Financial Regulation Group Focus – April 2016

The Fintech and Payments Revolution of PSD2: What do I need to know?

Technology and competition are revolutionising the provision of payment services. Long established business models are being disrupted by innovative new entrants to the market. A new payment services directive ("**PSD 2**") will broaden the scope of regulation of the sector.

1. Background

PSD 2 came into force on 12 January 2016. The deadline for implementation of PSD 2 into national law is 13 January 2018.

PSD 2 is relevant to payment service providers ("**PSPs**") (e.g. credit institutions, payment institutions and e-money firms) and their agents, many FinTech firms and technology providers to PSPs, operators of e-commerce marketplaces, store card/gift card operators and bill payment service providers amongst others.

The first Payment Services Directive ("**PSD 1**") was adopted in 2007 and implemented in Ireland in 2009. PSD 1 created a single market in payment services across the EU, introduced greater competition in Europe's payment services market and established a common set of rules for the payment services industry. PSD 1 also contained the legal basis for the Single European Payments Area ("**SEPA**") which became fully operational in 2014. A new type of regulated entity called a 'payment institution' was established under PSD 1. Payment institutions included money remitters, non-bank card issuers, merchant acquiring firms and certain mobile network operators offering payment services. Not all providers of payment services require authorisation as a payment institution as exemptions from authorisation apply to some regulated entities (e.g. credit institutions) amongst others. PSD 1 also allowed small scale providers of payment services to obtain a simpler registration (rather than authorisation) as a small payment institution.

PSD 2 is designed to respond to rapid technological changes in the payments industry since PSD 1 and to make payments safer, more secure and less expensive. It will also address differences in implementation of PSD 1 by Member States which are perceived as distorting competition.

www.williamfry.com Copyright © William Fry 2016. All Rights Reserved In Association with Tughans, Northern Ireland

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

2. New payment service categories introduced

The definition of "payment services" will expand under PSD 2. Two additional types of payment service will fall within the expanded scope of PSD 2: payment initiation services and account information services.

Payment initiation services play a role in e-commerce payments by establishing a software bridge between the website of the merchant and the online banking platform of the PSP which maintains a payment account for the payer in order to initiate internet payments on the basis of a credit transfer without the need for a payment card. PSD 2 will make the provision of payment initiation services a regulated payment service. Confidentiality, data protection and security requirements contained in PSD 2 will apply to the provision of payment initiation services.

Account information services enable customers to view consolidated information from their different payment accounts in one place. They typically allow customers to analyse their spending patterns and provide an aggregated overview of their finances. PSD 2 will prohibit banks and other account service providers from restricting third party account information service providers from accessing this data provided they hold appropriate authorisation/registration and the customer has provided its explicit consent for this to happen.

PSD 2 also clarifies that bill payment services (enabling a consumer to pay a bill to an intermediary rather than the supplier of goods or services) should in general be treated as money remittance. This clarification in the recitals of PSD 2 is intended to address inconsistencies in the application of PSD 1 to providers of bill payment services across the EU.

3. Authorisation/registration process for providers of payment initiation services and account information services

Once PSD 2 is implemented, the providers of payment initiation services and account information services will be regulated for the first time. However, PSD 2 imposes distinct (and in some respects less onerous) authorisation/registration requirements on providers of payment initiation services and account information services compared to providers of the more established types of payment services already regulated by PSD 1.

Firstly, providers of payment initiation services who do not hold clients funds at any time will only be required to have an initial capital of €50,000 and to hold either professional indemnity insurance or a comparable guarantee and will be exempt from the own funds requirements set out in PSD 2.

Secondly, providers of account information services will only need to "register" with their national regulator rather than be authorised as a payment institution. They will be required to hold professional indemnity insurance or a comparable guarantee and to submit a business plan and programme of operations to the national regulator and upon registration will be able to passport their services throughout the EU. Furthermore, account information service providers will be completely exempt from the PSD 2 rules on minimum capital, own funds requirements, safeguarding requirements and record-keeping that apply to other

 Copyright © William Fry 2016. All Rights Reserved

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

payment institutions. The likely justification for this light-touch approach is that account information services do not involve handling client funds at any time.

4. Exemptions narrowed

A number of exemptions from authorisation that were available under PSD 1 have been narrowed under PSD 2. The European Commission was concerned that differing implementation of the exemptions contained in PSD 1 by EU Member States was distorting competition and ran contrary to the aim of a single market in payment services.

Service providers have also often relied on their own assessments as to whether they may avail of an exemption under PSD 1. In certain circumstances, PSD 2 will oblige service providers to notify their activities to the relevant authorities which means there will be greater regulatory oversight of whether a particular exemption is available.

The revised exemptions in PSD 2 seek to standardise the exemptions in order to create a level playing field, reduce risk and provide greater legal protection for payment service users. This tightening of the exemptions will have a dramatic impact on the business models of many firms which to date have fallen outside the regulatory scope of PSD 1.

5. Commercial agent exemption narrowed

PSD 1 included an exemption from authorisation as a payment institution for payment transactions through a commercial agent authorised to negotiate or conclude the sale or purchase of goods or services on behalf of the payer or payee.

This exemption has been applied differently across the EU with some Member States (including Ireland) permitting a commercial agent acting on behalf of <u>both</u> the payer and payee to avail of the exemption and other Member States only permitting its use where a commercial agent acts for <u>either</u> the payer <u>or</u> the payee. The EU Commission believes this inconsistent interpretation runs contrary to the goal of a single market for payment services.

Under PSD 2, the commercial agent exemption is being narrowed to address this. In future, the exemption will generally only be available when a commercial agent acts on behalf of <u>either</u> the payer <u>or</u> the payee. If a commercial agent acts for both sides the exemption will only be available if the agent does not possess or control client funds at any time.

Copyright © William Fry 2016. All Rights Reserved

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

6. Limited network exemption narrowed

PSD 1 contained an exemption from authorisation for the provision of payment services based on instruments (e.g. cards) that may be used to acquire goods or services only 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 or services (e.g. certain store cards, gift cards, fuel cards and loyalty programmes). However the exemption did not clarify what constituted a “limited network”. This has led to concerns within the European Commission that the exemption is being relied upon more than was intended resulting in risks and a lack of legal protection for consumers.

Under PSD 2 this exemption will be narrowed and will apply to payment instruments that may only be used:

- for the purchase of goods and services in a specific retailer or specific retail chain only in the premises of the issuer or within a limited network of service providers under a commercial agreement with a professional issuer;
- for the purchase of a *very* limited range of goods and services; or
- in a single Member State where the instrument is regulated by a national or regional public authority for specific social or tax purposes to acquire specific goods or services having a commercial agreement with the issuer.

If a service provider performs either of the first two above activities and the value of the total payment transactions in a given year exceeds €1 million, it will be required to notify the national regulator which will assess whether or not the limited network exemption may be availed of by the service provider. This change is likely to prompt more rigorous enforcement of the limited network exemption than was the case under PSD 1.

7. Telecoms exemption narrowed

PSD 1 contained an exemption from authorisation for payment transactions by means of a telecoms or IT device (e.g. mobile phone) where the network operator acted not only as intermediary for the delivery of digital goods and services but also added value to them (such as operator billing or direct phone to bill services). The exemption was drafted ambiguously and has been implemented differently across the EU.

Given the growth in the volume of payments being made by consumers via smart-phones and other IT devices in recent years, the exemption is being narrowed in PSD 2. Under PSD 2 the exemption will only be available for digital content (e.g. apps, wallpaper, ringtones, games, etc. use of which is restricted to a technical device), voice-based services, charitable activities or the purchase of tickets provided that the value of any single payment transaction does not exceed €50 and the cumulative value of payment transactions for a single subscriber does not exceed €300 per month. If payment services by a telecoms operator fall outside these parameters it will require authorisation as a payment institution.

 Copyright © William Fry 2016. All Rights Reserved

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

Service providers seeking to rely on the exemption in future will also have to submit an annual audit opinion to the national regulator testifying that their activities comply with these limits. This is also likely to lead to more rigorous enforcement of the telecoms exemption than under PSD 1.

8. ATM exemption

Payment services provided by operators of independent ATMs were exempted entirely from the scope of PSD 1. The exemption stimulated the growth of independent ATM providers, particularly in less populated rural areas. PSD 2 extends transparency rules relating to withdrawal charges to ATM providers to ensure that double-charging of customers cannot occur on cross-border ATM transactions. PSD 2 attempts to strike a balance by continuing to exempt ATM providers from requiring formal authorisation as payment institutions while reducing confusion about withdrawal charges by requiring such charges to be disclosed both before withdrawal of cash and upon receipt of cash.

9. Territorial scope broadened

PSD 1 applied to the provision of payment services in the EU where the PSPs of both the payer and the payee were located in the EU or the sole PSP was located in the EU.

Under PSD 2 certain provisions (primarily regarding transparency of terms and conditions and information) will now be extended to transactions:

- In any currency where the PSPs of both the payer and payee are located in the EU; and
- Where the PSP of either the payer or the payee is located outside the EU as regards the EU leg of the payment transaction.

10. Enhanced security requirements

Strong customer authentication

Under PSD 2, the European Banking Authority ("**EBA**") is to develop technical standards for 'strong customer authentication' methods by January 2017. These standards will allow a payer to authenticate a transaction by using at least two of the following independent elements:

- knowledge (e.g. passwords or PIN codes);
- possession (e.g. physical possession of payment cards); or
- inherence (e.g. fingerprints, iris-scans of the user).

Copyright © William Fry 2016. All Rights Reserved In Association with Tughans, Northern Ireland

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

Once the security standards for strong customer authentication have been developed, PSPs will generally be expected to implement them whenever a payer:

- accesses their payment account online;
- initiates an electronic payment transaction; or
- carries out any action through a remote channel which may imply a risk of payment fraud or other abuses.

If the payer's PSP does not implement the strong customer authentication methods in any of the scenarios listed above, the payer shall not bear any financial losses unless the payer has acted fraudulently. Additionally, where a payee or the PSP of the payee fails to accept strong customer authentication, it shall also be obliged to refund the financial damage caused to the payer's PSP.

Fraud controls

EBA technical standards will also cover protection of confidentiality and integrity of payment service users' personalised security credentials to limit the risks relating to phishing and other fraudulent activities. The standards may well result in greater use of authentication codes such as one-time passwords to enhance the security of payment transactions.

Incident notification

A PSP will be obliged to notify the national regulator if it experiences a "major operational or security incident" and customers if the incident "has or may have an impact on the financial interests of its payment service users". The EBA has been mandated to devise guidelines defining what will constitute a "major operational or security incident" and to develop notification procedures by January 2018.

11. Stronger consumer protection measures

Reduced timelines for complaints handling

The process by which payment service users can make complaints has been strengthened in favour of users under PSD 2. PSPs will only have 15 business days (or in exceptional circumstances 35 business days) to respond to a complaint. They will also be obliged to advise payment service users in a clear, comprehensive and easily accessible way of at least one alternative dispute resolution body (e.g. the Financial Services Ombudsman) who can deal with their disputes if unresolved.

 Copyright © William Fry 2016. All Rights Reserved

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

Detailed statements

PSPs will also be obliged to provide payment service users with a monthly statement if they have entered a framework contract for frequent payment transactions. The statement must provide a breakdown of all payments made, charges levied and exchange rates used in respect of each payment transaction.

Restrictions on surcharges

The Multilateral Interchange Fees (MIF) regulation will cap all interchange fees charged by banks before PSD 2 enters into force in January 2018. As these interchange fees are often cited as justification by merchants for surcharges levied on consumers, PSD 2 ensures that payees shall no longer be able to levy surcharges on the use of payment instruments affected by the MIF regulation. The European Commission estimates that 95% of all card payments made in the EU will be protected from surcharges in future.

Reduced cap on liability for unauthorised transactions

In cases where an unauthorised payment transaction is carried out on a payer's account, the maximum liability that the payer will incur will be €50 (reduced from €150) unless the payer is directly responsible for the fraud or gross negligence.

12. A more level playing field for credit institutions and payment institutions

Credit institutions will be obliged to facilitate payment institutions to access their payments account services on an objective, non-discriminatory and proportionate basis under PSD2. This change will oblige credit institutions to facilitate payment institutions, like payment initiation services and account information services, to access their customers' accounts. This change will also be relevant for money remittance services as many of these providers have lost access to the banking system in recent years.

Once PSD 2 is implemented, rules governing access to payment systems (such as the Visa and Mastercard schemes) will also have to be objective, non-discriminatory and proportionate. This change will enable payment institutions to have equal access to payment system schemes, which have been dominated by credit institutions to date.

13. Transition phase

PSD 2 must be transposed into Irish law by 13 January 2018. However, payment institutions which have already obtained authorisation under PSD 1 will be permitted to continue operating under their existing authorisation until 13 July 2018. They will have to submit all relevant information required by the national regulator before 13 July 2018 to demonstrate that they comply with the revised authorisation requirements under PSD 2 or else lose their authorisation. The national regulator may also deem existing payment

 Copyright © William Fry 2016. All Rights Reserved

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.

institutions to be automatically authorised if it is satisfied that they meet all PSD 2 requirements. Smaller firms which have been "registered" as small payment institutions (rather than "authorised" as payment institutions) will have until 13 January 2019 to obtain a full authorisation or demonstrate that they comply with the revised small payment institutions requirements of PSD 2.

14. Next steps

As the deadline for implementation of PSD 2 is less than two years away it is important that firms which operate in the area of payment services begin to assess how the revised law will affect them. Many businesses will face regulation for the first time. Legal advice should be obtained in order to assess the impact these changes will have on a firm's business model so that an appropriate strategy can be put in place well ahead of time.

15. How can William Fry assist your business?

William Fry is already acting for multiple firms in relation to all aspects of payment services law and regulation including PSD 2. We are available to assist you with legal advice on the new regime. Please contact Shane Kelleher (E: shane.kelleher@williamfry.com, D: +353 1 6395148) or any member of William Fry's Financial Regulation Group or your usual William Fry contact for legal advice.

Contact Us

Shane Kelleher
Partner

E: shane.kelleher@williamfry.com
D: +353 1 639 5148

WF-16422493-1

Copyright © William Fry 2016. All Rights Reserved

In Association with Tughans, Northern Ireland

This publication is intended only as a general guide and not as a detailed legal analysis. It should not be used as a substitute for professional advice based on the facts of a particular case.