Client Alert

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# EU: Payments regime reform - revolutionary evolution?

## In brief

On 28 June 2023, the EU Commission published its long-awaited package of reforms to the EU payments regulatory regime. Deeming the package an "evolution not a revolution" of the EU payments framework, the Commission has published proposals for:

- a third Payment Services Directive (PSD3) repealing and replacing the Payment Services Directive (PSD2) and Electronic Money Directive (EMD2);
- a new Payment Services Regulation (PSR), which will harmonize and directly apply most of the conduct obligations imposed on payments firms;
- a new Regulation on a framework for financial data access, relating to open finance; and
- a new Regulation on the establishment of a digital euro (with Annexes).

These proposals seek to achieve four specific objectives:

1. Strengthen user protection and confidence in payments – to be achieved through improvements to the application of strong customer authentication (SCA), strengthened measures to combat payment fraud, measures to improve the availability of cash, and improvements to user rights and information.
2. Improve the competitiveness of open banking services – to be achieved through improving the performance of data interfaces and new open banking permissions dashboards.
3. Improve enforcement and implementation in Member States – to be achieved through directly applicable conduct obligations in the new PSR, reinforcing national competent authority enforcement powers, and merging the payments and e-money regimes.
4. Improve (direct or indirect) access to payment systems and bank accounts for nonbank payment service providers (PSPs) – to be achieved through allowing PSPs direct access to all EU payment systems, and granting them a right to have a bank account.

On the whole, the proposals represent a step change in regulatory oversight of payments across the EU. While the changes proposed by the Commission are all evolutionary in movement, the structural reorganization of the framework, with a merger of the payments and e-money regimes and direct application of conduct obligations, will lead to significantly enhanced oversight for the industry. With an implementation period of 18 months proposed, payments and e-money firms affected by the potential changes should begin to consider what they mean for their businesses. We set out the key highlights below.

## Contents

# The future of EU payments regulation

## A change in the regulatory framework's structure – and some amendments to scope

The most fundamental structural change to the regime is the introduction of a split legislative framework for payments, with a new PSD3 and a new directly applicable PSR. PSD2 will be repealed and replaced, with the rules in PSD2 split between the new directive and regulation.

PSD3 covers authorization, licensing and supervision requirements, which will need to be transposed into national law. The PSR contains the conduct obligations applicable to payment institutions, rules on access to payment systems, transparency and information requirements, and open banking requirements, among others.

Helpfully, Annex III to PSD3 contains a correlation table explaining where the PSD2 and EMD2 rules are to be found in PSD3 and the PSR.

Alongside these structural changes, the Commission also proposes some amendments to definitions and scope, responding to the EBA's June 2022 opinion on PSD2. For example, the Commission clarifies that:

- a payment account is defined as an account that is used for sending and receiving funds to and from third parties (which excludes, for example, savings accounts);
- Near-Field Communication (NFC) and digital "pass-through wallets" are payment functionalities or technical services, not payment instruments; and
- given their principally lending nature, "Buy Now Pay Later" services should not constitute a payment service (and instead are covered by the proposed Directive on consumer credits which will revise and replace the Consumer Credit Directive).

These clarifications in the definitions would bring welcome harmonization, with varied approaches to the treatment of these products currently seen across Member States.

## Merging payments and e-money

The other headline structural change is the merging of the payments and e-money regimes into one harmonized regulatory framework. E-money institutions (EMIs) are folded into the new payments regime as a sub-category of payment institutions (PIs). "Electronic money services" is defined in PSD3 as the issuance of e-money, the maintenance of payment accounts storing e-money units, and the transfer of e-money units. This is a shift from the current position under EMD2 which regulates only e-money issuance (albeit these additional e-money services are probably caught as payment services under PSD2).

However, the Commission's proposal notes that the licensing requirements, in particular initial capital and own funds, and certain governance requirements specific to EMIs, including the issuance of e-money, e-money distribution and redeemability, are distinct from the services provided by PIs, and are therefore preserved in the merger.

The merger of the regimes also has implications for the crypto sector, specifically in relation to e-money tokens. The licensing regime for PIs, as they will replace the EMIs, will now also apply to issuers of e-money tokens under the Regulation on Markets in Cryptoassets (MiCAR). Further, given that MiCAR deems e-money tokens to be e-money, e-money tokens are included as e-money in the definition of funds in the new PSD3/PSR regime.

## Substance and authorization requirements

As is currently required by PSD2, under PSD3 a PI seeking authorisation in a Member State will need to be carrying out "a part" of its payment service or e-money business in that Member State. Citing divergent interpretations among Member States of the phrase "a part", the Commission has clarified that this should mean "less than the majority of the institution's business" as to otherwise require a PI to carry out most of its business in its home Member State would render useless the cross-border services passport.

The procedures for application for authorization and acquisitions of control are mostly unchanged from PSD2, with some notable exceptions:

- alignment for institutions providing payment services and electronic money services consistent with the merger of the regimes;
- a new requirement for a winding-up plan to be submitted with an application;

- an option for payment initiation service providers (PISPs) and account information service providers (AISPs) to hold initial capital of €50,000 at the licensing or registration stage instead of a professional indemnity insurance; and
- updated initial capital requirements (except for PISPs) to account for inflation.

While currently licensed PIs and EMIs will need to reapply for authorization under PSD3, existing licenses will be grandfathered for one year after the new regime takes effect, provided that the PI or EMI makes an application for authorization no later than six months after the new regime takes effect. This reauthorization process is similar to the approach taken with the implementation of PSD2.

Note also that, while the safeguarding rules for PIs are largely unchanged, significant changes to note include the option to safeguard either in a separate account in a credit institution authorized in a Member State or in a central bank account (at the discretion of the central bank), and a new requirement to avoid concentration risk by not safeguarding all funds with one credit institution (with the EBA to develop regulatory technical standards on safeguarding requirements and risk management frameworks). The safeguarding rules for PIs providing e-money services are also aligned with those applying to PIs only providing payment services.

## Triangular passporting

PSD3 will bring clarity and harmonization to the challenges raised by so-called “triangular passporting”, where a PI authorized in Member State “A” uses an intermediary (such as an agent, distributor or branch) located in Member State “B” for offering payment services in Member State “C”. The EBA’s opinion notes divergent interpretations on the permissibility of passports in these circumstances, which are not explicitly envisaged or prohibited by PSD2. These different approaches have led to inconsistency on the extent to which agents in another Member State can rely on the passport of a PI, with some jurisdictions taking a restrictive approach. Triangular passporting also raises supervisory challenges, and difficulties in determining which AML/CTF and consumer protection regulations are applicable to services provided by the intermediary in the host Member State.

The Commission’s Q&A response of January 2023 clarifies that the passporting rights belong to the PI, with passporting notifications to be sent from Member State A to Member State C regardless of whether payment or e-money services are provided via an intermediary in Member State B – i.e. confirming that 'triangular passporting' is permitted. PSD3 also confirms this position, with the EBA empowered to develop RTS on cooperation and information exchange.

## Non-bank PSP direct access rights

In very welcome news for the payments industry, PSD3 amends the Settlement Finality Directive to allow non-bank payment service providers (PSPs) access to all EU payment systems, by adding PIs to the list of institutions which may participate directly in payment systems (although this does not extend to securities settlement systems). The current status quo creates a significant bias against non-bank PSPs, requiring them to rely on their competitors – banks – for indirect access. Opening direct access to non-bank PSPs should relieve this tension and increase competition for payment service users.

## Changes to SCA

While SCA has had a “significant” impact on reducing payment fraud, it has been “more challenging to implement than anticipated” and, further, as the Commission noted in a May 2023 statement, SCA is insufficient to prevent new types of fraud, such as APP fraud. Because of this, the Commission has proposed some targeted amendments to the PSD2 liability and refund rules. The proposed changes, set out in the PSR, include:

- A new requirement that PSPs must have transaction monitoring mechanisms in place to provide for the application of SCA and to improve the prevention and detection of fraudulent transactions. The transaction monitoring mechanisms must be based on an analysis of payment transactions, taking into account environmental and behavioral characteristics such as those related to location of the payment service user, time of transaction, device being used, spending habits, online store where the purchase is carried out.
- Clarification that SCA must be applied at the set-up of the mandate for a merchant-initiated payment transaction (MIT), without need to apply it to further MITs.
- Clarification that, for mail orders and telephone orders, only the initiation of a payment transaction needs to be non-digital in order for that transaction to not be covered by SCA.

- Simplification for AISPs, by confirming that SCA is only required for account information services on the occasion of the first data access; however, AISPs must require SCA when their customers access aggregated account data on the AISP's domain, at least every 180 days.
- Requirements to improve the accessibility of SCA to ensure that all customers, including those without access to digital channels or a smartphone, have at least one means to enable them to perform SCA.
- Clarification that, for remote payments, the specific amount and the payee must be explicitly linked to the transaction which is to be authenticated by the payer. These measures are also applied to electronic payment transactions for which a payment order is placed through a payer's device using proximity technology for the exchange of information with the payee's infrastructure, and for which the performance of SCA requires the use of internet on the payer's device.
- A requirement that SCA must be performed at the moment of the enrolment (i.e., token creation or replacement) of a payment instrument (for example, a virtual payment card) in a digital wallet under the responsibility of the PSPs that issued that instrument.
- A requirement for PSPs and technical service providers to enter into outsourcing agreements in cases where the latter provide and verify the elements of SCA, and new liability provisions for technical service providers and operators of payment schemes for failure to support SCA.
- Clarification that the payer is not to bear any financial losses where either the PSP of the payer or the payee applies an exemption from the application of SCA.

## Other payment verification and anti-fraud measures

The PSR will implement matching verification requirements, applying to all intra-EU credit transfers in EU currencies and instant credit transfers in currencies which are not in euro. Together with the Commission's current proposal on matching verification in its draft Regulation on instant payments, which will apply matching verification requirements to instant credit transfers in euro, the Commission proposes to apply matching verification to all credit transfers across the EU.

The Commission also proposes new liability provision for incorrect application of the matching verification service. The PSP of the payer will be held liable for the full amount of the credit transfer where that PSP has failed to notify the payer of a detected discrepancy. Where the liability is attributable to the PSP of the payee, the latter is to refund the financial damage incurred by the PSP of the payer.

Citing the proliferation of "social engineering" fraud cases blurring of lines between authorized and unauthorized transactions, under certain circumstances the PSR requires PSPs to refund consumers tricked into authorizing payment transactions to fraudsters impersonating PSP employees. The PSR also requires electronic communications services providers to cooperate with PSPs with a view to further fraud prevention.

## Consumer protection measures

In addition to the SCA changes and anti-fraud provisions, there are a number of enhanced consumer protection measures proposed by the Commission in the PSR, including:

- extending the ban on surcharges to cover credit transfers and direct debits in all EU currencies;
- new product intervention powers granted to the EBA to temporarily prohibit the sale of certain payment and e-money products;
- extending consumer protection measures, such as refunds, to direct debits and merchant initiated transactions

## Review

The Commission's proposals provide for a review to be completed five years after the date of application. The review will have to pay particular attention to the provisions on open banking rules, fees and charges for payment services, and rules on liability and redress for fraudulent transactions.

### Timing

The Commission has proposed an 18-month implementation period before the requirements take effect after the new regime enters into force. Given that reauthorization is likely to be necessary and many of the obligations on the industry are enhanced, PIs and EMIs should keep a close eye on the proposed framework as it goes the legislative process.

## Open banking and open finance

Turning to open banking, the Commission has proposed a number of changes in the PSR to improve the functioning of open banking and increase competitiveness. While ASPSPs will be required to maintain a dedicated interface for open banking data access, the requirement to maintain a permanent fallback interface has been removed. ASPSPs will also need to offer open banking users a permissions "dashboard" allowing the withdrawal of data access from any given open banking provider.

Building on the open banking regime established in PSD2, the proposed Regulation on a framework for financial data access will govern access to and use of customer data in the financial sector. The new framework will:

- require market participants to provide customers with financial data access permission dashboards, set eligibility rules on access to customer data and empower the European Supervisory Authorities (ESAs) to issue guidelines to protect consumers against unfair treatment or exclusion risks;
- mandate access for data users to selected customer data sets across the financial sector, always subject to permission by the customers to whom the data relates to;
- require market participants to develop common standards for customer data and interfaces concerning data that are subject to mandatory access, as part of schemes; and
- require data holders to put in place APIs against compensation, implementing the common standards for customer data and interfaces developed as part of schemes and require scheme members to agree on contractual liability.

For firms to be able to access customer data, they will either have to be regulated financial firms or be authorized as a new category of data user called a financial information service provider (FISP). Financial institutions will be required to provide access to defined categories of data at the request of the customer when acting as data holders, and allow the sharing of data based on customer permission when acting as data users. In-scope financial institutions include market participants across the entire range of financial sectors:

- credit institutions;
- PIs and EMIs (including those which are exempt);
- investment firms;
- cryptoasset service providers and issuers of asset-referenced tokens under MiCAR;
- alternative investment fund managers and UCITS management companies;
- insurance and reinsurance undertakings;
- insurance intermediaries and ancillary insurance intermediaries;
- institutions for occupational retirement provision;
- credit rating agencies;
- crowdfunding service providers; and
- PEPP providers.

FISPs are required to be authorized under the proposed Regulation, with organizational and operational compliance obligations, including capital requirements. FISPs are also added to the categories of financial institution subject to the requirements of the EU Digital Operational Resilience Act (DORA). Third country FISPs wishing to access financial data in the EU are permitted to be authorized but must appoint a legal representative in the EU to act on its behalf. A passport is available to FISPs to enable cross-border data access.

Categories of customer data relating to a wide range of financial products are covered including loans, savings, investments, occupational and personal pensions, and non-life insurance; data relating to payment accounts are excluded as access to this data is governed by PSD2 and the proposed PSR, and data relating to creditworthiness and life, sickness and health insurance are excluded as the risks of financial exclusion may outweigh potential benefits.

Data holders and data users must become members of at least one financial data-sharing scheme governing access to customer data. Among other requirements, the scheme must establish the model by which data holders can charge data users for access, and the contractual liability of the scheme members.

While most of the Regulation's provisions take effect two years after entry into force, data holders and data users must become members of at least one financial data sharing scheme, when the Regulation's provisions on schemes take effect. The FISP authorization requirements also start to apply 18 months after entry into force.

## Preparation for the digital euro

While a decision from the European Central Bank is awaited as to whether it will launch a digital euro, the Commission's proposals update the payments regulatory framework to prepare for integration of the digital euro into the regime to be treated as if it were cash or scriptural money. The Commission's proposed Regulation on the establishment of a digital euro sets out the applicable legislative framework; key highlights include:

- Granting legal tender status to the digital euro and establishing mandatory acceptance obligations
- Ensuring that the digital euro is available for both online and offline payment transactions
- Applying payments and anti-money laundering regulatory requirements to digital euro payment services
- Providing that the digital euro will not bear interest
- Establishing distribution obligations and restrictions within and outwith the eurozone

To support the framework, the Commission has also proposed a Regulation on the legal tender of euro banknotes and coins, and a Regulation on the provision of digital euro services by PSPs incorporated in member states whose currency is not the euro. Further, PSD3 proposes to include central bank digital currencies (CBDCs) issued for retail use within the definition of "funds".

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