
- the workability of the conduct of business requirements; and
- the applicability of the Directive to the different business models of payment service providers.

1.14 Several amendments, designed to reflect risk-based considerations, proportionality and workability concerns, were subsequently agreed with the support of other Member States.

III. AIMS OF THIS CONSULTATION DOCUMENT

1.15 This consultation document provides interested parties with the opportunity to engage with the Government on how it can best implement the Directive into UK law, taking into account Better Regulation objectives of ensuring risk-based and proportionate implementation. It aims to:

[2] http://www.hm-treasury.gov.uk./consultations_and_legislation/payment_services_directive/consult_payment_services_index.cfm

- explain the scope of the PSD;
- explain the provisions of the Directive by Title;
- present the Government's proposed approach to implementation;
- consult on options for implementation, where there is a degree of discretion for Member States; and
- provide stakeholders with a list of questions to assist preparation of their written input into the consultation process.

1.16 This document is a consultation on policy. Responses will provide valuable information to facilitate decision-making, and subsequently inform the drafting of the UK's implementing legislation in 2008. The consultation document is accompanied by a consultation Impact Assessment which outlines the indicative costs and benefits of different options for implementation. Stakeholder responses will inform the production of a full Impact Assessment, to be published alongside the Government's response to the consultation in spring 2008.

1.17 The interpretation of the Directive presented in this consultation document constitutes an initial view, and will be subject to further detailed analysis in the transposition process. The interpretation of specific provisions within the Directive will ultimately be for the Courts.

IV. OUTLINE OF OVERALL APPROACH TO IMPLEMENTATION OF THE DIRECTIVE

1.18 It is Government policy that European Directives should be transposed into UK law in order to achieve the objectives of the agreed measure on time and in accordance with other UK policy goals, including minimising the burdens on business[3]. The Government's approach to implementation of the PSD will be guided by risk-based considerations, proportionality and workability, and developed through a process of ongoing, inclusive and open stakeholder engagement.

1.19 The competent authority for most aspects of the PSD will be the Financial Service Authority (FSA). However, other bodies will also have roles. Namely:

- HM Revenue and Customs (HMRC) will retain responsibility for the anti-money laundering supervision of money service businesses, and will additionally be responsible for the anti-money laundering supervision of mobile phone operators and bill payment service providers, which will fall into the scope of the Third Money Laundering Directive due to the PSD;
- the Office of Fair Trading (OFT) will be responsible for the implementation of Article 28 (access to payment systems), which has a competition objective; and
- the Financial Ombudsmen Service (FOS) will provide the out-of-court redress mechanism envisaged in Article 83 of the PSD.

[3] *Transposition Guide, Better Regulation Executive*, Department for Business, Enterprise & Regulatory Reform, 2007

Risk-based considerations

1.20 The PSD introduces a prudential authorisation regime for larger non-credit or e-money institutions (Title II of the Directive). This regime has the dual function of opening up current EU payments market to fresh competition, balanced with ensuring the financial soundness of new providers and enhancing customer protection. Smaller payment institutions (and potentially their agents and branches) will need to be registered under the PSD, as will the agents and branches of authorised firms. There is a degree of uncertainty over whether all domestic branches will need to be registered. This will need to be explored in transposition. HM Treasury aims to ensure that the regime created will accommodate the different levels and types of risks faced by payment institutions, and honour the broader Lisbon objective of encouraging providers to set up within the EU.

1.21 Like other EU Member States, the UK has the right to exercise certain regulatory flexibilities in implementing Title II of the Directive. These include: discretion in the implementation of ongoing capital requirements; safeguarding requirements for user funds; and waiving Title II provisions for providers whose total payment transactions do not exceed €3 million per month (referred to as 'registered' payment institutions), and which only intend to provide services domestically.

1.22 The Government intends to take advantage of derogations which enable competent authorities to take a risk-based approach to the prudential regulation of payments institutions, and allow firms to continue addressing their financial and operational risks through existing systems and controls.

Proportionality

1.23 The principle of proportionality which underpins the risk-based prudential regime for payment institutions also extends to the conduct of business rules. The Government will seek to avoid information overload for end-users, while ensuring they have sufficient information to exercise an informed choice. In particular, where there is no consistent and proven supply-side failure in information provision and in order not to adversely affect innovation in payment services, payment service providers should be able to choose the most cost-effective way of adhering to the Directive's transparency rules.

1.24 The Government therefore intends to take advantage of derogations in the PSD which promote regulatory proportionality, so long as this is not to the detriment of to the consumer.

Consistency and avoidance of unintended consequences

1.25 The consistent interpretation of PSD conduct of business rules throughout the EU is crucial to creating a truly integrated Single Market in payment services. Differences in Member States' interpretation of the PSD could prevent firms from reaping its benefits. HM Treasury will therefore liaise closely with industry and other EU Member States to ensure a consistent approach to interpretation. Where necessary, the Government will also consider how PSD implementation will fit with other legislative provisions which place requirements on payment service providers, for example consumer credit legislation.

1.26 Since the PSD conduct of business rules apply to all payment service providers, the Government's intended approach is to ensure the rules are sensitive to different business models, especially where such models have delivered benefits to end-users. In particular, providers should be able to exercise commercial discretion and provide end-users with better conditions than those in the Directive. Notably, the PSD expressly permits payment service providers always to better the PSD requirements for their customers.

Engagement

1.27 This consultation document has already been informed by discussions over the last 18 months with representatives of payment service providers and end-users. Firms, individuals and corporations now have the opportunity to respond formally to the Government's suggested approach to PSD implementation in the UK.

1.28 Throughout the implementation process, HM Treasury will continue to engage with industry, consumer and business groups on issues raised by the PSD. HM Treasury will also participate fully in the PSD transposition work convened by the European Commission, working alongside other EU Member States in order to ensure a consistent interpretation of the Directive's requirements.

V. IMPLEMENTATION TIMELINE

1.29 The deadline for implementing the PSD is 1 November 2009. The Government intends to lay the necessary legislation before Parliament before the end of 2008, in order to allow businesses time to adjust to the PSD requirements before this deadline when the legislation comes into force.

1.30 The next steps in the process of implementation are:

- following the policy consultation period, HM Treasury will publish a summary of responses and a revised Impact Assessment in spring 2008;
- draft UK implementation legislation (the form of which is currently under consideration) will be published by summer 2008, accompanied by further consultation material; and
- final legislation will be laid before Parliament by end-2008, in order to ensure that UK providers have time to adapt procedures and systems before the implementation deadline.

VI. DEVOLVED ADMINISTRATIONS

1.31 The proposed implementation of the Payment Services Directive will need to take into account differences in legal systems and regulatory frameworks in England, Wales, Scotland and Northern Ireland. The Government would welcome any observations on this issue in respect of each consultation question in this document.

VII. HOW TO RESPOND

1.32 HM Treasury invites comments on the policy proposals for implementing the PSD. Specific questions are included in subsequent chapters of this document, and a full set of questions is listed in Annex A. Respondents are, of course, free to frame their responses and input as they see fit.

1.33 This consultation document forms part of a wider process of discussion and engagement with stakeholders, which will continue throughout the implementation process. The Treasury is happy to try to accommodate requests to explain its proposals or to listen to specific proposals.

1.34 The Government welcomes the views of all stakeholders on the issues raised in this document. The consultation period begins with the publication of this document, and will run for 12 weeks plus an additional week for the winter break. Please ensure that your response reaches us by 18 March 2008.

1.35 Comments should be sent to:

Payment Services Directive Consultation
Payments and Inclusion team (Room 3/20)
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

E-mail: PSDconsultation@hm-treasury.x.gsi.gov.uk

1.36 If you have a specific query about this consultation document, please contact: angela.vanderlem@hm-treasury.gsi.gov.uk or meenakhi.borooah@hm-treasury.gsi.gov.uk.

1.37 This document can also be found on the HM Treasury website: www.hm-treasury.gov.uk

1.38 Hard copies are available on request from:

Payment Services Directive Consultation
Payments and Inclusion team (Room 3/20)
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

1.39 When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

VIII. CONFIDENTIALITY OF RESPONSES TO THIS CONSULTATION

1.40 Written responses will be made public on HM Treasury's website, unless the author specifically requests otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response. If you wish part, but not all, of your response to remain confidential, please supply two versions; one for publication on the website with the confidential information deleted, and a second confidential version for the Payments and Inclusion team only. Furthermore, since the FSA has been identified as the competent authority for most aspects of the Payments Services Directive, unless the author specifically requests otherwise, consultation responses will be shared with the FSA for the purpose of analysis.

1.41 Even where confidentiality is requested, if a request for disclosure of the consultation response is made in accordance with freedom of information legislation, and the response is not covered by one of the exemptions in the legislation, the Government may have to disclose the response in whole or part.

1.42 Any Freedom of Information Act queries should be directed to:

Correspondence and Enquiry Unit
Freedom of Information Section
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

Telephone: +44 (0) 207 270 4558

Fax: +44 (0) 207 270 4681

Email: public.enquiries@hm-treasury.x.gsi.gov.uk

2 Scope and Definitions

2.1 The Payment Services Directive (PSD) is divided into 6 sections or Titles. The entire final text can be found at the following website http://eur-lex.europa.eu/LexUriServ/site/en/oj/2007/l_319/l_31920071205en00010036.pdf. Title I and the Annex to the PSD set out the subject-matter of the Directive, the types of payment service provider and payment service activities covered, and the definition of relevant terms.

2.2 This Chapter of the consultation document covers Articles 1-4 and 29 of the text as well as the Annex, and sets out:

I. the existing regulatory regime for payment service providers in the UK;

II. the regulatory changes introduced by the PSD;

III. the intended scope of the Directive: providers and activities;

IV. the intended negative scope of the Directive;

V. issues related to some of the definitions used in the Directive; and

VI. the policy options open to Member States in relation to scope.

I. EXISTING REGULATORY REGIME FOR PAYMENT SERVICES PROVIDERS IN THE UK

2.3 Credit institutions and electronic money (e-money) issuers provide payment services as a fundamental part of their business. They are currently prudentially regulated through the Banking Consolidation Directive and the E-Money Directive, respectively. Many of the conduct of business rules for payment services performed by credit institutions are detailed in the self-regulatory Banking Code, to which banks, building societies and credit card issuers voluntarily subscribe. Compliance with the code is monitored by the Banking Code Standards Board (BCSB). It is expected that the Banking Code will be revised in light of PSD implementation.

2.4 For e-money issuers, the Financial Services Authority's (FSA) Electronic Money sourcebook contains some conduct of business rules which govern, amongst other things, redemption conditions, information requirements and purse limits.

2.5 Businesses such as money transfer operators, bill payment service providers and mobile phone companies are not currently subject to prudential regulation and are subject to minimal conduct of business regulation. Some sectors (such as the money transfer industry) have, however, formed trade associations and drawn up voluntary conduct of business standards for their members.

2.6 Alongside their core payment service offerings, non-credit or e-money institution credit card issuers and some money transfer operators currently extend credit lines to their customers. Broadly speaking, all businesses that lend money to consumers are licensed by the Office of Fair Trading (OFT) under its consumer credit regime. More generally, all payment service providers are subject to other pieces of consumer protection legislation, to the extent that they operate distance-selling contracts, or if the provider issues a standard service contract to their customers.

2.7 Money transfer operators are currently supervised by HM Revenue and Customs (HMRC) for compliance with the Money Laundering Regulations. This supervisory regime is aimed at ensuring compliance with those Regulations, rather than regulating the provision of payment services.

II. PSD REGULATORY CHANGES

The authorisation regime and registration

2.8 The PSD creates a harmonised legal framework for the provision of payment services across all EU Member States. The main objective of the new regulatory framework is to promote competition, efficiency and innovation in payment services, balanced with ensuring suitable customer protection.

2.9 Alongside credit institutions and e-money issuers, the PSD identifies another category of payment service provider, which it refers to as **payment institutions.** Payment institutions – which in the current UK payments market include firms such as money transfer operators, bill payment service providers, non-credit or e-money institution credit card issuers and mobile phone operators – will be authorised to provide the payment services listed within the Annex of the Directive.

2.10 The PSD introduces a **prudential authorisation or licensing regime** for payment institutions which:

- execute more than €3 million payment transactions a month, or
- wish to passport their services into one or more EU Member States other than the Member State in which they obtained the licence.

2.11 Institutions matching these criteria will need to apply for full authorisation as a payment institution. Some of the authorisation requirements differentiate between the types of services provided by payment institutions, and also takes into account whether payment institutions operate any non-payment service businesses alongside the provision of payment services.

2.12 By way of derogation, the PSD also introduces a **registration regime** for payment institutions that:

- execute less than €3 million worth of payment transactions a month, and whose management has no convictions for financial crime; and
- do not wish to passport their services in other EU Member States.

2.13 The registration regime is at the discretion of individual Member States, which may or may not exercise the derogation to create such a regime. The registration regime is designed to be less demanding than full authorisation, and to cater for smaller firms that operate lower volumes of payment services. If the derogation is exercised, such firms could be exempt from the capital and safeguarding requirements in the PSD discussed in Chapter 3 of this consultation document. Registered firms may only provide payment services domestically (i.e. within their Member State of registration). Firms operating below the €3 million threshold which wish to expand their operations to other EU Member States would, therefore, be required also to apply for full authorisation as a payment institution. All registered payment institutions must abide by the PSD conduct of business rules in Titles III and IV. The PSD also requires all payment institutions (and their agents and branches) to be entered on a public register identifying the payment services they undertake.

Access to payment systems

2.14 Article 28 introduces a separate requirement on access to payment systems. This stipulates that the rules governing access to payment systems should be fair and non-discriminatory. The scope and intention of this provision are further discussed in Chapter 4.

Conduct of business rules

2.15 In addition to the authorisation and registration regime, the PSD introduces harmonised conduct of business rules for all providers of payment services. Title III of the Directive provides rules on the transparency of conditions and information requirements for payment services. These include provisions on, for instance:

- the information to be provided to customers prior to the execution of a payment transaction;
- information accompanying a payment transaction; and
- the ways in which changes to payment service contracts must be communicated to customers.

2.16 The depth of information that firms need to provide varies with, for example, whether the payment concerned is a one-off transaction, part of a series of transactions performed by a provider within a long-term contract, or involves a currency conversion.

2.17 Title IV of the Directive sets out the **rights and obligations** of all payment service providers and their end-users. Provisions include:

- provider responsibilities for executing payment transactions;
- the liability of both providers and users for unauthorised payment transactions;
- conditions surrounding the refund of transactions; and
- complaints and redress procedures.

2.18 There is a wide degree of overlap between the conduct of business rules under the PSD and the conduct of business standards set out in the Banking Code. The Government would, however, expect the Code to be revised in the future, in light of the legislation on the PSD.

2.19 Service providers that issue credit cards or offer a credit line ancillary to their payment services, will remain subject to existing consumer credit legislation on conduct of business (enforced by the OFT), in addition to the new PSD conduct of business rules.

2.20 As indicated earlier, some payment service providers are currently subject to a variety of consumer protection legislation. These include the Distance Marketing Regulations (DMR) and the Unfair Terms in Consumer Contracts Regulations. These general consumer protection rules, which apply to many different types of consumer situations, including the consumption of payment services, will in future co-exist alongside PSD conduct of business rules, which will only apply to payment services. The PSD specifically provides for cases in which a payment service provider has obligations under the DMR and overlapping obligations under the PSD, such that any duplication is avoided.

2.21 The detailed requirements of the PSD's conduct of business rules, in Title III and IV of the Directive text, are discussed further in Chapter 5.

III. SCOPE OF THE PSD

Payment service providers

2.22 There are six categories of provider covered by the Directive:

- payment institutions;
- credit institutions;
- e-money issuers;
- Post Office Giro Institutions;
- central banks when not acting as a monetary or other public authority; and
- Member States/regional/local authorities when not acting as public authorities.

Payment institutions

2.23 Payment institutions include:

a) Authorised payment institutions: these include the larger money transfer operators, bill payment service providers, mobile phone companies, non-credit or e-money institution credit card issuers, and other businesses which operate a mixture of these services, as well as firms that provide payment services alongside their non-payment business. Authorised payment institutions will be subject to the full prudential requirements under Title II of the PSD, in addition to the conduct of business rules in Titles III and IV. Initial estimates are that around 65 firms in the UK may need to be authorised as payment institutions. In the UK it is estimated that up to 175,000 agents of principally the larger authorised payment institutions could need to be registered. The Government would like to hear from any firms which believe they might need to obtain authorisation, and have yet to engage with HM Treasury on the PSD.

b) Registered payment institutions: these differ from authorised payment institutions in that they operate on a smaller scale (less than a €3 million transaction value on average per month) and may have business models aimed at a localised/niche market of users. Registered payment institutions will, on exercise of the waiver, be subject to fewer prudential requirements than authorised payment institutions. They will, however, still be subject to the conduct of business rules in Titles III and IV. Initial estimates are that around 2,700 firms in the UK, the majority of which are money remitters, will need to be registered as payment institutions. The Government would like to hear from firms that expect to seek registration, especially those which provide payment services other than money remittance. The Government is currently considering whether information on the agents of registered payment institutions may also need to be provided to the competent authority. If so, their names will appear on a publicly available register.

Consultation questions

1. Do you think you will need to obtain authorisation as a payment institution, or would you qualify for the waiver, enabling you to register only?
2. What types of payment services do you provide?
3. How many agents and branches do you have?

Credit institutions

2.24 Credit institutions include both banks and building societies. There are currently 322 banks and 61 building societies in the UK. Credit institutions will be subject to the conduct of business rules in Titles III and IV of the PSD.

E-money issuers

2.25 These are defined as those electronic money institutions that fall within the meaning of Article 1 (3)(a) of the E-money Directive (EMD). There are currently 13 authorised e-money issuers in the UK and 12 credit institutions with permission to issue e-money. A further 39 businesses are waived from the requirements of the EMD and hold "a small e-money issuer" certificate. All e-money issuers, whether authorised or waived, will be subject to the conduct of business rules in Titles III and IV of the PSD. As many e-money issuers perform payment services, the existing activities of such firms will straddle both the EMD and PSD regimes. While the EMD governs the issuing of e-money, it does not regulate the distribution of e-money.

Post Office Giro Institutions

2.26 The PSD conduct of business rules established in Titles III and IV of the Directive will apply to the payment service activities of a third category payment service provider, known as post office giro institutions. The legal definition of the post office giro institution category in the PSD in relation to the status of the Post Office Limited in the UK is currently under consideration.

Central banks when not acting as a monetary or other public authority

2.27 The PSD conduct of business rules will apply to payment services provided by the Bank of England only when it is not acting in its capacity as a monetary authority or other public capacity.

Member States/regional/local authorities when not acting as public authorities

2.28 The PSD conduct of business rules will apply to payment services provided by central and local government authorities when they are not acting as public authorities.

2.29 As is clear from the above, all six categories of payment service provider may provide the payment services listed in the Annex of the Directive, and all must adhere to the conduct of business rules in Titles III and IV. Article 29 of the Directive prohibits

natural or legal persons that are neither payment service providers nor explicitly excluded from scope of the Directive, from providing payment services.

Payment service activities covered by the PSD

2.30 The payment services in scope of the PSD are set out in the Annex to the Directive, as provided by Article 4(3), and are reproduced in Box 2.1, along with an indication – subject to transposition – of the types of activity which Article 4(3) and the Annex might be interpreted as including.

Box 2.1: Payment Services in scope of the PSD – Initial reading of the Annex

ANNEX	**Initial reading of activities (subject to transposition)**
1) Services enabling cash to be placed on a payment account as well as all the operations required for operating a payment account.	• current accounts • e-money accounts
2) Services enabling cash withdrawals from a payment account as well as all the operations required for operating a payment account.	• current accounts • e-money accounts
3) Execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider: • execution of direct debits, including one-off direct debits, • execution of payment transactions through a payment card or a similar device, • execution of credit transfers, including standing orders.	• current accounts • e-money accounts • some models of bill payment service
Execution of payment transactions where the funds are covered by a credit line for a payment service user: • execution of direct debits, including one-off direct debits, • execution of payment transactions through a payment card or a similar device, • execution of credit transfers, including standing orders.	• current accounts • businesses operating with a consumer credit licence
4) Issuing and/or acquiring of payment instruments.	• card issuing and card merchant acquiring services (rather than merchants themselves)
5) Money remittance.	• money transfer/remittances • some models of bill payment service
6) Execution of payment transactions where the consent of the payer to execute a payment transaction is given by means of any telecommunication, digital or IT device and the payment is made to the telecommunication, IT system or network operator, acting only as an intermediary between the payment service user and the supplier of the goods and services.	• mobile phone payments

Consultation question

4. Do you agree with the suggested interpretation of payment service activities covered by the PSD annex?

2.31 Article 2 states that the Directive applies to payment services provided within the Community. With the exception of the provision in Article 73 of the PSD on value dating, the conduct of business rules will apply only to intra-EU payment transactions.

2.32 The conduct of business rules will only apply where the sole payment service provider in a payment transaction is, or both the payer's payment service provider and the payee's payment service provider are, located in the EU, thereby capturing so-called "two legs in" transactions. However, the provisions on value dating in Article 73 also apply to payment transactions going out of the EU or coming into the EU from a third country, capturing "one leg in" transactions. This raises the question of what "location" means, and how Article 73 should apply to non intra-EU/"one leg out" payment transactions. The issue of location and its meaning will be considered further in the transposition groups.

Currencies

2.33 Article 2 also stipulates that the conduct of business rules in Titles III and IV should only apply to payment services offered in euro or in any other official currency of one of the EU Member States. Titles III and IV conduct of business rules do not, therefore, apply to payment transactions denominated in non-EU currencies, apart from the value dating provision in Article 73, which according to Article 68(2) is not at the disposal of the parties.

IV. NEGATIVE SCOPE

2.34 Article 3 sets out those services and transactions to which the Directive will not apply. In general, the distinction between the firms and services caught in and out of scope of the Directive centres on whether the activity in question relates to the provision of payment services to customers, including small businesses and corporate entities. The intended approach is to cover the interface between providers and end-users from the latter's point of view, rather than to govern the underlying technical or other workings which facilitate the delivery of the payment service. The issue of whether the firm in question acts exclusively as an intermediary to settle the debtor-creditor relationship between two parties through a transfer of funds is also relevant.

2.35 Broadly, there are four principles which separate those firms and activities in positive scope of the directive from those in negative scope. These concern:

- the focus on electronic as opposed to paper-based payments;
- the provider-user relationship;
- the possession of client funds; and
- whether the provider acts exclusively as an intermediary.

Electronic payments

2.36 As the Directive focuses on resolving market issues relating to electronic payments, and given that the provisions of the Directive will supersede existing European legislation on electronic payments, non-electronic payment service providers and transactions are not covered by the Directive. These include, for example:

- cash handling or transportation,
- money exchange businesses,
- cash-back services offered by retailers, and
- other paper-based payment methods such as cheques, bankers' drafts, travellers' cheques and postal orders.

2.37 The PSD does, however, capture cash deposits and withdrawals, such as a cash deposit made at a bank branch, where there is an electronic component to the transaction.

2.38 The relevant provisions of the Directive are Article 3 (a) and (c) to (g).

Provider-user relationship

2.39 Apart from Article 28 on access to payment systems, the PSD primarily addresses the competitive and contractual space between the payment service provider and the end-user. The PSD provisions are concerned with the result of the service for the end-user, rather than how payment service providers operate among themselves to deliver the payment to the end-user.

2.40 By virtue of this, the Directive does not cover the intra-payment service provider space (e.g. internal treasury operations) or the inter-payment service provider space, which can cover inter-bank settlement, securities settlement systems and the clearing and settlement arrangements between different divisions within one payment service provider.

2.41 The relevant provisions of the Directive are Article 3 (h), (i), (m) and (n).

Possession of user funds

2.42 Title II of the Directive introduces prudential requirements for payment institutions. Recital 11 of the Directive indicates that the purpose of these requirements is to help payment institutions establish suitable financial and operational risk management conditions which allow them to accept and protect funds received from end-users, and to use such funds exclusively for the purposes of performing payment services.

2.43 While some firms that currently operate in the UK may provide payment services in the general sense of the term, a closer examination of their business models places them outside the intended scope of the Directive.

2.44 Independent ATM operators, for example, dispense funds to customers; they do not, however, typically accept funds from customers and/or hold such funds in payment accounts. Crucially, the funds dispensed by such operators belong to the operators themselves and are dispensed at their own risk since they rely on the customer's card issuing provider – often a credit institution – reimbursing the funds dispensed once the cash withdrawal has taken place. The independent ATM operator in this instance simply provides a physical unit from which a customer can access cash, without entering into possession of the customers' own funds.

2.45 Services provided by technical and infrastructure facilitators, such as IT and communication networks, data processing, storage and authentication, all of which support the provision of payment services but are effectively invisible to the end-user,

are also outside the scope of the PSD. For example, mobile phone top-up services provided through cash machine terminals are not caught by the Directive. This is because the terminal, linked to the ATM communication network, is purely providing mobile phone voice service providers with an additional channel through which they can sell airtime to customers. The payment for the purchase of such airtime is not made to the ATM terminal or provider, but through a debit from the customers' account to credit the mobile phone provider, via direct debit or a card payment.

2.46 The relevant provisions of the Directive are Article 3(b), (j) and (o).

Acting exclusively as an intermediary

2.47 There are two distinct but related elements of this principle. Firstly, if a payment service provider facilitates the transfer of funds between a customer and a third party in payment for a good or service, but at the same time by virtue of the nature of the good or service and/or how it must be consumed adds value to the good or service being paid for, then the payment transaction is out of scope of the Directive. If, on the other hand, a payment service provider does not add value to the good or service being paid for, and is purely an intermediary between the payer and the provider of the goods or services, then the payment service provider is in scope of the Directive. The Directive is intended to regulate payment service providers whose main activity consists in the provision of payment services to users, rather than firms which provide those goods and services directly.

2.48 The second element concerns the negotiability of the instrument issued by the payment service provider. If the payment instrument issued can only be used either to acquire goods or services in the premises used by the issuer, or under a commercial agreement with the issuer within a limited network of service providers or for a limited range of goods and services, then the issuing payment service provider is not acting solely as an intermediary, but restricting the environment in which the payment instrument it issues can be used. Such services, which may include store cards or canteen cards, are out of scope of the Directive.

2.49 The relevant provisions of the Directive are Article 3(k) and (l).

Consultation question

5. Do you agree with the interpretation of negative scope? Are you aware of activities or business models that might unintentionally fall within scope of the PSD?

V. DEFINITIONS

2.50 Article 4 contains the definitions of terms used within the Directive. Issues already raised on these definitions by stakeholders, are discussed below.

Payment accounts (Article 4 (14))

2.51 The definition of a "payment account" is very broad and does not clearly distinguish between different types of account such as current and savings accounts. Also relevant is Article 16(2), which provides that a payment institution may only hold payment accounts used exclusively for payment transactions. These provisions could be interpreted as implying a wide definition of a payment account which covers all types of accounts (including savings accounts). The conduct of business provisions would then apply to transactions made to and from, say, a savings account held with a bank. However, a payment institution would not be able to provide a savings account on the basis that an account with a savings element would not be used exclusively for payment transactions. As this practical task of determining what is meant by the

reference to payment accounts used exclusively for payment transactions is complicated, we intend to raise this matter for discussion in transposition. The Government considers that the definition of payment account should be strictly related to the objective of regulating payment services.

Money remittance (Article 4 (13))

2.52 Money remittance is defined under the PSD as a service whereby funds are received from a payer without any payment accounts being created in the name of the payer or payee, for the sole purpose of transferring a corresponding amount to the payee or to another payment service provider acting on behalf of the payee. As explained in PSD Recital 7, money remittance can incorporate the provision of bill payment services, unless the competent authority considers the activity to fall under another payment service activity in scope of the PSD. The intention of Recital 7 and the way in which bill payment service providers will be treated under the PSD will be considered further in transposition.

Micro-enterprise (Article 4(26))

2.53 Micro-enterprises are defined in Recommendations 2003/361/EC as businesses that have a turnover of less than €2 million per year and nine or fewer employees.

2.54 This is important in the context of Titles III and IV of the Directive, where the UK may exercise a derogation to require that providers apply the conduct of business rules to micro-enterprises in the same way as to consumers. The definition will also have ramifications for which businesses have access to the out of court redress procedures for disputes between payment service users and their providers arising from the rights and obligations of the Directive, discussed further in Chapter 5.

2.55 Subject to any other issues being raised, the Government intends to transpose the definitions in Article 4 of the Directive unchanged into UK law.

Consultation question

6. Are there any concerns or issues you would wish to raise with respect to the interpretation of any definitions in the Directive?

VI. POLICY OPTIONS

2.56 Article 2(3) of the Directive allows Member States to exercise a derogation to waive all or parts of the Directive for certain institutions. These include:

- the National Savings Bank;
- the Commonwealth Development Finance Company Limited;
- the Agricultural Mortgage Corporation Limited;
- the Scottish Agricultural Securities Corporation Limited;
- the Crown Agents for overseas governments and administrations;
- credit unions; and
- municipal banks.

2.57 This derogation mirrors a parallel derogation in the Capital Requirements Directive (CRD). It may not be of relevance to all the institutions named above, some of which are not providers of payment services in the UK, and while others may not be

undertaking payment services at all, as defined by the scope of the Directive. For UK credit unions, this derogation is an important and useful provision, as is detailed in the next section.

Consultation question

7. Are there reasons to exempt any of the following institutions from all or part of the PSD: the National Savings Bank, the Commonwealth Development Finance Company Limited, the Agricultural Mortgage Corporation Limited, the Scottish Agricultural Securities Corporation Limited, Crown Agents for overseas governments and administrations, and municipal banks?

Credit unions

2.58 In the revised Regulatory Impact Assessment of the PSD published last December, the Government confirmed that it would continue its efforts to seek an exemption for credit unions from the PSD. This was because the cost of complying with the Directive would be excessive for credit unions, and could even lead to closures. As many credit unions provide basic banking services to the financially excluded, closures could generate significant social costs, impact negatively on the Government's financial inclusion agenda and reduce the availability of affordable credit.

2.59 The UK successfully secured the waiver provision for credit unions in the PSD. The question remains, however, as to whether credit unions should gain a partial or total exemption from the Directive.

2.60 As credit unions are already exempt from the prudential requirements of the CRD, it would be consistent also to exempt them from the Title II prudential requirements of the PSD. However, credit unions would also not be able to comply with many aspects of the PSD conduct of business rules in Titles III and IV, particularly those pertaining to execution times and value dating. As many credit unions are only staffed for part of the week, payments are typically not processed on a daily basis. Credit unions also rely on weekly or monthly statements from banks, which set out the inward payments that have been made to the credit union's pooled account before monies are segregated among members. Credit union members are generally well aware of these delays, and continue to use this type of payment service for reasons other than fast payments processing.

2.61 The Government's policy aim is to avoid constraining the ability of credit unions to offer payment services to their members, while maintaining the redress protection that members are currently afforded through the Financial Ombudsman Service (FOS). The Government will continue to engage with the credit union movement on financial services legislation, especially in the light of any changes to credit union business models, to ensure that the regulatory approach towards the sector remains proportionate, risk-based and workable.

2.62 In conclusion, the Government intends to exempt credit unions from the entirety of the PSD provisions, but would welcome views.

Consultation question

8. Do you agree that credit unions should be exempt from all of the PSD?

3 The Prudential Regime - Title II

3.1 Title II of the Directive establishes the legal requirements for authorisation of payment institutions. This Title also establishes the minimum registration requirements for firms eligible to be waived from all or part of the prudential authorisation regime.

3.2 This Chapter of the consultation, covering Articles 5-27 of the Directive, sets out:

I. the objectives of Title II;

II. an overview of the Title II requirements;

III. the intended overarching approach to supervision of Title II;

IV. the responsibilities of firms seeking authorisation or registration;

V. the role and powers of the competent authority; and

VI. policy options permitted under Title II.

3.3 As Title II only applies to payment, the Government would particularly welcome responses to this section of the consultation from those in the scope of this Title and the users of such services.

I. Objectives of Title II

3.4 The authorisation requirements are designed to enable payment institutions to passport throughout the EU on the basis of authorisation in their home Member State. During the negotiations, some Member States expressed concerns that the operational failure of payment institutions might have adverse consequences for financial stability. The inclusion of capital requirements was seen as a means of mitigating this concern.

3.5 The Government's position is that a more proportionate approach to mitigating the risks posed by payment institutions, which are substantially different from those posed by credit institutions and e-money issuers, would comprise qualitative requirements and safeguarding measures for user funds. In order to ensure that UK providers could take full advantage of the passporting element of Title II and operate in other EU Member States, the Government agreed to a broadly harmonising prudential licensing regime, recognised by all other EU Member States and containing a degree of discretion for the competent authority in managing the risks generated by payment institutions.

3.6 In implementing Title II provisions, the Government intends to recognise that payment institutions engage in more specialised and restricted activities than credit institutions and e-money issuers. This will help ensure that the regime maintains financial soundness and consumer protection, while continuing to promote competition.

II. Overview of the Title II requirements

3.7 The authorisation requirements of Title II apply to payment institutions that:

- execute more than €3 million worth of payment transactions a month, or
- wish to sell or "passport" their services into one or more EU Member States other than the Member State in which they are authorised.

3.8 For firms applying for authorisation as a payment institution, Title II establishes the PSD rules on:

a) Applications: Article 5 contains a comprehensive check list of information that firms must provide in their application for authorisation, including initial capital requirements and evidence that management is of good repute and possesses appropriate knowledge and experience, and that there are measures to safeguard payment service users' funds;

b) Capital and own funds: Articles 6-8 provide information on the different levels of initial capital – varying according to type of activity – that firms must possess when applying for authorisation, and the three methods for measuring ongoing capital from which competent authorities can choose when deterimining the amount of own funds that a firm must hold at all times;

c) Safeguarding / Ringfencing: Article 9 stipulates the methods by which payment institutions must safeguard user funds from other business activities undertaken by the payment service provider, such that they are insulated in the event of an insolvency;

d) Maintenance of authorisation: Article 14 mandates that the authorised payment institution must inform the competent authority of its home member state without undue delay, if there are changes to the information it previously provided under Article 5;

e) Accounting and statutory audit: Article 15 stipulates the statutory accounting practices expected of authorised payment institutions, and the separation of information on the payments business from other business activities the firm may undertake. In particular, it requires that authorised payment institutions submit their annual accounts to the competent authority on an annual basis;

f) Activities: Article 16 provides a list of activities that authorised payment institutions are allowed to undertake, in addition to payment services. The Article also outlines the conditions under which payment institutions may grant credit;

g) Use of agents and outsourcing: Article 17 requires payment institutions to communicate information to the competent authority regarding their use of agents, or any intention to outsource the operational functions of their payment business. The competent authority must then register such agents;

h) Liability: Article 18 states that payment institutions will remain fully liable for acts of their employees, agents, branches or outsourced entities;

i) Record keeping: Article 19 requires payment institutions to keep all appropriate records for the purposes of Title II for at least five years; and

j) Right to passport: Article 25 stipulates that an authorised payment institution wishing to passport for the first time into an EU Member State other than its home member state must inform the competent authorities in its home Member State.

3.9 For the competent authorities administering and supervising the PSD prudential regime, Title II establishes the expected supervisory procedures for:

a) Authorisation: Article 10 details the terms under which a competent authority should grant or refuse authorisation to firms. Authorisation must only be granted to a legal person established in a Member State;

b) Communications of decision on application: Article 11 sets down the timeframe and manner in which the competent authority must inform the applicant firm of its decision to grant or refuse authorisation;

c) Withdrawal of authorisation: Article 12 provides a list of scenarios under which the competent authority may exercise the right to withdraw an authorisation already issued to a payment institution, and the manner in which such withdrawals shall be communicated;

d) Registration: Article 13 stipulates that Member States must establish a public register of authorised payment institutions, their agents and branches, and those smaller providers which are waived from the full authorisation requirements (and, potentially their agents);

e) Ongoing supervision: Article 21 specifies the steps that competent authorities may take to ensure payment institutions' compliance with Title II;

f) Exchange of information: Article 24 sets out the obligation of competent authorities in different Member States to co-operate with each other and with other public authorities; and

g) Right to passport: Article 25 sets out the home/host responsibilities of competent authorities for passporting firms.

III. OVERARCHING APPROACH TO SUPERVISION OF TITLE II

3.10 HM Treasury favours a proportionate and risk-based approach to the PSD Title II regime, and the FSA will apply its general risk and principles-based approach when supervising the Title II licensing requirements. This should ensure that the rules do not create unnecessary barriers to entry, keep sound payment institutions out of the market, or cause payment service providers to leave the market altogether.

3.11 To deliver a proportionate and risk-based approach, the Government intends to make use of any powers or derogations in Title II which allow the regulatory burdens on firms to be minimised or simplified without reducing the benefits for customers. In policy terms, the Government will seek to avoid going beyond the minimum provisions necessary to comply with the Directive, unless exceptional circumstances arise and unless UK payment market participants can present a rigorous cost-benefit justification for doing so.

Proportionality

3.12 In broad terms, Title II must not generate such a high regulatory burden so as to force firms either to withdraw certain services, or to operate outside the legal framework.

3.13 The Government has always maintained that reliance on sound internal procedures and safeguarding requirements is a more proportionate way of managing the types of risk posed by payment institutions than capital requirements. However, the existence of harmonised capital adequacy rules in Title II suggests that the Government, together with providers and users, needs carefully to examine some of the

flexibilities afforded to Member States within the safeguarding or ring-fencing provisions.

Risk-based considerations

3.14 The PSD acknowledges that payment institutions typically engage in specialised activities, and tend to generate risks that are narrower or easier to monitor than those arising from the more varied activities undertaken by credit institutions.

3.15 A firm's right to authorisation is determined not only by the capital requirements and safeguarding measures of Title II, but also by its ability to meet a wide range of qualitative requirements. These include robust governance arrangements, effective risk management procedures and internal control mechanisms.

IV. THE RESPONSIBILITIES OF FIRMS SEEKING FULL AUTHORISATION

3.16 This section discusses the key requirements for firms wishing to obtain authorisation as a payment institution.

Application for authorisation

3.17 Firms wishing to obtain authorisation as a payment institution must submit an application to their home state competent authority. The information required for authorisation is set out in Box 3.1.

Box 3.1: Applications for authorisation (Article 5)

For authorisation as a payment institution, an application shall be submitted to the competent authorities of the home Member State, together with the following:

(a) a programme of operations, setting out in particular the type of payment services envisaged;

(b) a business plan including a forecast budget calculation for the first three financial years which demonstrates that the applicant is able to employ the appropriate and proportionate systems, resources and procedures to operate soundly;

(c) evidence that the payment institution has the amount of initial capital mentioned in Article 6;

(d) for the payment institutions mentioned in the first subparagraph of Article 9(1), a description of the measures taken for safeguarding payment service users' funds in accordance with Article 9;

(e) a description of the applicant's governance arrangements and internal control mechanisms, including administrative, risk management and accounting procedures, which demonstrates that these governance arrangements, control mechanisms and procedures are proportionate, appropriate, sound and adequate;

(f) a description of the internal control mechanisms which the applicant has established in order to comply with obligations in relation to money laundering and terrorist financing under Directive 2005/60/EC and Regulation 1781/2006 EC;

(g) a description of the applicant's structural organisation and, including, where applicable, a description of the intended use of branches and agents and a description of outsourcing arrangements, and of its participation in a national or international payment system;

(h) the identity of persons holding in the applicant, directly or indirectly, qualifying holdings within the meaning of Article 4(11) of Directive 2006/48/EC, and the size of their effective holding and evidence of their suitability taking account the need to ensure the sound and prudent management of a payment institution;

(i) the identity of directors and persons responsible for the management of the payment institution and, where relevant, persons responsible for the management of the payment services activities of the payment institution, as well as evidence that they are of good repute and possess appropriate knowledge and experience to perform payment services as determined by the home Member State of the payment institution;

(j) where applicable, the identity of statutory auditors and audit firms as defined in Directive 2006/43/EC;

(k) the applicant's legal status and the articles of association;

(l) the address of the head office.

For the purposes of paragraph 1 point (d), (e) and (g), the applicant shall provide a description of its audit arrangements and the organisational arrangements it has set up with a view to taking all reasonable steps to protect the interests of its users and to ensure continuity and reliability in the performance of payment services.

3.18 The Government intends to transpose Article 5 unchanged, but would welcome views on issues on which providers would like further clarification or guidance.

Capital requirements

Initial capital requirements

3.19 Applicants need to show evidence in their application that they hold a certain amount of initial capital comprised of the items defined in Article 57(a) and (b) of the Capital Requirements Directive (CRD). Article 6 varies this amount according to the type of payment services undertaken, as follows:

- money remittance: initial capital of €20,000
- mobile phone payment services: initial capital of €50,000
- payment institutions providing more complex services (i.e. covering points 1-5 of the Annex): initial capital of €125,000

3.20 It is expected that firms will be able to use bank statements, accompanied by an authentication by a suitably qualified third party, audited accounts, or Companies House returns as proof of initial capital. However, the competent authority will have the discretion to request further documentation from firms to assist its assessment.

Ongoing capital requirements

3.21 Under Article 8, the regulator must determine the method, of which there are three, by which the firm's ongoing capital requirements shall be calculated:

- Method A: based on a firm's level of overheads;
- Method B: based on a firm's level of payment transactions; or
- Method C: based on a firm's level of income.

3.22 Regardless of the amount of ongoing capital resulting from any of these methods, the Directive stipulates that a payment institution must always possess an amount of own funds not less than the minimum initial capital requirement set out in Article 6, as set out above. Moreover, under Article 7(2), Member States must take measures to prevent multiple use of elements eligible for own funds where the payment institution belongs to the same group as another payment institution, credit institution, investment firm, asset management company or insurance undertaking. This applies accordingly where a payment institution has a hybrid character and carries out activities other than those in the Annex.

3.23 Illustrative worked examples of the three ongoing capital methodologies are provided in Box 3.2. These are for general reference only and should not be taken as formal guidance.

Box 3.2: Worked examples of calculating ongoing capital requirements

Method A

This approach is based on a firm's fixed overheads over the preceding year. How it works:

- The amount of capital must be at least equal to 10% of the firm's fixed overheads from the previous year;
- If the firm has not been in business for a year, the capital must be 10% of the fixed overheads projected in the firm's business plan;

Example 1:

Money transmitter has fixed overheads of €500,000

Must hold capital of €50,000

Example 2:

Money transmitter has fixed overheads of €100,000

Must hold capital of €20,000 (note this equals to the minimum amount of capital equal to the initial capital requirement for money transmitters)

Method B

This approach is based on the value of payments executed by a firm over the preceding year. How it works:

- **Step 1**: Work out a firm's Payment Volume using the formula below:

  Payment Volume = total value of payment transactions executed by the firm in the previous year, divided by 12

- **Step 2**: Using the results of Step 1, calculate the sum of the following, using the slices until the firm's Payment Volume is reached:

Payment Volume (€ million)		Multiple of Payment Volume (%)	
Slice 1 Up to 5	x	4	PLUS
Slice 2 5 to 10	x	2.5	PLUS
Slice 3 10 to 100	x	1	PLUS
Slice 4 100 to 250	x	0.5	PLUS
Slice 5 Above 250	x	0.25	

- **Step 3**: Then, multiple the result of the above by the scaling factor:

  0.5 for money transmitters

  0.8 for mobile phone payment operators

  1.0 for other non-credit or e-money institutions

Example

A money remitter has total payment transactions the previous year of €1.2 billion.

Step 1: Payment Volume = €1.2 billion divided by 12 = €100 m

Step 2:

4% of € 5 m (€0 to €5m slice)		= € 200,000
2.5% of € 5 m (€5m to € 10m slice)		= € 125,000
1% of € 90 m (€10m to €100m slice)		= € 900,000
	TOTAL	= € 1,225,000
Step 3:	X 0.5	= € 612,500

Conclusion: Firm must hold ongoing capital of at least € 612,500

Method C

This approach is based on a firm's income over the preceding year. How it works:

- **Step 1:** Work out the firm's Income Indicator from: Interest income + Interest expense + Commissions and fees received + Other operating income
- **Step 2:** Using the result from Step 1, calculate the sum of the following, using the slices until the firm's Payment Income is reached:

Income Indicator (€ million)		Multiple of Payment Volume (%)	
Slice 1 Up to 2.5	x	10	PLUS
Slice 2 2.5 to 5	x	8	PLUS
Slice 3 5 to 25	x	6	PLUS
Slice 4 25 to 50	x	3	PLUS
Slice 5 above 50	x	1.5	

- **Step 3**: Then, multiple the result of the above by the scaling factor:

  0.5 for money transmitters

  0.8 for mobile payment operators

  1.0 for other non-credit or e-money institutions

Example:

Step 1: A money transmitter has an Income Indicator of € 25 m.

Step 2:

10% of €2.5 m (€0m to €2.5m slice)		= €250,000
8% of €2.5 m (€2.5m to €5m slice)		= €200,000
6% of €20m (€5m to €25m slice)		= €1,200,000
	TOTAL	= €1,650,000
Step 3:	x 0.5	= € 825,000

Conclusion: The firm must hold ongoing capital of at least € 825,000

3.24 While the competent authority has the final say on which methodology a payment institution must use in calculating its ongoing capital requirements, the Government envisages that, in practice, each payment institution will have the opportunity to submit its views on which would be appropriate, given its business model. Payment institutions will have to be prepared to demonstrate to the competent authority that they have correctly calculated their own ongoing capital requirements, and to show at all times that they hold the amount required.

Consultation questions

9. Are there issues relating to the initial or ongoing capital requirements which would benefit from further clarification? Please also give views on which of the three methods would be most appropriate to your business model.

10. Should payment institutions be able to choose the method they use for calculating their ongoing capital, subject to final agreement by the FSA?

Safeguarding requirements

3.25 Article 9(1) requires hybrid payment institutions that also engage in a non-payments business activity (e.g. telecommunications services alongside a payments business) to safeguard or ring-fence any funds received from payment service users. The Directive provides firms with two options, as set out in Box 3.3.

Box 3.3: Hybrid institutions; safeguarding funds received – Article 9

1……

Either:

(a) they shall not be commingled at any time with the funds of any natural or legal person other than payment service users on whose behalf the funds are held and, where they are still held by the payment institution but not yet delivered to the payee or transferred to another payment service provider by the end of the business day when the funds have been received, they shall be deposited in a separate account in a credit institution or invested in secure, liquid low-risk assets as defined by the competent authorities of the home Member State; and

(b) they shall be insulated according to the national law of the Member State in the interest of those payment service users against the claims of other creditors of the payment institution, in particular in the event of insolvency;

or:

they shall be covered by an insurance policy or some other comparable guarantee from an insurance company or a credit institution, which does not belong to the same group as the payment institution itself for an amount equivalent to that which would have been segregated in the absence of the insurance policy or other comparable guarantee, payable in the event that the payment institution is unable to meet its financial obligations.

Option 1 **3.26** The purpose of 9(1)(a) is to avoid accounting confusion or arbitrage between the funds that a payment institutions receives for its payment service-related and non-payment service-related businesses. The provision also aims to protect users that pay in funds to their providers in advance of a transaction, for example prior to a monthly migrant remittance transaction, or for use on a pre-paid payment instrument. At the end of the business day following the day when the customer first paid in the money, payment institutions that still hold such funds must:

- deposit the monies into a bank account, and not release them until a payment order is made on those funds; or
- invest such funds into secure, liquid and low-risk assets such as cash deposits.

3.27 Further to this, Article 9(1)(b) is an important customer protection provision. Currently, if a firm declares insolvency, the proceeds of the sale of any remaining assets are split according to a strict order of priority. They will be used, first, to pay any liquidation or administration expenses, preferential creditors, and debts secured by a floating charge, and only then to pay unsecured creditors (which, in a payments context, would include the normal customers of a payment service provider). Under the PSD provision, the funds paid in by customers will, in the event of an insolvency, be insulated or earmarked against the claims of other creditors.

Option 2 **3.28** Alternatively, payment institutions could choose to safeguard user funds through the purchase of insurance policies or similar guarantees. It is unclear whether UK payment service providers currently have access to such instruments, and whether this might also offer less protection than segregated accounts. Insurance premiums could be high; and if a failing company were to stop paying the premiums prior to becoming insolvent, the insurance company might exercise a right to invalidate the insurance contract.

Consultation question

11. Does your business currently operate some form of ring-fencing or safeguarding of user funds? If so, how does this match the ring-fencing options under the PSD? If you do not currently ring-fence user funds, how will this requirement affect your costs and business model? How might ring-fenced user funds be best protected in the event of insolvency?

Statutory audit

3.29 The PSD clarifies that payment institutions must abide by the relevant existing directives (Directives: 78/660, 83/349 and 86/635) and provisions for international accounting standards, unless exempt under such directives. Statutory auditors or audit firms within the meaning of Directive 2006/43/EEC must audit their annual accounts and consolidated accounts. Accounting information for the payments business must be separated from other business activities, and subject to an auditor's report.

Permissible Activities

3.30 Under Article 16, a payment institution can, apart from conducting the payment services listed in the Annex, also engage in other activities such as:

- the provision of operational and closely related ancillary services such as ensuring execution of payment transactions, foreign exchange services, safekeeping activities, and storage and processing of data;
- the operation of payment systems, without prejudice to the rules set out in Article 28 (see chapter 4); or
- business activities other than the provision of payment services, as long as such activities are conducted in accordance with relevant Community and national law.

3.31 Many payment institutions, such as money transfer companies, currently undertake ancillary services to their main payments business, as well as some non-payments-related businesses. Article 16 confirms that such activities will not be affected by virtue of a firm obtaining authorisation as a payment institution.

3.32 However, Article 16(3) introduces new rules that will affect payment institutions, which provide credit to customers. This affects, specifically, payment institutions that grant credit in relation to the payment services set out in Box 3.4.

Box 3.4 - ANNEX

….

4) Execution of payment transactions where the funds are covered by a credit line for a payment service user:

- execution of direct debits, including one-off direct debits;

- execution of payment transactions through a payment card or a similar device;

- execution of credit transfers, including standing orders.

5) Issuing and/or acquiring of payment instruments

…..

7) Execution of payment transactions where the consent of the payer to a payment transaction is transmitted by means of any telecommunication, digital or IT device and the payment is made to the telecommunication, IT system or network operators, acting only as an intermediary between the payment service user and the supplier of the goods and services.

….

3.33 For such firms, and where the payment institution providing such credit wishes to passport its business into other EU Member States, the Directive mandates that a customer must repay the credit debt to the payment service provider within a short period, which shall in no case exceed 12 months.

3.34 There is no statutory time limit in the UK on the repayment of credit card debt, or the repayment of other credit extended in conjunction with some other payment services, such as money transfer. Where payment institutions extend credit for use in the UK only, UK consumer credit legislation – enforced by the OFT – will continue to apply, and firms will need to abide by the conduct of business rules of the PSD in relation to payment service activity.

3.35 For UK payment institutions that extend credit in relation to their payment services and wish to provide these same services outside the UK, however, the Directive stipulates that such credit must be repaid within 12 months. This provision limits the passporting payment institution's ability to extend credit throughout the EU.

3.36 There are additional restrictions that apply to the granting of credit in all cases (i.e. whether the services are passported or not). In particular, credit cannot be granted from funds received or held for executing payment transactions. Additionally, the competent authority must be satisfied that the payment institution's own funds are appropriate in view of the amount of credit granted.

Other responsibilities

Use of agents and branches

3.37 Where a payment institution wishes to provide payment services through an agent, it must communicate to the competent authority:

- the name and address of the agent;
- a description of the internal control mechanisms that will be used by agents to comply with existing anti-money laundering rules; and
- the identity of directors and persons responsible for the management of the agent, and evidence that they are fit and proper persons.

3.38 Where the payment institution also wishes to outsource any of its operational functions, the competent authority must also be informed.

3.39 Payment institutions must retain full responsibility and liability for the action of their agents and branches, and ensure that they meet the requirements of the Directive. In practical terms, this means that the onus is on the payment institution to check and monitor that its network of agents and branches has the systems and controls in place to comply with the PSD conduct of business rules. Payment institutions may not ignore any duty to comply with the Directive by virtue of having relied on third parties for the performance of payment services or operational functions.

Passporting

3.40 If the payment institution wishes to exercise its right to supply services or establish a branch for the first time in any other EU Member States other than its home Member State, it must inform the competent authority in its home Member State of its intention.

Withdrawal of authorisation

3.41 Once a firm obtains authorisation, this authorisation can be revoked if the payment institution:

- does not make use of it within 12 months;
- ceases to engage in its business for more than 6 months;
- has obtained the authorisation by providing false information;
- no longer fulfils the conditions for obtaining authorisation (e.g. if its governance arrangements or internal control mechanisms are deemed to no longer be proportionate, appropriate, sound and adequate);
- constitutes a threat to the stability of a payment system by continuing its payment service business; or

- falls within one of the other cases where UK law provides for the withdrawal of authorisation.

3.42 To ensure the continued validity of their authorisation, authorised payment institutions are responsible for communicating accurate information to the competent authority regarding their business, and swiftly providing updated information if circumstances change.

V. THE ROLE AND POWERS OF THE COMPETENT AUTHORITY

3.43 This section of the consultation document explains the role of the competent authority under Title II of the Directive, and considers where the competent authority may exercise certain powers.

Administration and supervision

3.44 The Government expects that the Financial Service Authority (FSA) will, as part of its role in setting up the prudential authorisation regime, develop an application process for firms seeking to obtain authorisation as a payment institution. The process might reasonably be expected to consist of guidance on the application process and the information required of firms; an arrangement for receiving and managing queries; and a system for vetting applications, communicating with applicant firms and collecting fees.

3.45 The competent authority will be responsible for interpreting the checklist of information required under Article 5, i.e. the factors that will contribute to its "favourable assessment" of an application.

3.46 Once the competent authority grants authorisation to a firm, it is entitled to check a payment institution's compliance with the prudential regime by taking a number of steps, including:

- requiring payment institutions to provide any information needed to monitor compliance; and
- carrying out on-site inspections of the payment institution and its associated agents, branches and outsourcing entities.

3.47 It is also entitled to withdraw an authorisation. It will be for the FSA to set up an ongoing supervision system and to decide, using risk-based considerations, the depth of and frequency with which it will carry out its ongoing supervisory responsibilities vis-à-vis each authorised payment institution.

Public register

3.48 All payment institutions, authorised and registered, must be listed on a public register, along with their branches and agents and the payment service activity for which they are being regulated.

Powers of the competent authority

Powers on own funds

3.49 Under Article 7(3), Member States or the competent authority may choose not to apply ongoing capital requirements to payment institutions which are included in the consolidated supervision of parent credit institutions authorised under the CRD.

3.50 This provision does not exempt payment institutions that are included under the consolidated supervision of credit institutions from the requirement to obtain authorisation. The Directive does, however, allow either the Member State or the competent authority not to apply the ongoing capital charge for such firms, on the basis that the capital requirements under consolidated supervisory regimes are higher than for non-consolidated ones.

3.51 The Government would expect to exercise this power under such circumstances, to prevent double-regulation. This would be consistent with the FSA's regulatory system, which works on the basis of a hierarchy of different prudential licensing regimes, and with the requirements of the credit institution regime superseding any other class of prudential requirements.

Consultation question

12. Do you agree that ongoing capital requirements should be applied for payment institutions already included under the consolidated supervision of credit institutions? Do you intend to passport your services? If so, please provide details.

Powers to vary ongoing capital

3.52 Article 8(3) enables competent authorities, based on an evaluation of risk management processes, risk loss data base and internal control mechanisms of the payment institution, to require payment institutions to hold an amount of ongoing capital which is up to 20 per cent higher or lower than the amount which would result from any of the three ongoing capital methods chosen for the payment institution.

3.53 If the competent authority wishes to avail itself to this supervisory tool, it would need to undertake a more detailed assessment of a payment institution's internal processes, to ensure that a robust quantitative justification could be made.

3.54 Were such discretion to be exercised and ongoing capital charges reduced, more firms might be encouraged to obtain authorisation than would otherwise be the case. As the discretion is based on an assessment of a firm's risk management processes, there might also be an incentive for firms to build more robust internal processes and control mechanisms, which could be more effective than capital requirements in countering some of the risks that payment institutions are exposed to (such as systems malfunctioning).

3.55 Equally, however, evaluation of the risk processes of a payment institution by the competent authority might result in a higher ongoing capital charge being set. Fees for payment institutions might also need to rise, to recover the cost of the additional authorisation and/or supervision work.

Consultation question

13. How do you think the FSA should approach its ability to exercise the discretion to vary ongoing capital charges by 20 per cent?

Powers on safeguarding measures

Future transactions

3.56 Safeguarding measures are mandatory for payment institutions that conduct a mixture of payments and non-payments-related business. Article 9(2) provides that, where a portion of the ring-fenced funds are used for future transactions, and where the volume of such future transactions is unknown in advance, Member States may allow payment institutions to apply safeguarding measures to only a representative portion of the funds. The payment institution may estimate this portion on the basis of historical data.

3.57 Such flexibility is important for businesses such as mobile phone companies that provide payment services. It is estimated that over 60 per cent of the 66 million active mobile phone subscriptions in the UK are provided through pre-paid accounts. These accounts generally maintain between £5 and £10 credit at any one time. The customer pays the money to the mobile operator, as a credit against any future costs that he or she might incur with the mobile operator. At the time this pre-paid credit is purchased, its future use is not known. The vast majority of these funds are spent on basic voice calls, text messaging and basic internet browsing.

3.58 The Government's view is that the discretion provided under Article 9(2) is key to ensuring that the safeguarding measures work for certain business models, and should be exercised.

> **Consultation question**
>
> 14. Should payment institutions be able to apply safeguarding measures only to an estimated portion of funds which might be used for future payment transactions, where these are unknown in advance?

Ring-fencing for non-hybrid businesses

3.59 Member States or competent authorities may, under Article 9(3), require payment institutions that only engage in payment services, and do not undertake any other non-payments-related business (non-hybrid payment institutions), to comply with the safeguarding measures under Article 9(1) for hybrid businesses.

3.60 As discussed previously, Article 9(1) seeks to protect payment user funds in the event that hybrid payment institutions become insolvent. Applying Article 9(1) to non-hybrid payment institutions would extend such protection to customers of firms which provide only payment services, thereby offering greater clarity to customers and avoiding a situation in which two customers received different standards of protection when using essentially the same service.

3.61 Hybrid businesses may execute a smaller volume of payment transactions than non-hybrids, since the business model of the latter is based solely on expanding a payments business. In such circumstances, it would appear disproportionate to impose ring-fencing on hybrids but not non-hybrids. Unintended consequences could arise if the differential treatment of hybrid and non-hybrid firms led hybrid businesses deliberately to break up their payments business into a separate legal entity, to avoid the cost of ring-fencing. Nevertheless, the cost of safeguarding payment service user funds, in addition to the cost of compliance with the capital requirement provisions in this area may outweigh the flexibility afforded to Member States.

Consultation question

15. Should non-hybrid firms have to safeguard user funds in a similar manner to hybrid payment institutions? What would be the costs and benefits of this?

Legal separation

3.62 An extension of the concept of ring-fencing in Article 9(1) is set out in Article 10(5). Where the non-payment service activities of a hybrid institution impair (or threaten to impair) either the financial soundness of the payment institution or the ability of the competent authorities to monitor that institution's compliance with the Directive's obligations, the competent authority may require the establishment of a separate entity for the payment service element of the business.

3.63 This provision is very wide-ranging. Creating such a legal separation would raise practical concerns, such as the need to transfer data and information between different legal entities within the same group for billing purposes. The justification for exercising such a supervisory tool is also unclear, given that Title II already imposes capital requirements and safeguarding measures on payment institutions.

3.64 It could be argued that, if the non-payment-related activities of a payment institution are deemed to be impairing its financial soundness, the solution should not be to demand a legal separation, but to ensure that the safeguarding measures designed to deter this situation are implemented properly. Moreover, it might be preferable for the competent authority to review the conditions under which the payment institution obtained authorisation and evaluate whether the conditions have been adequately met, rather than seek a potentially costly and legalistic solution to the problem.

Consultation question

16. How should the competent authority approach the option to demand the legal separation of a payment institution's payments business from its non-payment activities?

VI. POLICY OPTIONS ON DEROGATIONS PERMITTED UNDER TITLE II

Safeguarding derogation

3.65 Article 9(4) enables Member States or the competent authority to limit safeguarding requirements in Article 9(1) to funds of payment service users that exceed a threshold of €600. This derogation could apply to funds paid in to hybrid and non-hybrid payment institutions, if the UK decided to impose safeguarding requirements on non-hybrid payment institutions under Article 9(3).

3.66 The derogation is premised on the principle of proportionality, with the safeguarding protection restricted to larger value transactions. The Government believes that there are three options on this derogation:

- Option 1: do not apply the derogation;
- Option 2: apply the derogation to hybrid payment institutions only; or

- Option 3: apply the derogation to hybrid and non-hybrid payment institutions.

Option 1 **3.67** The option of not applying the derogation would require all funds paid in by customers to be ring-fenced, regardless of the size of the amount paid in. For some transactions, the cost of ring-fencing might outweigh the amount being ring-fenced; mobile phone payment institutions that typically offer low-value payments of not more than £5 to £10 might find, for example, that they needed to pay disproportionately large ring-fencing costs, causing providers to withdraw low-value payment services from the market. In addition, as the Directive includes the possibility of simplifying conduct of business rules for low-value payments up to a variety of thresholds, all of which are below €600; a decision not to apply a ring-fencing derogation for low-value payments might appear inconsistent with this.

3.68 Since, however, all funds have to be ring-fenced under this option, payment institutions would not need to invest in systems to track whether the client monies they received were above or below the threshold of €600. The Government would welcome industries views on whether the benefits of applying this ring-fencing derogation would be greater than the cost of any systems changes needed to introduce ring-fencing for all transaction amounts.

Option 2 **3.69** Applying the derogation to hybrid payment institutions only, would be an option only if a Member State decided not to exercise the discretion granted under Article 9(3) to apply ring-fencing to non-hybrid payment institutions.

3.70 Since, however, both hybrid and non-hybrid payment institutions provide payment services to customers, customers would be justified in expecting similar standards of protection for the same types of services.

Option 3 **3.71** Applying the derogation to all payment institutions would mean that only funds paid in by customers that exceeded €600 would be protected by the safeguarding requirements provided under Article 9(1). The impact on firms is unclear since, as mentioned above, the cost of installing a system to track the size of each payment transaction might outweigh the cost of simply ring-fencing all payments. There might, for example, be some financial instruments that allowed firms to ring-fence in bulk. Firms would have the option of also safe guarding funds below the €600 threshold (i.e. safeguarding everything).

3.72 A broader question is how the €600 threshold, which cannot be varied under the derogation, maps onto the UK payments landscape and onto individual payment service sectors. According to a recent study commissioned by the Department for International Development (DFID) on the UK remittances market, the average value of the "last remittance" sent by money transfer companies was around £324. Of the migrant households surveyed, 73 per cent responded that the "last remittance" they sent home was below £200.[4] This would suggest that most transactions would not benefit from the provision, were the derogation threshold to be applied.

Consultation question

17. Should safeguarding be limited to funds exceeding €600? How might the use/non-use of this flexibility affect firms' processes and operating costs?

[4] UK Remittance Market, Department for International Development, November 2005

Derogation to provide a registration regime – Article 26

3.73 From the UK's perspective, Article 26 is an important derogation. It provides Member States with the option of waiving the application of all or part of the Title II prudential requirements for firms that:

- are legal or natural persons;
- execute less than €3 million worth of payment transactions a month;
- do not wish to sell, or "passport" their services in other EU Member States; and
- can prove that none of the persons responsible for managing the business has been convicted of offences relating to money laundering or terrorist financing or other financial crimes.

3.74 Such persons would be treated as payment institutions, but would not have the right to passport into other EU Member States. Member States would have to establish a registration regime for waived payment institutions. It should be noted that firms waived from PSD authorisation would not be exempt from compliance with PSD conduct of business requirements.

3.75 Informed by consultation with firms and end-users, the Government regards a waiver or derogation for small firms as important in ensuring that money transfer companies providing migrant remittance services remain registered and visible to the appropriate regulators in the UK, especially for anti-money laundering (AML) purposes. Such waiver provisions must, however, take into account the higher risks with respect to exploitation by money launderers and terrorist financiers, noted in HM Treasury's recent review of Money Service Businesses[5].

3.76 In the UK, it is expected that the majority of firms falling within the waiver criteria set out on the Directive will be money transfer companies. Money remitters are currently supervised by HMRC for compliance with the Money Laundering Regulations and will continue to be supervised by HMRC for these purposes following implementation of the PSD. Under the 2007 Money Laundering Regulations (MLR07) that will enter into force this December, money remitters will be subject to an objective "fit and proper" test, which is intended to disrupt criminal access to the money service business sector by denying registration to businesses owned or controlled by individuals who present a high risk with regard to money laundering or terrorist financing. The criteria in the test include convictions for money laundering, terrorist financing and some financial crimes, but also extend to other risk indicators such as an offence under the Fraud Act, disqualification as a Company Director and consistent failure to comply with money laundering regulations.

3.77 In deleting the provisions of the Third Money Laundering Directive which require money transmission or money remittances offices to be licensed or registered in order to operate their business legally, the PSD also removes this "fit and proper" requirement for such businesses (although the PSD does still require, in relation to waived firms that none of the persons responsible for managing the business should have been convicted of offences related to money laundering or terrorist financing or other financial crimes). Following the conclusion of the Money Service Business Review, as set out in the Government's Financial Crime Strategy, the Government

[5] *The regulation of Money Service Business*: a consultation document, HM Treasury, September 2006

believes that the fit and proper test outlined in MLR07 should be retained. The test outlined in MLR07 will ensure that HMRC is well equipped to rootout those associated with organised crime or terrorism and those consistently non-compliant with the Money Laundering Regulations and therefore meets the policy intentions behind both the Third Money Laundering Directive and the international Financial Action Task Force recommendation on Money Laundering and Terrorist Financing. The Government therefore proposes to maintain this more stringent form of "fit and proper" test for waived firms that are money transmission or remittance offices.

3.78 In practical terms, there appear to be two options for achieving this. The first option would be to retain the registration and fit and proper regime provided by MLR07 alongside the minimum waiver criteria set out in Article 26 (in effect, have the money laundering and the PSD waiver regimes running in parallel). The alternative would be to remove the registration and fit and proper regime provided by the MLR07, but then simultaneously to replicate it under the PSD regime by exercising the flexibilities provided by the PSD waiver provision. In particular, under Article 26 (1), the UK could apply some of the Title II provisions to waived institutions, for example aspects of paragraphs (f), (h) and (i) of Article 5. We will be considering this matter further, and consulting on these options in the next consultation.

3.79 There is a broader issue which concerns the extent to which the Government should exercise the derogation. There appear to be three options:

- Option 1: do not exercise the derogation;
- Option 2: exercise a partial derogation and apply provisions that might further enhance customer protection;
- Option 3: exercise the derogation, either applying only those provisions that enable the UK to continue to apply a fit and proper test to money transfer companies, or, where the fit and proper test continues to be applied under the MLR07, in full.

Option 1

3.80 Not applying the derogation would represent a shift in the Government's position, which has been based on ensuring that small payment institutions, many of which operate locally, are not priced out of the market by prudential requirements or forced to operate underground.

3.81 In this scenario, there would be no PSD registration regime. Small firms would need to comply with all the provisions in Title II, which include initial and ongoing capital requirements as well as safeguarding measures. Fees would be likely to be higher than would be the case if firms were required only to obtain registration under a waived regime. For small firms that operate only a marginal payments business alongside their core business, the cost of such compliance could be prohibitive.

Option 2

3.82 The Government's previous consultation indicated that larger money transfer companies believed that a waiver for small firms would be acceptable under the Directive, as long as waived firms provided customers with a level of protection commensurate with that by authorised payment institutions.

3.83 Many of the rules under Title II of the Directive are aimed at ensuring the financial soundness of a firm. The only provision which might be said to be targeted specifically at enhancing customer protection, is the group of safeguarding measures under Article 9 (which ring-fences funds that customers pay in to a payment service provider in the event of insolvency). Arguably, customers that use different payment

service providers will expect similar levels of protection for using the same service regardless of the firms' business model and size. However, customers that use smaller firms may value lower cost and convenience over the statutory protection of their funds, particularly if the transaction amounts are relatively small.

Option 3 **3.84** In the absence of a compelling cost-benefit case from participants in the UK payments market in favour of Option 2, the Government's preference is to create a separate registration regime for smaller and non-passporting payment institutions and to continue to apply only the fit and proper test currently in place. As discussed in paragraph 3.80, this might be achieved either by applying parts of the PSD authorisation requirements, or by retaining the registration and fit and proper regime provided by MLR07 alongside the minimum waiver criteria set out in Article 26. It should be noted that the PSD does not prohibit firms eligible for the waiver from applying for authorisation as a payment institution, if they perceive any benefits to be derived from obtaining full authorisation, provided they have the necessary controls in place.

Consultation question

18. Do you agree with the approach to exercise the waiver, while retaining the fit and proper test outlined in MLR07?

Agents **3.85** There is a question that arises in relation to options 2 and 3 above as to whether part of Article 17 on the use of agents (i.e. the requirement for payment institutions to provide the names and addresses of their agents to the competent authority) needs to be applied to waived institutions. This is because the article on registration (Article 13) stipulates that a public register should be established which includes the agents of natural and legal persons benefiting from the waiver in Article 26. While it could be argued that Article 13 should not necessarily take precedence over Article 26 (which seems to allow for Article 17 to be waived in its entirety), it seems clear that the intention of the directive is that the agents of all payment institutions, authorised and registered alike, should be registered. In this case, part of Article 17 would need to be applied to waived institutions. The Government would welcome views on this.

Consultation question

19. Should the agents of registered payment institutions be registered?

Transitional provisions **3.86** Article 88 establishes transitional provisions for Member States to enable payment institutions that are already conducting payment service activities when the Directive enters into force[6], to continue those activities without authorisation under Article 10, but only within their home Member State and until 30 April 2011. By this date they must be authorised, otherwise they will be prohibited from providing payment services. Likewise, Member States can derogate to enable small firms in need of registration under Article 26, to continue their activities for a transitional period of no longer than 3 years without being registered. While such payment institutions may be given transitional leeway before applying for authorisation or registration, they, and other payment service providers under the PSD, will still have to comply with the PSD

[6] This will be 20 days after publication in the Official Journal, on 5 December 2007.

conduct of business rules in Titles III and IV by the deadline for implementation of 1 November 2009. We intend to clarify whether this interpretation is the case during transposition.

Consultation question

20. Do you intend to take advantage of the transitional provisions? Please provide details.

4 ACCESS TO PAYMENT SYSTEMS – ARTICLE 28

4.1 Article 28 of the Directive includes a standalone provision on access to payment systems. This Chapter of the consultation document sets out:

I. the objective of Article 28;

II. the scope and intention of the Article; and

II. the approach to implementation of this Article into UK law.

I OBJECTIVE OF THE ARTICLE

4.2 The objective of Article 28 is to promote competition, in particular by ensuring that the rules governing payment service providers' access to payment systems are objective, non-discriminatory and proportionate. This is to enable payment institutions to gain access to payment systems and compete in the payments market, alongside credit and e-money institutions, and also to ensure that new entrants are not excluded from EU payment systems. The Sector Inquiry into Retail Banking[7], suggested that a pro-competitive Single Euro Payments Area held the potential to remove many restrictive access rules to payment systems, and that this could provide retailers with a greater choice of payment processing services.

4.3 However, Article 28 also requires that access rules should be robust enough to guard against potential operational, settlement and other specific risks in payment systems. This is with a view to protecting the financial and operational stability of the payment system (the importance of which was highlighted by stakeholders in HM Treasury's consultation during the negotiation phase of work on the Directive).

II SCOPE AND INTENTION OF THE ARTICLE

4.4 The access provisions in Article 28 are described in Box 4.1. Article 28(1), parts 1 and 2, sets out the access principles, while 28(2) sets out which payment systems will be exempt from the principles in Article 28(1).

[7] The Sector Inquiry into Retail Banking was published by the European Commission on 31 January 2007,

Box 4.1: Access provisions under Article 28

Article 28(1):

[PART 1] Member States shall ensure that rules on access of authorised or registered payment service providers that are legal persons to payment systems shall be objective, non-discriminatory and proportionate and shall not inhibit access more than is necessary to safeguard against specific risks such as settlement risk, operational risk and business risk and to protect the financial and operational stability of the payment system.

[PART 2] Payment systems may not impose on payment service providers, on payment service users or on other payment systems any of the following requirements:

a) restrictive rules on effective participation in other payment systems;

b) a rule which discriminates between authorised payment service providers or between registered payment service providers in relation to the rights, obligations and entitlements of participants;

c) any restriction on the basis of institutional status.

Article 28(2): Paragraph 1 shall not apply to:

a) payment systems designated under Directive 98/26/EC, and

b) payment systems exclusively composed of payment service providers belonging to a group composed of entities linked by capital where one of the linked entities enjoys effective control over the other linked entities;

c) payment systems meeting all of the following requirements:

- a sole payment service provider (whether as a single entity or as a group) is or can act as the payment service provider for both the payer and the payee and is exclusively responsible for the management of the system; and

- where that sole payment service provider (whether as a single entity or as a group) licenses other payment service providers to participate in the system, the latter have no right to negotiate fees between or amongst themselves in relation to the payment system although they may establish their own pricing in relation to payers and payees.

4.5 The aim of Article 28 is to enable payment service providers to access payment systems on the same terms, thus ensuring that payment systems are not able to impose exclusivity criteria on membership (for example by mandating that members of the system cannot become members of other systems). Furthermore, access rules should not discriminate between authorised payment institutions and payment service providers benefiting from the Article 26 waiver from authorisation.

4.6 The access principles in the second part of 28(1) need, however, to be read in conjunction with the first part of 28(1). While the Article's objective is to avoid discrimination between different types of providers, the need for the payment system to safeguard against specific risks is also acknowledged. This is in order not to

compromise the integrity and stability of payment systems. Recital 16 supports this interpretation.

4.7 Article 28(2) establishes three instances in which the access principles in Article 28(1) will not apply:

- payment systems designated under the under Directive 98/26/EC, Settlement Finality Directive (SFD). These are systemically important payment systems, for which Member States have the right to limit access. In the UK, this would cover BACS, CHAPS Euro and CHAPS Sterling and securities settlement systems;

- payment systems composed of payment service providers belonging to a group. This is intended to cover, for example, the internal payment systems of banking groups and the treasury functions set up within payment service providers to settle funds between their different departments; or

- proprietary payment systems that are established and operated by a single provider, and that exercise their right bilaterally to license the use of their intellectual property (including trademarks and technology) on a discretionary basis to other payment service providers. This covers three-party payment systems, where a single payment service provider offers services to both the originator and recipient of a payment, with the transaction travelling across the books of this one provider. Typically, such systems do not involve, or permit, the creation of direct links between their third party licensees, and maintain exclusive responsibility for managing the proprietary network.

4.8 Based on the above explanation of scope and intention, the Government's understanding is that in the UK, the LINK scheme and the four-party card schemes will be affected by the Article 28 provisions.

Consultation questions

21. Do you agree with the interpretation of the scope and aim of Article 28 on access to payment systems, and the schemes that will be affected in the UK? Are there other payment systems that may be affected?

III IMPLEMENTATION OF ARTICLE 28

4.9 In view of the competition objectives underlying the Article 28 provision, the Office Of Fair Trading (OFT) is the most appropriate UK body to be responsible for the Article's enforcement once it has been implemented into UK law. The legislative options for implementing this provision are still under consideration, since the wording of the provision leaves some flexibility for Member States in deciding how it should be enforced. There appear to be two possible legislative models: ex post enforcement or ex ante enforcement.

4.10 A model of ex post enforcement would involve a prohibition on payment system rules that are neither objective, non-discriminatory nor proportionate, and which inhibit access more than is necessary to safeguard against specific risks and to protect the financial and operational stability of the payment system. Payment systems bound by the provision would have a legal duty to comply with it. Penalties would be

established in legislation to enforce the prohibition, with an associated appeals mechanism. This would follow the Competition Act 1998 model.

4.11 A model of ex ante enforcement would entail the OFT considering the effects of any rule in a payment system before it was implemented, to ensure it met the requirements of Article 28(1) in all cases. Enforcement in this model would be based on FSMA 2000, and might have a reduced risk (compared with the ex post variant) of systems failing to meet the requirements.

4.12 Under either model, the OFT would need to be able to investigate, balancing concerns relating to financial stability and risk with the competition aims of the provision. The Government would welcome stakeholder views on how the provision might best be implemented in the UK.

Consultation question

22. What are the merits of an ex ante or an ex post approach to implementation of Article 28 on access to payment systems? Are there any other approaches that should be considered?

4.13 In view of the creation earlier this year of the Payments Council, which now has the responsibility for governing the development and strategic direction of UK payment systems, as well as responsibility over some (but not all) of the systems affected by this Article, it is proposed that the OFT should engage with the Payments Council, as well as with individual payment schemes affected and other public authorities as appropriate, to consider in practical terms the interpretation of the rules in this Article.

5 Conduct of business - Titles III and IV

5.1 Titles III and IV of the Directive contain the conduct of business rules applicable to all payment service providers, including credit institutions, e-money issuers, and authorised and registered payment institutions. Title III establishes the conditions for the provision of information to payment service users, while Title IV establishes the rights and obligations of both payment service providers and users.

5.2 This Chapter of the consultation document, covering Articles 30 to 83 of the Directive, sets out:

I. the objectives of the PSD conduct of business rules;

II. the proposed approach to implementation;

III. the role of the competent authority;

IV. an overview of the requirements;

V. policy options for Member States; and

VI. compliance with Titles III and IV.

I. Objectives of the PSD conduct of business rules

5.3 To ensure a truly integrated Single Market in payment services, Title III introduces harmonised rules on the provision of information to payment service users. These are aimed at ensuring that users across the EU receive the same standards of information about the payment services they receive. This should help to improve the transparency of pricing and service levels between different providers, and encourage further cross-border competition. Customers should also be better positioned to make an informed choice between providers and products.

5.4 Title IV contains harmonised rules on the rights and obligations of payment service providers and users. These relate to authorisation and execution procedures for payment transactions, value dating and provider-user liabilities. They should serve to provide customers with greater certainty about the way payments will be executed, and what happens in the event of a transaction going wrong.

II. Proposed approach to implementation in the UK

5.5 In implementing the PSD conduct of business requirements, the Government aims to avoid information overload, ensure customers are well-informed and receive suitable protection in relation to payment services, and support continued competition, innovation and efficiency in the payments industry.

5.6 In line with its Better Regulation principles, the Government will seek to minimise the regulatory burden on business and sustain innovation in payment service provision. When assessing derogation options, the overarching aim will be to keep in mind workability from the perspective of payment service providers.

5.7 From the provider´s perspective, harmonised conduct of business rules should enable firms to benefit from greater legal certainty in terms of their rights and duties towards customers across Members States. A consistent interpretation of the conduct of business requirements across Member States is fundamental to providers reaping the benefits of the Directive. HM Treasury will therefore work closely with other Member

States and the European Commission on issues of interpretation that arise in the transposition process.

III. ROLE OF THE COMPETENT AUTHORITY

5.8 The FSA is expected to undertake ongoing supervision to ensure that payment institutions comply with the prudential requirements of Title II. In relation to Titles III and IV, Article 80 of the PSD requires supervision of the conduct of business rules through a complaints-based system, much like the existing approach for many regimes involving conduct of business elements. This would require the FSA to be responsible for considering complaints about alleged infringements of the provisions of national law implementing the provisions of the PSD.

5.9 Article 81 requires Member States to set effective, proportionate and dissuasive penalties for infringements. Article 82(2) clarifies that in the event of an infringement or suspected infringement of the PSD conduct of business rules, the relevant competent authorities shall be those of the home Member State of the provider (except for agents and branches conducted under the right of establishment, i.e. under the passport, where the competent authority is that of the host Member State). The broad aim is that it is the local competent authority which should deal with complaints about the firm or its agent or branch in relation to Titles III and IV.

IV. OVERVIEW OF THE REQUIREMENTS

Title III: Transparency and information

5.10 The PSD conduct of business requirements concerning information to end-users distinguish between single transactions and ongoing framework contracts. Rules applicable to both concern:

a) charging: Article 32 stipulates that providers may not charge users for the information required by the PSD. However, provider and users may agree on charges for extra or more frequent information than that specified by the PSD rules. Where such charges are imposed, they must be “appropriate and in line with actual cost”.

b) the burden of proof: Article 33 includes an option for Member States to place the burden of proof regarding compliance with information requirements, on the provider;

c) low value payment instruments: Article 34 offers an option to providers offering low value payment instruments, to provide users with information on only the main characteristics of the payment service.

d) currency conversation: Article 49 stipulates that, where a currency conversion service is offered prior to initiation of a transaction, the party offering the service shall disclose all charges, in addition to the exchange rate to be used; and

e) additional charges: Article 50 provides that where, for the use of a given instrument, the payee or a payment service provider or third party requests a charge or offers a reduction, they shall inform the user prior to initiation of the transaction.

Single transactions **5.11** A lower level of information is required for single transactions, with the following conditions established:

a) prior information and conditions: Articles 36 and 37 establish that, before the user is bound by a contract, the provider must make available in an easily accessible manner: the unique identifier (e.g. a PIN number); the maximum execution time for the transaction; all charges payable, and a breakdown where applicable; and the reference exchange rate where applicable.

b) information after the payment order/execution: Articles 38 and 39 prescribe that immediately after receipt of the payment order or execution of the transaction, the provider shall make available: a reference for the payer/payee to identify the transaction; the amount of the transaction in the currency in which the funds are available; the amount of any charges and a breakdown; the exchange rate and amount of transaction before the currency conversion; and the date of receipt of the order or (in the case of direct debits) the credit value date.

Framework contracts **5.12** For transactions covered by a framework contract, the following conditions apply, in addition to the requirements for single transactions:

a) prior information and conditions: Articles 41, 42, and 43 provide that, before the user is bound by a contract, the provider must make available:

- the name and address of the provider, any addresses relevant for communication, the supervisory authority and registration number of the provider;
- a description of the main characteristics of the service, the unique identifier (e.g. a PIN number) the procedure for giving consent to execution, the point in time at which the order will have been deemed received, the maximum execution time and any cut-off time (i.e. end of the business day) established by the provider;
- any possibility of agreeing spending limits for use of the instrument;
- interest and exchange rates to be applied, and methods for their calculation, including bases and indexes;
- the means of communication for transmission of information, the manner and frequency of information, language of the contract, and the user's right to receive information on request;
- information on steps necessary to keep the instrument safe, how to notify the provider on becoming aware of loss, theft or misappropriation, and conditions for blocking the instrument;
- the liability of the payer, how the user must notify the provider of an incorrect transaction, the provider's liability for execution, and the conditions for refund; and
- information on the form for making changes to the contract, the duration of the contract, the rights of the user to terminate, and information on the complaints and redress procedures;

b) change in conditions of the contract: Article 44 states that any changes to the conditions of the contract shall be proposed no later than 2 months before their date of application, with the user having the right to terminate beforehand and without charge. Changes in interest or exchange rates must also be implemented in a neutral manner that does not discriminate against users;

c) termination: Article 45 allows the user to terminate the contract at any time, unless a notice period of 1 month or less has been agreed. After 12 months, termination is free for the user. In other cases, charges must be "appropriate and in line with actual costs". Member States have the option to provide more favourable provisions for user;

d) information before execution: Article 46 stipulates that before execution of an individual transaction under a framework contract, the provider shall, at the payer's request, provide information on the maximum execution time and charges for this transaction; and

e) information on individual transactions: Articles 47 and 48 confirm that, after the transaction, the provider shall provide the same information that is required for single transactions. However, a framework contract may include a condition that the information is provided or made available periodically, at least once a month. Member States have the option to require that providers provide information on paper once a month, free of charge.

5.13 A direct transposition is proposed for the articles on information. However, the Government would welcome views on areas where further clarification is needed on how the provisions should apply, or on the practicalities of implementation. The policy options open to Member States under Title III are discussed later in this chapter.

Consultation question

23. Is any clarification needed in relation to any of the information requirements and how they relate to a given payment method or business model?

Title IV: Rights and Obligations

General provisions

5.14 Title IV addresses the authorisation procedures for payments, refunds and liability for unauthorised or incorrect payments, procedures for execution, and value dating. The requirements apply as the default conditions for any contract, unless providers and users agree otherwise, and where the user is not a consumer.

5.15 Where a user is not a consumer, the parties may agree that certain provisions will not apply. This helps reduce the risk of moral hazard that could arise if the rights and obligations appropriate to micro-enterprises and customers were also applied to large corporates, typically able to invest more in payments security.

5.16 The PSD stipulates that providers may not charge users for fulfilment of their conduct of business obligations, unless explicitly specified in the articles enumerated under Article 52. Where charges are applied, the onus is on the provider to prove, in the event of a challenge, that the charges imposed meet the test of being "appropriate and

in line with the payment service providers' actual costs". A direct transposition of this language is proposed.

Payments and currency conversions

5.17 The Directive mandates that where a transaction does not involve a currency conversion, the payer must be responsible for any fees charged by their payment service provider, whilst the recipient of the payments must pay the charges levied by their respective payment service provider. This is also known as the SHARE principle, which is based on the sharing of charges.

5.18 The Directive does not, however, prescribe whether the payer or the payee should pay in the event that a transaction does involve a currency conversion. The choice is left to the users to decide amongst themselves whether the sending or the receiving party should be responsible for all or only part of the charges, regardless of which payment service provider levies the charge. These are known as the OUR (the payer pays) or BEN (the beneficiary/recipient pays) principles.

5.19 In relation to migrant money transfers within the EU, this seems to suggest that if payers send funds in the currency desired by the recipient, the SHARE principle of charge payment applies. If, however, the remittance ordered by the payer requires either his or the recipient's provider to carry out a conversion, the payer can choose to cover all the costs levied throughout the route of that payment.

Authorisation of payment transactions

5.20 This chapter of Title IV covers:

a) consent: Article 54 provides that a transaction is considered authorised only if the payer has given consent to execute it, in the form agreed between the payer and provider;

b) limits on use of an instrument: Article 55 prescribes that if a payment instrument is blocked, the provider shall, where possible, inform the payer of the reasons beforehand;

c) obligations of providers and users:

- Articles 56 confirms that users must keep the security features of the instrument safe, and notify their providers on becoming aware of theft, loss or misappropriation.

- Article 57 confirms that providers are obliged to ensure that the security features of an instrument are not accessible to other parties; that they, refrain from sending unsolicited instruments unnecessarily; that they ensure the user can notify the provider at all times of loss or theft and request unblocking; and that they prevent all use of the instrument, once a notification has been made.

d) unauthorised/incorrect transactions: Articles 58 and 59 establish that user notification to providers of unauthorised or incorrectly executed transactions shall be no later than 13 months after the debit date, unless the provider has failed in its Title III obligations. Where a user denies having authorised a transaction, or claims it was not correctly executed, it is for the provider to prove the transaction was authenticated.

e) liabilities of providers and users: Articles 60 and 61 stipulate that providers must immediately refund the amount of an unauthorised transaction and restore the debited account to its previous state. The payer shall bear losses

up to a maximum of €150, unless the payer has acted fraudulently or been grossly negligent, in which case liability is unlimited. Member States have the option to reduce liability in cases where the payer has not acted fraudulently or with intent (discussed in section V); and

f) refunds: Articles 62 and 63 set out the conditions for receiving a refund. Notably, for direct debits, Article 63 stipulates that the request must be within 8 weeks from the date on which the funds were debited (discussed in section V, below).

5.21 It should be noted that certain provisions, for instance Article 55 on limits of the use of a payment instrument, are without prejudice to objectively justified security reasons or legislation in the anti-money laundering domain.

Direct Debit Refunds

5.22 Currently, in the UK, users of direct debits benefit from the Direct Debit Guarantee. Should a customer find that a direct debit was ordered and/or made in error by the payee organisation, such as a utility company, or by the payer's payment service provider, there is no time limit as to when he or she may request or can receive a refund. Article 63, which harmonises the provisions for direct debit refunds in order to facilitate the development of pan-European direct debit services, states that payers must be able to request a refund during a period of eight weeks. This will be transposed into national law. However, this clearly contrasts with the unlimited Direct Debit Guarantee currently operated by UK banks and building societies that take part in Direct Debit Scheme.

5.23 Elsewhere in the Directive, however, Article 86(3) is an overarching provision permitting payment service providers to grant more favourable terms to their users. The Government would encourage the industry to maintain the current level of customer protection for direct debits by invoking Article 86(3). Although some payees, and their payment service providers, might argue that the eight-week refund limit would finally provide certainty for direct debit payments, the Government believes that consumers should continue to benefit from existing levels of protection. Furthermore, some payees and payment service providers prefer the convenience of receiving and processing direct debits, and the UK Direct Debit Guarantee provides an incentive for their continued widespread usage.

Conditions for execution of payment transactions

5.24 Article 64 provides that the point in time of receipt is the time when the payment order has been received by the provider. If this is not a business day, the order will be deemed as received on the following business day, and providers can establish a cut-off point near the end of a business day, after which point the order will be deemed as being received the next day. If a specific day has been agreed for a payment transaction to take place, the point in time of receipt will be that day.

5.25 Article 66 provides that a user cannot revoke an order once received by their provider, and after their consent has been given to execute it. However, in the case of direct debits and standing orders, the payer may revoke the order by the end of the business day preceding the agreed debit day. The provider may charge for revocation if agreed in the framework contract, and if the request falls after the time limits prescribed in the PSD.

5.26 Article 69 on execution times provides that payments must be executed by D+1 by 1 January 2012, up until when a time of D+3 may be agreed upon between providers and users. A further business day is permitted for paper-initiated transactions. Article 73 stipulates that the credit value date for the payee's account will be no later than the

business day on which the transaction is credited to the payee's payment service provider's account. Similarly, for payers, the debit value date for the payer's account will be no earlier than the time at which the transaction is debited to that account. This provision removes the potential for float.

5.27 Article 75 establishes conditions on non-execution or defective execution. When an order is initiated by the payer, the payer's payment service provider is liable for correct execution, unless he can prove that the payee's provider received the amount of the transaction, in which case the payee's provider shall be liable to the payee for correct execution. Where liable, the payer's provider must promptly refund the amount of the non-executed or defective transaction, and restore the account to its original state. Where the payee's provider is liable, they shall immediately place the amount of the transaction at the payee's disposal and credit the payee's account. Where a transaction is not executed or is defective, the payer's provider must make immediate efforts to trace the transaction and notify the payer of the outcome. Parallel conditions apply where a transaction is initiated by or through a payee. Additionally, payment service providers shall be liable to their respective users (payer/payee) for any charges and interest to which the user is subject as a consequence of non- or defective execution.

Out of court redress procedures

5.28 Article 83 requires Member States to ensure that adequate and effective out-of-court complaint and redress procedures for the settlement of disputes between payment service users and their providers are put in place. In the UK, this will be through the Financial Ombudsman Service (FOS).

V. POLICY OPTIONS IN TITLES III AND IV

Title III: Policy options

Application to micro-enterprises

5.29 Under Article 30(2), Member States may provide for provisions in Title III to be applied to micro-enterprises in the same way as to consumer. In other words, as a derogation from Article 30(1), Member States can stipulate that where the payment service provider's contracting party is a micro-enterprise, all of the Title III provisions will apply. HM Treasury's previous consultation process highlighted the view that micro-enterprises and consumers tend to share similar levels of information asymmetry vis-à-vis their payment service providers.

5.30 If the derogation is not exercised, some payment service providers could agree with micro-enterprises that certain types of information under Title III will not be provided. This would risk micro-enterprises being charged for information provision by their payment service providers, a factor that might restrict their use of certain payment methods. The Government's preference is therefore to make the provisions of Title III compulsory where the payment service user is a micro-enterprise.

Consultation question

24. Do you agree with making Title III provisions compulsory when payment service providers deal with micro-enterprises, as for consumers?

Burden of proof

5.31 Member States may, under Article 33, stipulate that the burden of proof regarding compliance with the information requirements under Title III, lies with the payment service provider. In English law, the legal burden of proof will usually rest with the claimant. In practical terms, it will be assumed that the payment service provider is complying with the information requirements under Title III, unless a customer complaint to the contrary is substantiated.

Low value payment instruments and e-money

5.32 A range of different models of low-value payment instruments exists within and across Member States. Article 34 (1) allows providers of low-value payment instruments and/or e-money payment instruments to agree with payment service users a derogation from some of the information provisions in the Directive. This derogation can be exercised if such instruments are used as part of a framework contract and:

- are used to make individual transactions not exceeding €30; or
- have a spending limit of €150; or
- have stored funds which do not exceed €150 at any time.

5.33 Article 34(1)(b) also gives providers the option to change contractual conditions on a low-value payment instrument more quickly than on traditional framework contracts. The decision to exercise this flexibility, which applies to both national and cross-border transactions, is a commercial one for payment service providers. Many low-value payment instruments are designed to facilitate quick and convenient transactions, for instance in a crowded urban environment. Respondents to HM Treasury's previous consultation noted that an obligation on such providers to provide considerable information to customers before and after every payment could slow down transaction times and reduce or negate the benefits derived from technologies such as contactless cards.

5.34 Member States have the flexibility to adapt the thresholds set out in Article 34(1) in line with national payment markets. Under Article 34(2), Member States may reduce or double these thresholds for national payment transactions, and increase the thresholds to €500 for pre-paid instruments. Many UK-based pre-paid card products, for example, currently have a £1,000 stored value limit, but no limit per transaction. The UK therefore has the option of increasing the thresholds in order to maintain incentives for providers of low-value payment instruments and ensure a proportionate administrative burden.

5.35 The flexibility offered by Article 34(1) does not come without a cost. The Directive is aimed at promoting a single market in payment services, and the ability of Member States to impose different thresholds could cause some providers to withdraw products in some countries, if the cost of complying with information requirements suddenly increased.

Consultation question

25. Do you think the UK should exercise the right to adjust thresholds for low value payment instruments in Article 34(1) for national payment transactions?

Termination

5.36 Article 45 sets out the terms under which payment service users and providers may terminate contracts. Under 45(6), Member States may provide more favourable provisions for users. The term "favourable provisions" is quite broad, and could potentially be used to allow, for example, users to give only give one day's notice when terminating a contract, or a customer to terminate a one-year framework contract before the year elapses without incurring charges.

5.37 The Government believes that this is an area which should be left to competition between providers. To prescribe further conditions might confuse the legal landscape for both providers and users, and encourage passporting providers to deploy different pricing strategies in different EU Member States. Exercising the derogation might also undermine the objective of maintaining harmonised conduct of business rules throughout the EU, which were designed to create legal certainty for customers and reduce the need for providers to re-orient themselves in every new market they entered.

Consultation question

26. Do you agree with the approach of not imposing further requirements on conditions for termination, as provided for in the derogation under Article 45(6)?

Information on paper - Articles 47(3) and 48(3)

5.38 Articles 47 and 48 set out the information that must be provided for individual transactions. Under 47(3) and 48(3), Member States may require providers to provide information once a month free of charge. As with termination, the Government believes that this is an area which should be left to competition between providers, rather than be subject to impose further legal requirements.

Consultation question

27. Do you agree with the approach of not imposing additional requirements concerning the provision of information on paper, as provided for in Articles 47(3) and 48(3)?

Title IV: Policy options

Micro-enterprises and corporates

5.39 As in Title III, Member States may provide, under Article 51(3), that Title IV provisions will be mandatory for payment service users that are micro-enterprises. For the reasons given in the discussion of Title III, the Government's preferred approach is to exercise this derogation in order to provide micro-enterprises with the same standards as individual customers.

5.40 Article 51(2) provides that Member States may choose not to extend access to out of court redress procedures for payment service users that are not consumers. Assuming that stakeholders agree with the Government's intention to extend Title IV provisions to micro-enterprises, Article 51(2) may be read to mean that out of court redress procedures may only be disapplied where the payment service user is not a consumer or a micro-enterprise.

5.41 The Government would support this approach. Smaller businesses have access to FOS in the same way as consumers do, whereas larger businesses do not. This is on the assumption that larger businesses are more likely to have the financial wherewithal to lodge a claim in the Courts.

Consultation question

28. Do you agree with the Government's intention of disapplying access to out of court procedures only where the payment service user is corporate and not a micro-enterprise?

Charges

5.42 Article 52(3) allows Member States to forbid or limit the right of payees to request any charges, taking into account the need to encourage competition and promote the use of efficient payment instruments. There is no legislation in the UK that forbids or limits the right of payees to request charges when payers choose to pay with certain methods. Some retailers that accept payments online, for instance, add a charge to the cost of the good or service, depending on the payment method selected by the payer.

5.43 In 2006, the Payment Systems Task Force agreed a new governance model for UK payments systems. The Payments Council, subsequently created in March 2007, is tasked with ensuring that payment systems meet the needs of users, providers and the wider economy. The Government believes that the debate on the efficiency of different payment instruments should be conducted through the Payments Council rather than determined through legislation.

Consultation question

29. Do you agree with the approach of not exercising the derogation to forbid or limit the right of payees to request charges for payers' use of a given payment instrument?

Low value payment instruments and e-money

5.44 Mirroring the derogation in Article 34 in Title III, Article 53(2) and (3) provides flexibility for providers of low value payment instruments and e-money. Article 53(2) enables providers to agree with their users that some of the Title IV requirements shall not apply in certain circumstances, and where the payment instrument concerned:

- is used to make individual transactions not exceeding €30; or
- has a spending limit of €150; or
- has stored funds not exceeding €150 at any time.

5.45 The decision to exercise this flexibility is a commercial decision for payment service providers. As discussed in Title III, the benefit of many low value instruments comes from rapid transaction times, and the ease and convenience of their usage in busy environments. Imposing the full force of Title IV conduct requirements on the providers of such instruments may precipitate their withdrawal. In some cases, the nature of the instrument may render it impossible to comply with the PSD conduct requirements, without substantial changes to the business model and increased costs.

5.46 With this flexibility, providers may agree with their users that Article 56(1)(b), Article 57 (1)(c) and (d), Article 61(4) and (5) shall not apply, if the instrument does not allow blocking or prevention of further use. Articles 56 and 57 relate to user notification of an instrument being lost, stolen or misappropriated, the provider ensuring means available at all times for the user to notify the provider of a problem, and the provider preventing all further use upon such notification. Article 61 stipulates that the user bears only limited financial consequences resulting from use of the lost, stolen or misappropriated instrument after notification, except where he or she has acted fraudulently or with gross negligence. In such circumstances the application of these provisions to low value instruments may not be appropriate, and could lead to their withdrawal from the market.

5.47 As in Article 34(2), Under Article 53(2), Member States have the possibility of reducing or doubling the thresholds in 53(1) for national transactions, and increase the threshold for prepaid instruments up to €500. Articles 60 and 61 will apply to e-money (of all values) unless the provider cannot freeze the account or the instrument. Member States have the option of limiting this derogation to accounts/instruments of a certain value.

5.48 One problem with the flexibility afforded to Member States in this article, as in Article 34, is that different thresholds may undermine the PSD objective of promoting cross-border competition. Providers will need to investigate the thresholds applied in different Member States and may decide commercially to offer their products only in countries with similar thresholds. Exercising the option to limit the e-money derogation to accounts/instruments of a certain value in Article 53(3) could risk discouraging some providers from operating within the UK. As argued in relation to the parallel Title III provision, and from the perspective of the UK market, it may be desirable to exercise the full flexibility afforded to Member States by Article 53(2).

Consultation question

30. Do you think the UK should exercise the right to reduce or increase the thresholds permitted for low value payment instruments under Article 53(1) for national payment transactions?

Liability for unauthorised use

5.49 In the event of an unauthorised transaction, both provider and payer are expected to bear some level of liability for the losses involved; a €150 maximum is set in cases where the payer has not acted fraudulently, or in gross negligence. Where the payer has acted fraudulently or with gross negligence, the payer faces unlimited liability. However, by way of derogation Member States have the option to reduce the €150 maximum, and reduce the liability faced by payers who have been grossly negligent but not fraudulent.

5.50 In practical terms, where a payer has failed to keep his PIN number safe, (i.e. acted negligently) Member States have the option to reduce the €150 maximum, derogating from Article 61(1). In cases where payers have acted in gross negligence, e.g. writing down a pin number and attaching this to the payment instrument, Member States have the option to derogate from the unlimited liability set out in the PSD, and provide for a lower level of liability. This would be a derogation from Article 61(2).

5.51 Current UK liability standards can be compared with the EU-wide standards set by the PSD, as summarised in table 5.1:

Table 5.1: Comparison of the liability requirements under the PSD and current UK standards

	Current standard in UK	PSD provision
Lost or stolen payment card, or card misused without permission, before card issuer has been notified	Maximum £50	Maximum €150, but option to reduce maximum liability to below €150
Lost or stolen payment card, or card misused without permission, once card issuer has been notified	No liability	No liability
Payment card misused with permission (broadly equivalent to fraud or failure with intent)	Unlimited	Unlimited
Payment card lost, stolen or misused because of holder's gross negligence	Broadly equivalent to "without reasonable care" – unlimited, unless the card was used as a credit token (e.g. credit card), in which case £50 limit applies	Unlimited, but option to retreat from this and to set a quantitative maximum cap

5.52 The Government favours maintaining existing UK standards of customer protection, while guarding against the risk of moral hazard. In cases where payers have lost their payment instruments, or have had them stolen or otherwise misused, perhaps by acting negligently, the Directive provides for a higher maximum liability (€150) than existing UK law and practice (£50). The Government favours exercising the derogation to reduce the €150 liability limit to £50 in the case of lost, stolen or misused payment instruments to reflect the current position in the UK (as set out in the Consumer Credit Act 1974 and the Banking Code).

Consultation question

31. Do you agree with the approach to derogations in relation to Article 61 of the Directive on the user's liability (i.e. to maintain current UK standards)?

National payment transactions

5.53 Article 69 provides a maximum execution time of D+1 for all payment transactions by 1 January 2012. This applies to transactions:

- denominated in euro;
- national payment transactions in the currency of the Member State concerned; and
- involve only one currency conversion between the euro and the currency of a non-euro Member State, provided that the required conversion is carried out in the Member State of the non-euro currency concerned and, in the case of cross-border transactions, that the cross-border transfer takes place in euro.

5.54 Article 72 provides that, in the case of national payment transactions, Member States may provide for shorter maximum execution times than D+1. In the UK, the industry agreed in May 2005 to introduce a Faster Payments system; this system will come into effect at end-May 2008. Once live, the system will bring an acceleration in electronic payments made by telephone, internet and standing order from a current three days to a matter of hours; well above the standards required by the PSD.

5.55 The Government's approach is that, beyond the legal maximums set in the Directive, industry should be allowed to operate in a competitive space. The Government sees no rationale for further intervention to legally mandate a shorter maximum execution for national transactions at this stage, but would encourage the Payments Council to continue monitoring the competitiveness and efficiency of the UK payments market.

Consultation question

32. Do you agree with not legislating beyond the maximum execution times set by the Directive?

VI. COMPLIANCE WITH TITLES III AND IV

5.56 Unless agreed by the parties otherwise, the default position is that the conduct of business requirements in Title III and IV are applicable to all payment service providers and users. The term "users" will, in this case, cover consumers as well as business. It is expected that payment service providers will need to amend the terms and conditions for both their framework contracts and the terms governing single transactions. Industry associations may wish to draw up guidance for their members to aid compliance, and inform customers about the changes in their statutory rights. This is not, however, a legal requirement.

5.57 Credit card issuance and payment services involving the granting of a credit line fall within scope of the PSD, as set out in Annex 4 and 5. The PSD conduct of business rules will apply to credit card issuance insofar as this falls outside the scope of other relevant European legislation. The Government's view is that there should be no reduction in the protection available for UK credit card users. The Government will consider how transposition of the PSD will fit with existing European and national credit legislation, taking into account the draft Consumer Credit Directive, which is currently being considered by the European Parliament. It would welcome stakeholder views on how the PSD rules affecting credit cards, including those relating to information disclosure, will interact with existing consumer credit legislation once it is transposed in the UK.

5.58 Other legislation, such as the Distance Marketing Regulations will also need to be considered in the light of the PSD conduct of business requirements.

Consultation questions

33. Do industry groups intend to produce codes of practice on PSD implementation for their members? To what extent can this be based on any existing trade association standards?

34. How do you think the PSD rules will interact with existing consumer credit legislation, and any other existing conduct of business legislation?

A List of consultation questions

Chapter 2: Scope of the Directive and definitions used

1. Do you think you will you need to obtain authorisation as a payment institution, or would you qualify for the waiver, enabling you to register only?
2. What types of payment services do you provide?
3. How many agents and branches do you have?
4. Do you agree with the suggested interpretation of payment service activities covered by the PSD annex?
5. Do you agree with the interpretation of negative scope? Are you aware of activities or business models that might unintentionally fall within scope of the PSD?
6. Are there any concerns or issues you would wish to raise with respect to the interpretation of any definitions in the Directive?
7. Are there reasons to exempt any of the following institutions from all or part of the PSD: the National Savings Bank, the Commonwealth Development Finance Company Limited, the Agricultural Mortgage Corporation Limited, the Scottish Agricultural Securities Corporation Limited, Crown Agents for overseas governments and administrations, and municipal banks?
8. Do you agree that credit unions should be exempt from all of the PSD?

Chapter 3: Title II: the prudential regime

9. Are there issues relating to the initial or ongoing capital requirements which would benefit from further clarification? Please also give views on which of the three methods would be most appropriate to your business model.
10. Should payment institutions be able to choose the method they use for calculating their ongoing capital, subject to final agreement by the FSA?
11. Does your business currently operate some form of ring-fencing or safeguarding of user funds? If so, how does this match the ring-fencing options under the PSD? If you do not currently ring-fence user funds, how will this requirement affect your costs and business model? How might ring-fenced user funds be best protected in the event of insolvency?
12. Do you agree that ongoing capital requirements should be applied for payment institutions already included under the consolidated supervision of credit institutions? Do you intend to passport your services? If so, please provide details.
13. How do you think the FSA should approach its ability to exercise the discretion to vary ongoing capital charges by 20per cent?
14. Should payment institutions be able to apply safeguarding measures only to an estimated portion of funds which might be used for future payment transactions, where these are unknown in advance?

15. Should non-hybrid firms have to safeguard user funds in a similar manner to hybrid payment institutions? What would be the costs and benefits of this?
16. How should the competent authority approach the option to demand the legal separation of a payment institution's payments business from its non-payment activities?
17. Should safeguarding be limited to funds exceeding €600? How might the use/non-use of this flexibility affect firms' processes and operating costs?
18. Do you agree with the approach to exercise the waiver, while retaining the fit and proper test outlined in MLR07?
19. Should the agents of registered payment institutions be registered?
20. Do you intend to take advantage of the transitional provisions? Please provide details.

Chapter 4: Access to payment systems

21. Do you agree with the interpretation of the scope and aim of Article 28 on access to payment systems, and the schemes that will be affected in the UK? Are there other payment systems that may be affected?
22. What are the merits of an ex ante or an ex post approach to implementation of Article 28 on access to payment systems? Are there any other approaches that should be considered?

Chapter 5: Titles III and IV conduct of business rules

23. Is any clarification needed in relation to any of the information requirements and how they relate to a given payment method or business model?
24. Do you agree with making Title III provisions compulsory when payment service providers deal with micro-enterprises, as for consumers?
25. Do you think the UK should exercise the right to adjust thresholds for low value payment instruments in Article 34(1) for national payment transactions?
26. Do you agree with the approach of not imposing further requirements on conditions for termination, as provided for in the derogation under Article 45(6)?
27. Do you agree with the approach of not imposing additional requirements concerning the provision of information on paper, as provided for in Articles 47(3) and 48(3)?
28. Do you agree with the Government's intention of disapplying access to out of court procedures only where the payment service user is corporate and not a micro-enterprise?
29. Do you agree with the approach of not exercising the derogation to forbid or limit the right of payees to request charges for payers' use of a given payment instrument?
30. Do you think the UK should exercise the right to reduce or increase the thresholds permitted for low value payment instruments under Article 53(1) for national payment transactions?

31. Do you agree with the approach to derogations in relation to Article 61 of the Directive on the user's liability (i.e. to maintain current UK standards)?
32. Do you agree with the approach of not legislating beyond the maximum execution times set by the Directive?
33. Do industry groups intend to produce codes of practice on PSD implementation for their members? To what extent can this be based on any existing trade association standards?
34. How do you think the PSD rules will interact with existing consumer credit legislation, and any other existing conduct of business legislation?

B IMPACT ASSESSMENT

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of the Implementation of the Payments Service Directive on business	
Stage: Consultation	Version:	Date: 18 December 2007
Related Publications: Implementation of the Payment Services Directive - A consultation document		

Available to view or download at:

http://www.hm-treasury.gov.uk

Contact for enquiries: Meenakhi Borooah/Angela van der Lem **Telephone:** 020 7270 5234/ 5920

What is the problem under consideration? Why is government intervention necessary?

The Directive's goal is to improve the EU's competitiveness by integrating national payment markets and creating a Single Payments Market. This is expected to improve economies of scale and competition, which should increase efficiency and reduce the total cost of payments to the EU.

The Directive aims to provide the legislative support necessary for the EU payments industry to build the infrastructure for a Single Euro Payments Area, within which cross-border euro payments can be made as easily, safely, efficiently and inexpensively as within national borders.

What are the policy objectives and the intended effects?

The Directive has three main objectives. These are:

- To enhance competition between national payment markets by opening up markets and ensuring a level playing field;
- To increase market transparency for both providers and users; and
- To standardise the rights and obligations of providers and users of payment services in the EU, with a strong emphasis on customer protection.

What policy options have been considered? Please justify any preferred option.

- The scope of Directive (A2(3)); the safeguarding requirements for payment institutions (PI) (A 9); the conditions for PIs waiving application for prudential requirements (A 26); the waiver of conditions in Titles III and Title IV for low-value PIs & e-money (A34), (A 53); & the payer's liability for unauthorised use of payment insturments (A61).
- If the Directive is implemented without the flexibility offered in the derogation, the estimated cost to business would be £34.0m oneoff & £19.6m p.a. By applying the dergations as suggested the estimated cost to business should fall to £28.6m one-off & £4.8m p.a.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The European Commission is expected to undertake a review of the implementation and impact of the adopted Directive no later than 3 years after the Directive has been transposed into the national law of each EU Member State.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

....Date: 18 December 2007

Summary: Analysis & Evidence

Policy Option: N/A	Description: Payments Service Directive taken at basic implementation level for business i.e. not taking forward any of the flexibility offered

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Key affected groups-credit institutions (383); e-money issuers (26 licenced & 39 certified); money transfer companies (2781); credit unions (566); and Others (14). Please see page 8 for details on the estimated fees used in these calculations. The compliance cost has been estimated to be £20m one-off.
£ 34.0m*	1	
Average Annual Cost (excluding one-off)		
£ 19.6m*		**Total Cost** (PV) **£ 56.8m**

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Efficiency gains reaped by UK business as a proportion of the estimated total £6.6 billion EU savings derived from the Commission's cost/benefit analysis and £33-66 billion ongoing. This UK apportionment is weighted by the UK share of EU GDP (16.5%).
£ 1,089.0m	1	
Average Annual Benefit (excluding one-off)		
£ 2,722.5m		**Total Benefit** (PV) **£ 7,885.0m**

Other **key non-monetised benefits** by 'main affected groups' UK non-bank payment providers can use their licence to passport into and compete within other payment markets across the EU. The introduction of a transparent conduct of business regime will allow small business and consumers to understand and easily keep track of their payments.

Key Assumptions/Sensitivities/Risks The development of more standardised payment service products through SEPA & the consolidation of payments infrastructure across the EU, according to C'ion, will result in efficiency savings of around £6.6 bn. By applying the dergations as suggested the estimated cost to business should fall to £28.6m one-off & £4.8m p.a.

Price Base Year 2007	Time Period Years 3	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£ 2,655.3m**

Question				Answer
What is the geographic coverage of the policy/option?				UK
On what date will the policy be implemented?				November 2009
Which organisation(s) will enforce the policy?				FSA
What is the total annual cost of enforcement for these organisations?				£ 300k**
Does enforcement comply with Hampton principles?				Yes
Will implementation go beyond minimum EU requirements?				No
What is the value of the proposed offsetting measure per year?				£
What is the value of changes in greenhouse gas emissions?				£ n/a
Will the proposal have a significant impact on competition?				Yes
Annual cost (£-£) per organisation (excluding one-off)	Micro **£7000***	Small **£7000***	Medium **£7000***	Large **£7000***
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £	Decrease of £	**Net Impact £**

Key: **Annual** **(Net) Present Value**

Summary: Analysis & Evidence

Policy Option: 2- full exemption of the Credit Union sector	Description: Scope of the Directive (article 2(3))

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'	
One-off (Transition)	**Yrs**		
£ 0			
Average Annual Cost (excluding one-off)			
£ 0		**Total Cost** (PV)	£ 0

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' There are approx 566 credit unions (CU) in the UK. By applying the full derogation - exempting CU from the entirety of the PSD - the sector will benefit from not having to comply with the conduct of business requirements. At present information on the cost savings for CU not needing to comply with the directive is not known.	
One-off	**Yrs**		
£			
Average Annual Benefit (excluding one-off)			
£		**Total Benefit** (PV)	£

Other **key non-monetised benefits** by 'main affected groups'
Credit unions continue to serve individuals that are unbanked.

Key Assumptions/Sensitivities/Risks The extra burden of even partially complying with the PSD could generate a significant social cost, impact negatively on the Government's financial inclusion agenda and greatly reduce the availability of affordable credit. Credit Unions will continue to be regulated and authorised under the Financial Service and Markets Act.

Price Base Year 2007	Time Period Years 3	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) £ 0m

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			November 2009	
Which organisation(s) will enforce the policy?			FSA	
What is the total annual cost of enforcement for these organisations?			£ 0	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro 0	Small 0	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Decrease of £ **Net Impact** £

Key: **Annual costs and benefits:** **(Net) Present Value**

Summary: Analysis & Evidence

Policy Option: 3 - all PIs to safegaurd	**Description: The general rules for safeguarding requirements for payment institutions (article 9)**

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	A proportion of the 64 lg & 2731 sm hybrid & non-hybrid PIs will need to install new software to disaggrate payments below €600. The technology is estimated to cost £50-200k one-off & ranging from £35k to £85k p.a. ongoing for technical & maintenance support. Clearer estimates should be received through the consultation process.
£ 349.4m	1	
Average Annual Cost (excluding one-off)		
£ 167.7m		**Total Cost** (PV) £ 485.7m

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Payment Institutions that primarily transact low value payments below the €600 threshold & do not need to invest in this technology. These are likely to be predominately hybrid firms. The quantity of the monetised benefits are currently unknown, however, clearer estimates should be received through the consultation process.
£		
Average Annual Benefit (excluding one-off)		
£		**Total Benefit** (PV) £

Other **key non-monetised benefits** by 'main affected groups'

Key Assumptions/Sensitivities/Risks Predominately small hybrid payment institutions will use this flexibility and large firms will safeguard all of there transactions, meaning that only a small proportion of firms will invest in the technology to disaggregate low- and high- value transations.

Price Base Year 2007	Time Period Years 3	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) £ -485.7m

Question	Answer
What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	November 2009
Which organisation(s) will enforce the policy?	FSA
What is the total annual cost of enforcement for these organisations?	£ 0
Does enforcement comply with Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	No
What is the value of the proposed offsetting measure per year?	£
What is the value of changes in greenhouse gas emissions?	£ n/a
Will the proposal have a significant impact on competition?	Yes/No

	Micro	Small	Medium	Large
Annual cost (£-£) per organisation (excluding one-off)				
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Decrease of £ **Net Impact** £

Key: **Annual costs and benefits:** **(Net) Present**

Summary: Analysis & Evidence

Policy Option: 3 – introduce criteria for waive firms	Description: Conditions for payment institutions waiving application for prudential requirements (article 26)

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' Payment institutions (PIs) that meet the criteria of the derogation - approxiamately 2731 firms - will need to pay registration fees. Please see page 8 for details on the estimated fees used for these calculations.	
One-off (Transition)	**Yrs**		
£ 0.3m*	1		
Average Annual Cost (excluding one-off)			
£ 0.5m*		**Total Cost** (PV)	£ 1.4m

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' PIs exempt from full authorisation fees & safeguarding costs if : legal or natural persons;·execute less than €3m worth of payment transactions a mth; don't wish to passport their services in other EU MS; & can prove that none of the persons responsible for managing the business has been convicted of ML offences.	
One-off	**Yrs**		
£ 335.0m	1		
Average Annual Benefit (excluding one-off)			
£ 183.0m		**Total Benefit** (PV)	£ 530.0m

Other **key non-monetised benefits** by 'main affected groups' The policy intentions behind both the Third Money Laundering Directive and the International Financial Action Task Force recommendation on Money Laundering and Terrorist Financing will continue to be met.

Key Assumptions/Sensitivities/Risks It was assumed that the PSD would go wider than the 3MLD requirements - money transmission or remittances offices to be licensed or registered in order to operate their business legally. However, its now clear that the PSD inadvertently removes the "fit and proper" requirement for registered (waived) PIs.

Price Base Year 2007	Time Period Years 3	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) £ 528.6m

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			November 2009	
Which organisation(s) will enforce the policy?			FSA	
What is the total annual cost of enforcement for these organisations?			£ 0	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			Yes	
What is the value of the proposed offsetting measure per year?			£	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			Yes/No	
Annual cost (£-£) per organisation (excluding one-off)	Micro £200*	Small £200*	Medium £200*	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Decrease of £ **Net Impact** £

Key: **Annual costs and benefits:** **(Net) Present**

Summary: Analysis & Evidence

Policy Option: 2 - increase threshold	Description: Waiving the application of the Title III and Title IV for low-value payment instruments and electronic money (article 34), (article 53)

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' Firms may have to invest in technology to differentiate low-value payments, however it is assumed that these firms would have invested in this technology when implementing the safeguarding derogation.	
One-off (Transition)	**Yrs**		
£ 0			
Average Annual Cost (excluding one-off)			
£ 0		**Total Cost** (PV)	**£ 0**

Other **key non-monetised costs** by 'main affected groups' Different thresholds across the EU may undermine the PSD objectives to promote cross-border competition.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' Payment institutions that regularly transact low value instruments, which are defined in the Directive as: - used to make individual transactions not exceeding €30; - have a spending limit of €150; or - have stored funds which do not exceed €150 at any time.	
One-off	**Yrs**		
£			
Average Annual Benefit (excluding one-off)			
£		**Total Benefit** (PV)	**£**

Other **key non-monetised benefits** by 'main affected groups' Existing innovative products in the UK can benefit from a lower, more proportionate administrative burden; low value instruments can continue to perform rapid transaction times, increasing the ease and convenience of use.

Key Assumptions/Sensitivities/Risks If MSs exercised this flexibility, some providers could withdraw products from some countries. However, increasing the UK threshold would allow providers (domestic & EU) to maintain their current product offering in the UK and sustain innovation.

Price Base Year 2007	Time Period Years 3	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£**

Question				Answer
What is the geographic coverage of the policy/option?				UK
On what date will the policy be implemented?				November 2009
Which organisation(s) will enforce the policy?				FSA
What is the total annual cost of enforcement for these organisations?				£ 0
Does enforcement comply with Hampton principles?				Yes
Will implementation go beyond minimum EU requirements?				No
What is the value of the proposed offsetting measure per year?				£
What is the value of changes in greenhouse gas emissions?				£ n/a
Will the proposal have a significant impact on competition?				Yes/No
Annual cost (£-£) per organisation (excluding one-off)	Micro **0**	Small **0**	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of £	Decrease of £	**Net Impact**	**£**

Key: **Annual costs and benefits:** **(Net) Present**

Summary: Analysis & Evidence

Policy Option: 3 – mirror current UK legislation	Description: Payer's liability for unauthorised use of payment instruments (article 61)

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' Cost will be minimal as this application of the derogation would mirror existing UK law as set out in the Consumer Credit Act 1974 and the Banking Code.
One-off (Transition)	**Yrs**	
£ 0		
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV) **£ 0**

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' Zero - current UK status quo maintained.
One-off	**Yrs**	
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0		**Total Benefit** (PV) **£ 0**

Other **key non-monetised benefits** by 'main affected groups' UK customer protection standards are maintained i.e. status quo

Key Assumptions/Sensitivities/Risks

Price Base Year 2007	Time Period Years 3	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			November 2009	
Which organisation(s) will enforce the policy?			FSA	
What is the total annual cost of enforcement for these organisations?			£ 0	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			Yes/No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £	Decrease of £	**Net Impact £**

Key: **Annual costs and benefits:** **(Net)**

Evidence Base (for summary sheets)

Notes:

*Fee estimates provided on page 2 and 5 are based on current fees charged for comparative types of firms and activities. The Financial Service Authority's (FSA) current initial fee for a moderately complex authorisation application is £5,000 and the expected initial registration fee for 3MLD registration will be £100. Average annual ongoing costs are estimated to be around £7,000 and £200 for authorised and registered payment institutions respectively. These estimates are likely to change as more information becomes available and are subject to FSA consultation. The FSA fee estimates do not include any one-off costs for developing the authorisation, registration and supervisory regimes, nor any IT development costs.

**While other bodies have roles under the Payment Services Directive, the competent authority for most aspects of the Payments Service Directive will be the FSA and this figure is for FSA costs only. The FSA estimated cost of enforcement is likely to change as it does not take into account the costs to supervisory areas in the preparation of cases for enforcement referral.

The Payments Service Directive

1. The goal of the Payment Service Directive (PSD) is to improve the EU's competitiveness by integrating national payment markets and creating a Single Payments Market. This is expected to improve economies of scale and competition, which should increase efficiency and reduce the total cost of payments in the EU. To achieve this, the Directive has three main objectives:
   - to enhance competition between national payment markets by opening up markets and ensuring a level playing field;
   - to increase market transparency for both providers and users; and
   - to standardise the rights and obligations of providers and users of payment services in the EU, with a strong emphasis on customer protection.
2. When implemented, the PSD will apply across the United Kingdom.
3. The Commission's aim is that the Directive should provide the legislative support necessary for the EU payments industry to build the infrastructure for a Single Euro Payments Area (SEPA), which aims to make cross-border Euro payments easy, safe, efficient and inexpensive as within national borders.

Background to intervention

4. Facilitating payments within the EU by harmonising the relevant legal provisions has been a priority for the European Commission's Directorate General for the Internal Market (DG MARKT). In 1997, a Directive on consumer protection rules for cross-border credit transfers (Directive 97/5/EC) was agreed. In 2001, the EU brought in Regulation 2560 on Cross-Border Payments in Euro. This Regulation stipulates that cross-border payments in Euro should be the same price as an equivalent domestic payment in Euro within any EU Member State, and was intended to provide industry with an incentive to build the payments infrastructure necessary for the creation of SEPA.
5. These existing pieces of legislation have, to some extent, made it easier and cheaper to make Euro payments across the EU. They have also encouraged industry to start the

process of building the payments infrastructure necessary for SEPA. However, an internal market in payments has not yet been delivered. In 2003, the Commission published a consultation document identifying 21 potential barriers to the development of SEPA and, following detailed consultation, decided to proceed with a proposal for a Directive to address the issues identified.

6. The PSD establishes a licensing regime for a new category of payment service provider known as a payment institution. This allows such institutions to operate across the EU on the basis of a licence obtained in any one EU Member State.
7. In July 2006, the Government consulted during the negotiations on the directive and published a summary of responses at the end of 2006 (http://www.hm-treasury.gov.uk/consultations_and_legislation/payment_services_directive/consult_payment_services_index.cfm)

Rationale for intervention – facilitating SEPA and an EU internal market in payments

8. How payments are made can have a significant impact on the productivity of an economy. Studies have suggested that gains in efficiency, particularly by taking advantage of economies of scale and by moving to electronic products, can increase a country's GDP by several percentage points. The efficiency of payment systems in the UK was raised in the Cruickshank Report on Competition in UK Banking of March 2000. This noted that "given the fundamental importance of payment systems to economic life, any inefficiency in these systems will have a significant impact on economic welfare". Following the publication of the Cruickshank Report, work was undertaken in the UK to improve the efficiency of the UK's payment systems, primarily through the Payment Systems Task Force (PSTF) which comprised of stakeholders from the banking industry, consumer and business groups and Government, and chaired by the Office of Fair Trading. The PSTF has since been superceded by the independent Payment Council, established in 2007, which is responsible for governing the development of the UK payment systems.
9. The Commission's view is that the current fragmented state of payment systems among EU Member States is imposing significant costs on the EU as a whole. A study completed for the Commission by McKinsey & Company in 2005 suggests that there are currently around 231 billion payments per year in the EU, representing a total value of €52 trillion. Moving to more efficiency payment services could bring significant savings to business and consumers. Opening up national payment markets to providers from across the EU should encourage this, by increasing competition and facilitating the cross-border marketing and provision of payment services. For example, bringing in an EU-wide direct debit scheme should improve the ease and efficiency with which bill payments are made across the EU, generating benefits for cross-border trade and mobility.
10. There is great variation in the efficiency of payment markets in different EU Member States. In some countries, electronic payments take at least three days to execute, whereas in other countries the execution of a payment transaction is on the same day. If the price of payments in all EU countries were to fall to the level of the best performer huge savings could be achieved. For example, some merchants have reported that if they were able to source payment services from the most competitive providers in the EU they could, in some cases, pay up to 20 times less for card payments.
11. The development of more standardised payment service products through SEPA and the consolidation of payments infrastructure across the EU, according to the European Commission, should result in efficiency savings of around £6.6 billion. The European Commission also estimates that if standardised, end-to-end automated payments were introduced through the integration of electronic payments with established business processes, such as e-invoicing, the EU as a whole could make further savings of around £33–£66 billion per annum.

12. It is difficult to identify the UK's share of any such aggregate benefits. Clearly, however, benefits would accrue if UK customers and business were able to make payments more easily and at a lower cost.

Flexibility in the Directive

13. As the PSD is a maximum harmonisation directive, flexibility for Member States to deviate from the PSD requirements in implementation is limited. This consultation impact assessment (IA), however, sets out the key options (with associated costs and benefits) where the UK has flexibility over implementation of Directive and where quantitative impacts can be assessed. This IA analyse the cost and benefits of the PSD regime over and above the applying the money laundering 'fit and proper' test and will consider policy options on:
    - the scope of the Directive (Article 2(3));
    - the safeguarding requirements for payment institutions (article 9);
    - the conditions for payment institutions waiving application for prudential requirements (article 26);
    - the waiver of conditions in Titles III and Title IV for low-value payment instruments and electronic money (article 34), (article 53); and
    - the payer's liability for unauthorised use of payment instruments (article 61).
14. As part of this consultation on policy, the Government is seeking comments on the analysis of cost and benefits, likely upside and downside risks and unintended consequences of the proposed options, as well as supporting evidence wherever possible. Suggestions for alternative options, or indeed alternative combinations of existing options, are welcome. The feedback to this consultation IA will provide information for decision making, which will feed into the subsequent final IA.
15. The consultation document and this consultation IA should be read together.

Sectors and groups affected by the Payment Service Directive

16. Article 1 of the Payment Services Directive (PSD) sets out the organizations that are in scope of the Directive and will have an impact on all businesses currently offering payment services as defined by the Directive. Subject to transposition, these are:
    - credit institutions;
    - e-money issuers;
    - Post office giro institutions;
    - payment Institutions
        - Money transfer companies;
        - Companies offering bill payment services; and
        - Non-credit institution credit card issuers;
    - national central banks; and
    - public authorities.
17. Article 2(3) of the Directive allows Member States to exercise a derogation to waive all or parts of the Directive to certain institutions. These include:
    - the National Savings Bank;
    - the Commonwealth Development Finance Company Limited;
    - the Agricultural Mortgage Corporation Limited;
    - the Scottish Agricultural Securities Corporation Limited;

- the Crown Agents for overseas governments and administrations;
- credit unions; and
- municipal banks.

18. This derogation mirrors a parallel derogation in the Capital Requirements Directive (CRD). The derogation may not be of relevance to all of the institutions named above, as some are not providers of payment services in the UK, and others, as defined by the scope of the Directive, may not be undertaking payment services at all. In the consultation process, the Government invites responses to the consultation question of whether any of these entities other than credit unions should be waived.
19. In the case of **credit unions**, this derogation is an important and useful provision for the UK, and has already been assessed through a Regulatory Impact Assessment in July 2006. Informed by the evaluation consultation responses and cost-benefit analysis, the Government concluded that it would continue its efforts to seek an exemption for credit unions from the PSD. As many credit unions provide basic banking services to the financially excluded, increased compliance costs could lead to closures which could generate significant social costs, have a negative impact the Government's financial inclusion agenda and reduce the availability of affordable credit.
20. The UK successfully secured the waiver provision for credit unions in the PSD. However, the issue arises as to whether credit unions should gain:
    - Option 1 - a partial exemption from the Directive whereby credit unions could be subject to registration (Title II) and/or conduct to business rules (Titles III and IV); or
    - Option 2 – a total exemption from the Directive.

Option 1 - Partial Exemption

Cost

21. As many credit unions are staffed for only part of the week, payments are typically not processed on a daily basis. Credit unions also rely on weekly or monthly statements from banks, which set out the inward payments that have been made to the credit union's pooled account before monies are segregated amongst it members. However, credit union members are generally well aware of these delays, and continue to use this type of payment service for reasons other than fast payments processing.
22. The extra burden of even partially complying with the PSD could generate a significant social cost, impact negatively on the Government's financial inclusion agenda and greatly reduce the availability of affordable credit. Many credit unions work to provide low-cost loans and need to avoid undue administrative burdens.

Benefit

23. The potential benefit to credit unions of option 1 would be the ability to passport as a payment institution. However, as the existing UK legislation restricts the ability of credit unions to use this flexibility, there would be no derived benefit.

Option 2 - Full exemption

Cost

24. Zero

Benefit

25. As credit unions are already exempted from the prudential requirements of the CRD, it would be consistent also to exempt credit unions from the Title II - prudential requirements of the PSD. Credit unions would also be unable to comply with many aspects of the conduct

of business rules in Titles III and IV of the Directive, particularly those pertaining to execution times and value dating.

26. Credit Unions will continue to be regulated and authorised under the Financial Service and Markets Act, contributing to an estimated £500m to the UK economy. However, the overall impact is zero, as credit unions would be unaffected by the Directive.

Discussion and Risk

27. The Government's policy aim is to avoid constraining credit unions from offering current or future payment services to their members, while maintaining the redress protection currently provided by the Financial Ombudsman Service (FOS). The Government will continue to engage with the credit union movement on financial services legislation, especially in light of any changes to business models, to ensure that the regulatory approach towards the sector remains proportionate, risk-based and workable.

Safeguarding requirements for payment institutions (article 9(1))

28. Article 9 of the Directive requires hybrid payment institutions that also engage in a non-payments business activity (for example telecommunications services), to safeguard or ring-fence any funds received from payment service users to protect the payment service users' funds in the event of the payment service provider becoming insolvent. At present, there is no legal requirement for firms to safeguard payment service users' funds against the risk of insolvency. Member States have the option of applying safeguarding requirements to hybrid and/or non-hybrid firms.
29. Article 9(4) permits Member States or the competent authority to apply the safeguarding requirements in Article 9(1) only to payment service users whose funds exceed €600. This derogation could apply to funds paid into hybrid and non-hybrid payment institutions, were the UK to decide to impose safeguarding requirements on non-hybrid payment institutions under Article 9(3).
30. This derogation is premised on the principle of proportionality, with the safeguarding protection restricted to larger value transactions. The Government believes that there are three options with regards to implementation:
    - Option 1: Do not apply the derogation;
    - Option 2: Apply the derogation to hybrid payment institutions only; or
    - Option 3: Apply the derogation to hybrid and non-hybrid payment institutions.

Option 1: Do not apply the derogation

This option requires that all funds paid in by customers have to be ring-fenced, regardless of the size of the amount paid in and regardless of the firm (i.e. applies to both hybrid and non hybrid firms)

Cost

31. There could be a potential impact of not applying the derogation to firms that regularly transact low-value payments, as the cost of ring fencing may render the institution's business model as unsustainable. Mobile phone payment firms typically offer low-value payments of not more than £5 to £10; the cost of ring-fencing each payment could therefore be deemed too expensive, prompting providers to withdraw low-value payment services from the market.
32. As the Directive also includes an option for simplifying conduct of business rules for low-value payments (article 34 and 53) up to a variety of thresholds – all of which are below €600 – a decision not to apply the ring-fencing derogation for low-value payments might appear inconsistent. The operational cost for the firm could increase, as it would have to comply with different thresholds for conduct of business and safeguarding.
33. Early indications are that the cost of compliance for a payment institution, in terms of investing in systems to track payments above the minimum threshold, is estimated to be £50k per firm, but is dependant on the size of the firm. Potential ongoing costs associated with the need for extra resources to maintain the safeguarding process and ongoing technical and operational support costs could range from between £35k and £85k.

Benefit

34. Since all funds have to be ring-fenced under this option, payment institutions do not need to consider investing in systems to track whether the client monies they receive are above or below the threshold of €600.
35. Consumers are given greater protection as all of their payments are safeguarded against insolvency.

Option 2: Apply the derogation to hybrid Payment Institutions only

This option would mean that non-hybrid PIs would not have to ring-fence payment service users' funds at all, and that hybrids would only ring-fence funds above €600.

Cost

36. There is a risk that if the derogation is not fully applied to both hybrid and non-hybrid payment institutions information asymmetries could arise, as customers might be justified in expecting similar standards of protection for the same types of services.
37. There is a risk that hybrid firms might restructure their business model and split their activities to avoid having to safeguard payments. This scenario could, under such circumstances, reduce consumer protection.

Benefit

38. Non-hybrid payment institutions will continue to transact low value transactions without being subjected to the cost of ring-fencing. Industry might also be able to present evidence showing that the benefits of applying this ring-fencing derogation might outweigh the cost of any systems changes needed to introduce ring-fencing for all transaction amounts.

Option 3: Apply the derogation to all payment institutions

This option would mean that only funds paid in by customers to both hybrid and non-hybrid firms that exceed €600 would be protected by the safeguarding requirements provided under Article 9(1). Firms would, however, have the option of also safeguarding funds below the €600 threshold.

Cost

39. The impact on firms is unclear since, as mentioned above, the cost of installing a system to track the size of each payment transaction might outweigh the cost of ring-fencing all payments. For example, it may be that there are some financial instruments that already allow firms to ring-fence in bulk. However, firms would have the option of also safeguarding funds below the €600 threshold (i.e. safeguarding everything).

Benefit

40. Applying Article 9(1) to non-hybrid payment institutions would have the advantage of extending such protection to customers of firms that only provide payment services. This could offer greater clarity to customers. Equity issues might arise if two customers were using essentially the same service, e.g. money remittance, but were afforded two different standards of protection.
41. Payment institutions that regularly and only transact low-level payments (below €600) will have the option of not complying with the ring-fencing requirement of the Directive and could choose to ring-fence everything.

Discussion and risk

42. The Government favours option 3. This option provides parity between hybrid and non-hybrid firms from a consumer protection prospective while avoiding loopholes and ensuring low value transactions can continue to be made at a lower cost to firms.

Conditions for payment institutions waiving application for prudential requirements (article 26)

43. Article 26 allows Member States to waive the application of all or part of the Title II prudential requirements for firms that:

    - are legal or natural persons;
    - execute less than €3 million worth of payment transactions a month;
    - do not wish to sell, or "passport" their services in other EU Member States; and
    - can prove that none of the persons responsible for managing the business has been convicted of offences relating to money laundering or terrorist financing or other financial crimes.

44. Such persons would be treated as payment institutions, but would not have the right to passport into other EU Member States. Member States would have to establish a registration regime for waived payment institutions. Firms waived from PSD authorisation are not exempt from compliance with PSD conduct of business requirements (Titles III and IV). In the UK, it is expected that the majority of firms falling within the waiver criteria set out on the Directive would be money transfer companies

45. Money remitters are currently supervised by HMRC for compliance with the Money Laundering Regulations and will continue to be supervised by HMRC for these purposes following implementation of the PSD. The 2007 Money Laundering Regulations (MLR07) will enter into force this December, which will require money remitters to complete an objective "fit and proper" test.

46. In deleting the provisions of the Third Money Laundering Directive, which require money transmission or money remittances offices to be licensed or registered in order to operate their business legally, the PSD also removes this "fit and proper" requirement for such businesses. Following the conclusion of the Money Service Business Review as set out in the Government's Financial Crime Strategy, the Government believes that the fit and proper test outlined in the MLR07 should be retained as it ensures HMRC is equipped to identify those associated with organised crime or terrorism and those consistently non-compliant with the Money Laundering Regulations. It, therefore, meets the policy intentions behind both the Third Money Laundering Directive and the international Financial Action Task Force recommendation on Money Laundering and Terrorist Financing. The Government therefore proposes to maintain this more stringent form of "fit and proper" test for waived firms.

47. In practical terms, even if the waiver from full authorisation was in place for firms meeting the criteria above, the UK might wish to apply some of the Title II provisions to waived institutions, which is permissible under Article 26(1). This would be particularly true of Article 5, which outlines the information required from firms wishing to obtain full authorisation as a payment institution, and contains three criteria that appear to be consistent with the intention of the MLR07 "fit and proper" test.

48. As well as the need to ensure that the waiver criteria matches existing UK obligations in other legislation affecting the payments market, there is a broader question of how far the Government should exercise the derogation. There appear to be three options:

    - Option 1 - do not apply the derogation;
    - Option 2 - exercise a partial derogation and apply provisions that might further enhance customer protection; or
    - Option 3 - exercise the derogation either applying only those provisions that enable the UK to continue to apply a fit and proper test to money transfer companies, or, where the fit and proper test continues to be applied under the Money Laundering Regulations, in full.

Option 1: Do not apply the derogation

Cost

49. Under this scenario, there would no PSD registration regime. Small firms would need to comply with all the provisions in Title II, including initial and ongoing capital requirements as well as safeguarding measures.
50. There would be a cost to the FSA from authorising 2731 additional firms and a cost to firms having to comply with the PSD. The average cost of compliance per firm has been estimated as a £5.0k one off authorisation cost, and an average £7.0k ongoing licence fee payment.
51. Industry is concerned that small payment institutions, many of which operate locally, may be priced out of the market by prudential requirements or forced to operate underground. As the competent authority will need to devote supervisory efforts to such small firms, in the same way as they do for larger and more established firms, firms will very likely face far higher licensing fees than if they were only required to obtain registration under a waived regime. For small firms that operate only a marginal payments business alongside their core business, the cost of such compliance would be prohibitive and could cause some to withdraw their services, reducing competition and customer choice.

Benefit

52. By not applying the derogation consumers would have the certainty that any payment service provider regulated by the FSA would be subject to a high level of prudential regulation.

Option 2: Exercise a partial derogation

Cost

53. Strictly speaking, many of the rules under Title II of the Directive are aimed at ensuring the financial soundness of a firm. The only provision which might be targeted specifically at enhancing customer protection would be the safeguarding measures under Article 9. As explained previously, the effect of Article 9 is to earmark funds that customers pay in to a payment service provider, so that in the event of insolvency, such funds are ring-fenced from other creditors, lending customers a preferential creditor status.
54. The cost would impact on both the FSA and the small firms, and could result in increased FSA fees, which might price some firms out the market.

Benefit

55. Arguably, customers that use different payment service providers will expect similar levels of protection for using the same service, regardless of the firms' business model and size. A partial derogation to impose the safeguarding requirements could provide enhanced consumer protection.

Option 3: Exercise the full derogation and apply only those provisions that enable the UK to meet its existing AML obligations.

Cost

56. There would be an initial one-off cost to register a payment institution of £100 and £200 p.a. for ongoing registration.
57. There is a risk that waived firms would receive the same reputational benefit as larger firms, as they could be seen to be approved by the FSA. However, customers that use smaller firms may value lower cost and convenience over the statutory protection of their funds, particularly if the transaction amounts are relatively small.

Benefit

58. During the Government's previous consultation process, larger money transfer companies believed that a waiver for small firms would be acceptable under the Directive, as long as waived firms provided customers with a level of protection commensurate with that by authorised payment institutions.

59. No additional PSD cost, except the one off registration cost of £100 and ongoing fee of £200.

Discussion and risk

60. As the risk of imposing additional requirements on waived firms could potentially cause these firms to disappear underground, the Government favours of option 3. Unless the participants of the UK payments market presents a compelling case in favour of Option 2 (which, if exercised, would amount to gold-plating of European legislation), the Government's preference is to create a separate registration regime for smaller and non-passporting payment institutions, and to continue to apply the 'fit and proper' test currently in place. The Directive does not prohibit firms that are eligible for the waiver from applying for authorisation as a payment institution if they perceive any benefits to be derived from obtaining a full licence, provided they have the necessary controls in place.

Waiving the application of the Title III and Title IV for low-value payment instruments and electronic money (article 34), (article 53)

61. Titles III and IV of the Directive contain the conduct of business rules applicable to all payment service providers. Title III establishes the conditions for the information provision to payment service users, while Title IV establishes the rights and obligations of both payment service providers and users. At present credit institutions and e-money issuers comply with a variety of legislations and voluntary codes of practice, including the Banking Code, Capital Requirement Directive, the Banking Consolidation Directive and the E-Money Directive.

62. Article 34 (Title III) and Article 53 (Title IV) allows providers of low value payment instruments, to provide users with information on only the main characteristics of the payment service. Providers can agree with their users that some of the Title IV requirements will not apply in certain circumstances. Many low-value and/or e-money payment instruments are designed to facilitate quick and convenient transactions, for instance in a crowded urban environment. The Directive defines the thresholds for low-value instruments as:

    - being used to make individual transactions not exceeding €30; or
    - having a spending limit of €150; or
    - having stored funds which do not exceed €150 at any time.

63. It will be for providers to decide whether they wish to exercise the flexibility offered by Article 34(1). For example, 34(1)(b) gives payment service providers the option to change contractual conditions on a low-value payment instrument more quickly than in the context of traditional framework contracts. This would seem proportionate and more workable (for instance in the case of "anonymous" payment instruments, where the provider does not have a regular and/or systematic way of communicating with the customer).

64. It is understood that the derogation in Article 34(1) applies to both national and EU cross-border transactions made on payment instruments which are used within the context of a framework contract and satisfy the values set out above. However, under Article 34(2), Member States or their competent authorities may reduce or double the amounts referred to in Article 34(1) for national payment transactions. Member States may also increase the thresholds under Article 34(1) to €500 for pre-paid instruments.

65. Article 53(2) enables providers of low-value instruments to agree with their users that some of the Title IV requirements will not apply in certain circumstances. With this flexibility, providers may agree with their users that Article 56(1)(b), Article 57 (1)(c), Article 61(4 and 5) shall not apply, if the instrument does not allow blocking or prevention of further use. Articles 56 and 57 relate to user notification of an instrument being lost, stolen or misappropriated, as long as the provider ensures both that the means are available at all times for the user to notify the provider of a problem, and prevents all further use upon such notification. Article 61 stipulates that the provider shall not bear any financial consequences resulting from use of the lost, stolen or misappropriated instrument after notification, except where he or she has acted fraudulently.

66. Articles 60 and 61 will apply to e-money (of all values) unless the provider cannot freeze the account or the instrument. Member States have the option to limit this derogation to accounts/instruments of a certain value.

67. During the negotiations on the Directive, it became evident that different models of low-value payment instruments exist within and across different Member States. Many UK-based pre-paid card products currently have a £1,000 stored value limit, but no limit per transaction. The market offering for low-value and e-money payment products is very variable across Member States, which can pose challenges in the context of a maximum harmonisation Directive.

68. Although the derogation in Article 34(1) is separate from that under Article 53, consistency and simplicity argue for applying the derogation to both Titles. The advantage of this derogation is that Member States will have the flexibility to reduce or increase the thresholds under Article 34(1) and Article 53 in accordance with the characteristics of their national payment markets. The UK has the following options:
    - Option 1 – do not apply the derogation;
    - Option 2 - increase the thresholds; or
    - Option 3 – reduce the threshold.

Option 1 – do not apply the derogation

Cost

69. Imposing the full force of the Title III and IV PSD conduct requirements on providers of low value instruments could risk the withdrawal of these instruments.
70. Many low-value and/or e-money payment instruments are designed to facilitate quick and convenient transactions, for instance in a crowded urban environment. During HM Treasury's previous consultation, respondents noted that any obligation on providers to provide a lot of information to customers prior to and after every low-value payment could slow down transaction times and reverse the benefits derived by using near-instantaneous technologies such as contactless cards.

Benefit

71. Consumers will be provided with clearly detailed information relating to every transaction they complete. They will also receive a higher-level of protection.

Option 2 – Increase the thresholds

Cost

72. Different thresholds across the EU could undermine the PSD objectives of promoting cross-border competition and risk causing some providers to withdraw product offerings in some countries if the cost of complying with information requirements increased.
73. A risk of higher thresholds is that certain payment products may vulnerable to first party fraud. Many low-value instruments are designed for rapid face-to-face transactions, with little or no user authentication. It will be very difficult in those circumstances for an issuer to prove such fraud occurred.

Benefit

74. Providers of local- or national-based low-value innovative payment instruments, which offer ease and convenience for many users, would continue to benefit from a lower, more proportionate administrative burden.

Option3 – Decrease the thresholds

Cost

75. The burdens of compliance regulations could constrain some providers' ability to offer low-value instruments, and dampen innovation.

Benefit

76. Negligible

Discussion and Risk

77. The Directive is aimed at promoting a single market in payment services, in order to improve the competitiveness of national as well as cross-border payment products. There is a risk that, were Member States to exercise this flexibility and impose different thresholds, some providers could withdraw some products from countries. Providers may take a commercial decision to operate only in Member States where the thresholds are at similar levels or higher. Increasing the UK threshold would, however, allow providers to maintain their current product offering and sustain innovation; the Government accordingly favours option 2.

Payer's liability for unauthorised use of payment instruments (article 61)

78. In the event of an unauthorised transaction, both provider and payer are expected to shoulder some level of liability for losses involved; a €150 maximum is set in cases where the payer has not acted fraudulently and; where the payer has been grossly negligent, the payer would be subjected to unlimited liability. However, Member States have the option of deciding whether to reduce the liability faced by payers under the PSD requirements.

79. In practical terms, where a payer has failed to keep his or her PIN number safe, Member States have the option of reducing the €150 maximum, derogating from Article 61(1). In cases where payers have acted in gross negligence, e.g. writing down a PIN number and attaching this to the payment instrument, Member States have the option of providing a lower level of liability. This would be a derogation from Article 61(2).

80. Current UK liability standards can be compared with the EU-wide standards set by the PSD, as summarised in the following table:

	Current standard in UK	PSD provision
Lost or stolen payment card, or card misused without permission, before card issuer has been notified	Maximum £50	Maximum €150, but option to reduce maximum liability to below €150
Lost or stolen payment card, or card misused without permission, once card issuer has been notified	No liability	No liability
Payment card misused with permission (broadly equivalent to fraud or failure with intent)	Unlimited	Unlimited
Payment card lost, stolen or misused because of holder's gross negligence	Broadly equivalent to "without reasonable care" – unlimited, unless the card was used as a credit token (e.g. credit card), in which case £50 limit applies	Unlimited, but option to retreat from this and to set a quantitative maximum cap

81. There are three options available to Member States:
   - Option 1- do not apply the derogation;
   - Option 2 – apply the derogation to reduce limit for lost or stolen cards' or negligence; or
   - Option 3 - **apply the derogation to mirror existing UK law** (as set out in the Consumer Credit Act 1974 and the Banking Code).

Option 1- do not apply the derogation

Cost

82. Changes would have to be made to the Banking Code.

83. Consumer protection set by UK standards may be compromised (i.e. reduced), with consumers subject to higher level of exposure.

Benefit

84. Card issuance companies will carry less l ' in relation to consumer negligence, when this is justified.

Option 2 – apply the derogation to reduce limit for lost or stolen cards; or negligence

Cost

85. The cost to business will be minimal, as it would involve lower liability for firms, than currently. However, the level of UK consumer protection will be reduced.

Benefit

86. The risk of moral hazard relating to gross negligence is guarded against.

Option 3 - apply the derogation to mirror existing UK law *(as set out in the Consumer Credit Act 1974 and the Banking Code)*

Cost

87. The cost will be minimal, as the implementation of the PSD would be aligned with existing UK law.

88. This option would mean that different levels of liability would apply across Member States which could pose a challenge in the context of a maximum harmonisation Directive.

Benefit

89. UK customer protection standards are maintained.

Discussion and Risk

90. The Government favours maintaining existing UK standards of customer protection, while guarding against the risk of moral hazard. In cases where payers have lost their payment instruments or have had them stolen perhaps by acting negligently, the Directive provides for a higher maximum liability (€150) than existing UK law (£50). The Government favours exercising the derogation to reduce the €150 liability limit to £50, to ensure that existing UK standards of customer protection are kept.

Specific Impact Tests: Checklist

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes/No	No
Small Firms Impact Test	Yes/No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

ISBN 978-1-84532-378-3
9 781845 323783