What is wrong with the PSD

Questions over its contents and implementation mean Europe's payments services directive provides shaky legal foundations for SEPA

René Smits

Europe's banks, corporates and governments are facing up to a major new challenge. Five years after the cash "leg" of the changeover to the euro, the job to be done now entails replacing national payment systems and standards with a Single Euro Payments Area (SEPA). SEPA is defined as "an integrated market for payment services which is subject to effective competition and where there is no distinction between cross-border and national payments within the euro area."[1] It implies "the removal of all technical, legal and commercial barriers between the current national payment markets."[2] Creating "a single domestic payments market in which citizens and economic actors will be able to make payments as easily and inexpensively as in their hometown" requires a cooperative effort on the part of the banking industry and the central banks. If the reality matches the rhetoric, Europe will experience a revolution in the way its single currency moves across "borders": payments will be faster and cheaper, encouraging cross-border business, creating new markets and freeing firms' working capital.

The European Central Bank (ECB) and the European Commission have been instrumental in furthering progress on the road to SEPA. The ECB and the national central banks (NCBS) of the member states that have adopted the euro (collectively referred to as the Eurosystem) have been given specific powers in the area of payment services (see box opposite). The commission, for its part, has proposed the legal underpinning necessary for Europe-wide domestic payments. It submitted a draft directive under the lofty name of the "new legal framework". This framework is supposed to provide the regulatory backdrop for the technical and organisational work undertaken by the banking industry. This article explores the contours of the payments services directive (PSD), the more colloquial name for the set of rules under consideration, and identifies some of its flaws. I begin, however, with a brief discussion of the recent work to produce payments schemes that will be governed by the PSD.

Box 1

Basic task of the Eurosystem in respect of payment systems: legal basis

Article 105 (2) EC treaty/Article 3.1 ESCB statute (4th indent): The basic tasks to be carried out through the ESCB shall be: (…) - to promote the smooth operation of payment systems.

Powers of the ECB and NCBS in respect of clearing and payment systems

Article 22 ESCB statute:

Clearing and payment systems

The ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the community and with other countries.

Role of the Eurosystem in the field of payment system oversight

policy statement of 21 June 2000, at: http://www.ecb.int/pub/pdf/other/paysysoveren.pdf

"In respect of retail payment arrangements, such systems handle large volumes of payments of relatively low value and generally carry little, if any, systemic risk. As a rule, the definition of the oversight of retail payment systems will continue to be performed by the relevant NCBS. However, where new developments occur or where retail schemes would have potential cross-border implications, general policy lines for oversight are defined at the Eurosystem level."

Harmonising principles

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While the PSD will provide the legal context, the new Europe-wide payment systems will be built on the basis of schemes, frameworks and standards set by the industry itself in the European Payments Council.[3] The rules which define the various products in the payments industry are to be harmonised and interoperability between the (participants in the) national payment systems should be ensured. Standards will be set to ensure that credit transfers, direct debit instruments and other forms of payment (such as credit cards) will be similarly processed across Europe and can be effected just as smoothly as now in one member state. At first, national payment infrastructures are to be made SEPA compliant. This stage should be reached as early as 1 January 2008. Three years later, on 31 December 2010, a critical mass of national credit transfers, direct debits and card payments should have moved to SEPA payment instruments. While there has been some discussion about these dates, it is clear that momentum is building within the industry and the tone in speeches from Europe's central bankers and the commission has been one of concerted determination.

Several characteristics of SEPA should be singled out to understand its nature. First, the process of standard-setting and technical adaptation is centred on the industry, with the authorities providing legal rules and organisational support. The latter element is closely linked to a second aspect, namely that public authorities are supposed to take the lead in the conversion to SEPA. The idea is that a critical mass of payments could be generated by the authorities just as, during the changeover to the euro in 1999, the immediate transition by governments and securities markets helped ensure a smooth transition to the single currency. Third, it is the intention of those involved in SEPA that its procedures and instruments should at least match the level of best practices within individual member states. Fourth, authorities and industry are in agreement about the principle that the payments system should be open to effective competition, implying open access and non-discriminatory conditions to join SEPA.

On this point, the European Competition Authorities[4] have voiced concerns. The Eurosystem, which is required to act in conformity with free competition (see box 2), also voiced its own concerns on possible implications of the SEPA cards framework.[5] The competition authorities have highlighted the importance of customer mobility and suggested the possibility of a switching facility that would apply across the European Union (EU) enabling customers to move between banks and possibly even retain their account number. Notably, they have called for a strengthening of the legal provisions on access.[6] This brings us to the issue of the legal framework for SEPA, and in the remainder of this article I will focus on the creation of "payment institutions", execution times and competition issues. I begin, however, with the choice of a *directive* as the type of law.

Firstly, the PSD should have been the PSR: a payments services regulation. A directive, while setting out the results to be achieved by national lawmakers, relies on them faithfully translating EU rules into member state legislation. Even if the rules are transposed correctly, in time and without

Box 2

Principle of an open market economy with free competition

Article 105 (1) EC treaty/article 2 ESCB statute:

The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4 of this treaty.

Article 4 EC treaty sets out economic union (in paragraph 1) and monetary union (in paragraph 2) after which paragraph 3 reads as follows:

These activities of the member states and the community shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

"gold-plating", operators across the eurozone will have to consult 13 pieces of legislation instead of one, and operators elsewhere within the new 27-strong EU may have to consult another 14 national laws to establish their exact rights and obligations under SEPA. I'll come back to this later.

The payment institution dilemma

From a competition point of view, it is good to see that the commission proposes to introduce a new group of payment-service providers, so-called "payment institutions". "(I)n order to remove legal barriers to market entry", so the preamble states, a new category of service providers is introduced, apart from credit institutions (ie, licensed banks), electronic money institutions (a class made subject to supervision in 2000) and post office giro institutions. Many observers have argued that the common restriction requiring payments operators to hold a banking license has discouraged new players from entering the market, innovation in products and improvement in performance. However, the extent to which these payment institutions will be subject to regulation and, hence, may compete with credit institutions on a possibly more favourable basis has been one of the main issues contested in the course of the discussions on the directive.

The proposed directive certainly lacks precision as regards these new institutions. For instance, it is unclear what other activities payment institutions may undertake. And how are "payment accounts", defined in the commission's proposed draft directive[7] as "an account held in the name of a payment service user which is used exclusively for payment transactions", to be qualified: are they "deposits or other repayable funds", ie, one element of the definition of a credit institution? Finally, the draft directive does not make clear which authorities will supervise these payment institutions. One would expect it to be national central banks, but it is not clear. At a more general level, I would argue that questions surrounding the inclusion of a new class of payment services providers have distracted lawmakers from what should have been their prime aim: adopting a single coherent set of payments rules to underpin SEPA.

Execution time slips

But even when one focuses on the core issues of payments law, the draft directive does not provide sufficient clarity and quality. The rules concerning the time of payment are scattered among various provisions concerning the authorisation and execution of a payment transaction, and on execution time. Execution at t+1 with exemptions is not the speed that we should expect or demand from a modern payments system. When one considers that even the t+1 scheme came in for criticism as being too ambitious from the European Parliament,[8] one cannot be optimistic about the outcome of discussions on the directive amongst Europe's finance ministers at the Ecofin council.

A word of caution is in place here since, to an outside observer, it is in fact impossible to get a sense of the possible outcome of the discussions on the directive. Although the original proposal and the amendments put forward in the European Parliament are publicly available, this is not the case for the apparently manifold changes tabled by the working group of Ecofin which discussed the draft. This sorry state of affairs reflects badly on the current method of lawmaking within the EU. It is only to be hoped that some of the worries voiced here have already brought about changes that may lead to improvements in the text of the framework law.

Towards a single focus

A single market with a single currency needs a single regulation setting out the main provisions of payments law. A regulation has direct effect and does not rely on implementation in member state law for the common rules to take effect. As noted above, a directive is not the best legal instrument – let alone a directive with national exemptions and variations.

A more direct approach would be better. I suggest that a regulation based on Articles 95 (1) and 123 (4), penultimate sentence, of the EC treaty would have been appropriate (see box 3). The draft directive is also far from a model of clarity or good drafting. One has to wait and see whether the amendments it will undergo in the council and the parliament will improve the legal quality of the text. A point only dealt with by the ECB in its opinion on the draft directive,[9] concerns the possible interference of the PSD with the regulatory competences of the central bank. The core legal provisions necessary as a framework for the industry to set technical standards and make the transition to SEPA, such as those on execution time, the time limit for revocation of a payment order and the irrevocability of such an order, might well have been adopted by the ECB on the basis of its own regulatory powers in this area (see box 1).[10]

Box 3

Possible legal bases for the adoption of a regulation on payments law

Article 95

(…) The council shall, acting in accordance with the procedure referred to in Article 251 and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in member states which have as their object the establishment and functioning of the internal market. (…)

Article 123 (4)

(…) The council, acting by a qualified majority of the said member states, on a proposal from the commission and after consulting the ECB, shall take the other measures necessary for the rapid introduction of the ecu as the single currency of those member states. (…)

This would have prevented lengthy political discussions and assured early clarity for the industry and for consumers.

The absence of clear and unequivocal rules on the time of payment and on execution time for payment transactions is to be deplored. Moreover, accepting a value date which would, for some member states, imply a step back from the current level of speed in payment transactions is not helpful in the creation of an ultra-modern payments system. Europe should be careful that is does not lag behind East Asia in payment practices (notably, biometric touch payments). In this respect, the caption above the commission's proposed directive is illuminating: it refers to the so-called Lisbon Agenda, which seeks to make the EU the world's most competitive economy by 2010.

Competition concerns

The provision in the directive on access to payment systems[11] may need to be strengthened as SEPA is introduced on the basis of standards set by the industry itself. Vigilance in respect of standard-setting by industry itself is required so that norms adopted do not create barriers to entry or otherwise make competition more difficult for payments services providers or those in adjacent industries (such as in the provision of the technical hardware for payments processing). Norms, the ability to set them, entrance fees or other conditions for membership, and other seemingly technical matters can have the effect of restricting entry for newcomers or of stifling innovation. Clear and non-discriminatory access rules and close supervision to guarantee increased competition are called for in order to make SEPA live up to its promise of opening hitherto closed national payment markets.

The competition issue is particularly acute in the context of the application of interchange fees. The recent announcement by MasterCard[12] that it will apply new levels of interchange fees (fees paid from the acquiring to the issuing bank for each card transaction) in the context of the transition towards SEPA highlights this issue. Although, on average, these new fees may be lower, for several member states they imply higher charges than

currently applied. This might imply that SEPA brings consumer harm instead of consumer welfare. This might lead to calls for the abolition of interchange fees, rather than their continuation at a different level. The card industry's claim that interchange fees are required to ensure the economic viability of card transactions is open to debate. Their use may just be a question of commercial choice.

A missed opportunity

Europe should have a single set of payment rules instead of maintaining a patchwork of national rules that are partially harmonised on the basis of a flawed directive. Unfortunately, this is the direction we appear to be going in. The rules should be forward-looking and stimulate innovation, competition and modernisation and not allow backward practices, such as three full days before a payment transaction is completed, to go on for too long. There is an urgent need to move ahead fast with the necessary core legal framework for SEPA. For now, however, SEPA will have to be based on the "new legal framework", ie the PSD. Perhaps, when bolder lawmakers will have been elected, a truly *new* legal framework may be adopted to suit the needs of payment providers and users alike. In the meantime, the ECB may provide "interim relief" by adopting some elements of a more technical nature in a payments regulation under Article 22 of the ESCB statute.

Completion of the monetary union in the area of payments should fulfil the potential of the single currency, albeit ten years late. It is imperative that the EU acts decisively and puts its own economic house in order, both in the area of payments, discussed here, and in economic governance, which is beyond the scope of this article. Only then can the EU be a strong player to meet global challenges.[13] In view of major issues facing us all (climate change, energy conservation and supply, the achievement of the Millennium Development Goals, matters of peace – Darfur, Middle East – and the problems of economic and cultural globalisation), Europe cannot afford to waste time and effort bickering about details of payments regulation. Much less coming up with a Payments Services Directive which needs improving on – right from the start. □

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1 There has been some misunderstanding as to the scope of SEPA. This acronym sometimes stands for: Single European Payments Area, ie, extending to payment transactions in other currencies than euro. The objective shared by the authorities and the banking industry is to establish a single payments market for the euro area, as well as for euro payments across the EU or, indeed the European Economic Area (EEA, consisting of the EU plus Norway, Iceland and Liechtenstein), plus Switzerland.

2 These quotes are from a joint statement by the European Commission and the ECB on the Single Euro Payments Area of 4 May 2006. See: http://www.ecb.int/press/pr/date/2006/html/pr060504_1.en.html.

3 See: http://www.europeanpaymentscouncil.eu/index.cfm.

4 An informal grouping of all EU/EFTA competition authorities (the commission, EFTA Surveillance Authority and national competition authorities (NCAS)), see: http://www.oft.gov.uk/ECA/About+the+ECA.htm.

5 In a recent document, the Eurosystem gave its views on the SEPA card framework. It voiced clear concerns about competition in the credit card industry upon the move to SEPA and specifically invited the commission to give guidance on competition-relevant issues such as interchange fees and other practices. See *The Eurosystem's view of a "SEPA for cards"*, November 2006, at: http://www.ecb.int/pub/pdf/other/eurosystemsviewsepacardsen.pdf.

6 *Competition issues in retail banking and payments systems markets in the EU*, a report by the European Competition Authorities, June 2006, at: http://www.nmanet.nl/Images/ECA%20FINAL%20REPORT%20PUBLIC%20VERSION_tcm16-89513.pdf.

7 See the commission's proposal for a directive of the European Parliament and of the council on payment services in the internal market and amending directives 97/7/EC, 2000/12/EC and 2002/65/EC, Document COM(2005) 603 final, 1 December 2005, at: http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0603en01.pdf.

8 The report on the draft payments services directive from the Parliament's Committee on Economic and Monetary Affairs of 20 September 2006 suggests a two-day execution time but extends this requirement to all EU currencies (not only the euro). See: http://www.europarl.europa.eu/omk/sipade3?PUBREF=-//EP//NONSGML+REPORT+A6-2006-0298+0+DOC+PDF+V0//EN&L=EN&LEVEL=0&NAV=S&LSTDOC=Y.

9 See the ECB's opinion of 26 April 2006 on a proposal for a directive on payment services in the internal market (ECB/2006/21), published under 2006/C 109/05 in the Official Journal of the European Union, No. C 109/10 of 9 May 2006, and found at:

http://www.ecb.int/ecb/legal/pdf/c_10920060509en00100030.pdf.

10 On the regulatory powers of the ECB, and the interpretation of Article 22 ESCB Statute in general, see "The role of the Eurosystem in payment and clearing systems", *ECB Monthly Bulletin*, April 2002, pp. 47–59.

11 Article 23 (Access to and operation of payment systems).

12 See: http://www.mastercard.com/us/company/en/newsroom/pr_SEPAInterchange.html

13 For the same call from a wider perspective, see the comment ("Europe needs to rise to its global challenges") on the future of Europe by Nicole Gnesotto and Giovanni Grevi in *European Voice*, 26 October–November 2006, at p. 18.