

The Payment Services Directive

Challenges for Financial Institutions

Webinar for FI clients, 11.12.2008



The Payment Services Directive

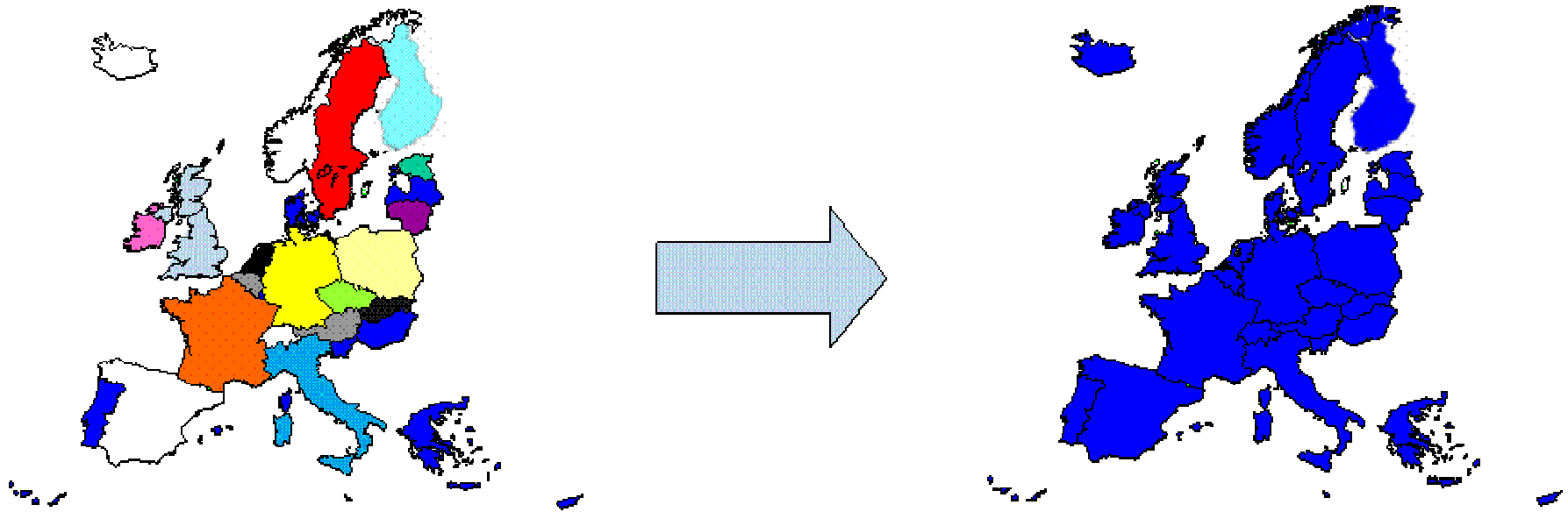
Agenda

- PSD: Origins and Key Facts
- PSD Requirements: Process Flow and Principles
- Interpretation Challenges in the Transposition Process
- How Should Banks Prepare for the PSD?
- Potential Impacts on Banks in Europe and Outside
- Potential Impacts on Clients
- The Future of Payments in Europe
- Conclusion
- Useful Information and Q&As

Harmonisation Needs to Underpin SEPA

- The European Payments Council (EPC) commissioned external legal advice aimed at identifying legal barriers to SEPA.
- Three key harmonisation requirements had been identified and industry turned to the European Commission to provide legal intervention.
- Needs for SEPA:
 - Harmonised rules on Right of Refund
 - Primacy of Account Number (IBAN) over name to allow fully automated processing.
 - Harmonisation, preferably removal, of Balance of Payments reporting requirements. [not provided by PSD]

Vision and Objectives: The Creation of SEPA



TODAY

- National / local solutions
- Different schemes, experiences, standards, consumer protection laws
- No interoperability of national schemes
- Fragmented industry
- Cross-border complexity and risk

SEPA

- “Local” solutions for Europe
- Common core schemes and experiences, consistent standards, application of harmonised consumer protection laws
- Improved interoperability
- Reduced complexity

Objectives of the EU Commission : PSD

The European Commission had two key objectives:

1. Compliance with FATF SR VI (inter-governmental body) requirements regarding alternative remittance
2. Increased competition in the EU payments market

To arrive at...

- A building block for SEPA
- Opening up markets and ensuring a level playing field
- Increased market transparency
- Standardised rights and obligations of payment providers and users and a high level of consumer protection
- Support modernisation and efficiency of payment systems

The PSD is...

- A Common legal framework for payments within the European Union
- A maximum harmonisation Directive
- Covering all payments (payment services) in all currencies within the European Union except cash and cheques
 - **One size doesn't necessarily fit all**
 - **Risk of over regulating**
- Focus is on Customer protection (not just consumer protection) i.e. the focus is on the relationship between providers of payment services and users of payments services
- End to end payer and payee relationship covered
- Certain provisions may be derogated for corporate users (non-consumers)

SEPA versus PSD

Scope of SEPA and PSD Compliance

	Existing structures	New structures	
Non EUR	<i>Domestic payment instruments and infrastructure (CHF)</i>	<i>SEPA payment instruments and infrastructure (EUR)</i>	CH
	<i>Domestic payment instruments and infrastructure (Non-EUR)</i>	<i>SEPA payment instruments and infrastructure (EUR)</i>	EEA
	<i>Domestic payment instruments and infrastructure (Non-EUR)</i>	<i>SEPA payment instruments and infrastructure (EUR)</i>	EU27
EUR	<i>Domestic payment instruments and infrastructure (EUR)</i>	<i>SEPA payment instruments and infrastructure (EUR)</i>	EU13

PSD Compliance

SEPA Compliance

PSD: a Directive for 27 (30) countries

- PSD Structure
 - I. Subject-matter, scope and definitions
 - II. Payment Service Providers
 - III. Transparency of conditions and information requirements for payment services
 - IV. Rights and obligations in relation to the provision and use of payment services
 - V. Amendments and Payments Committee
 - VI. Final Provisions
 - Annex Payment Services under Article 2(1)

PSD – Key Facts (1/2)

Objectives of the PSD: competition, efficiency and innovation, customer protection

- The PSD represents a legal framework for payments within the European Union Single Market, covering the EU 27 as well as Norway, Iceland, Lichtenstein.
- The PSD is a European Directive, which means that all Member States will have to implement PSD rule into their national legislation, a process called transposition, by the deadline of the 1st November 2009.
- The PSD applies to payment transactions in euro and all other Member State currencies within the Single Market, where those are provided by payment service providers located in this Community.
- The PSD will cover all electronic payment services, while cash to cash transactions and cheques are exempted from the scope.
- The PSD does not intend to cover payment services associated with securities asset servicing.
- PSD focus is on customer protection (not just consumer protection), covering the relationship between providers and users of payments services.

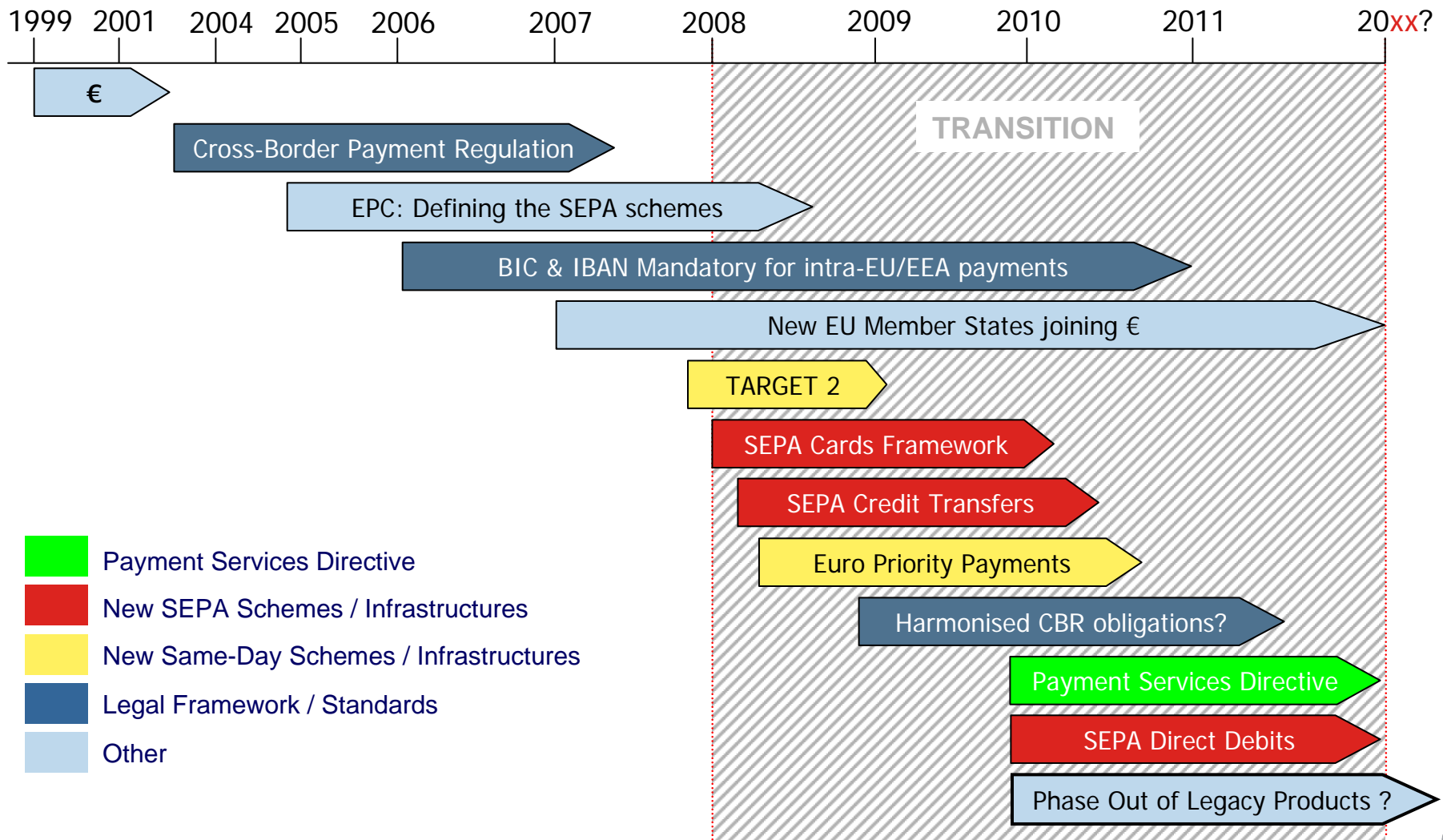
PSD – Key Facts (2/2)

Banks need to get ready for compliance and enhanced competition

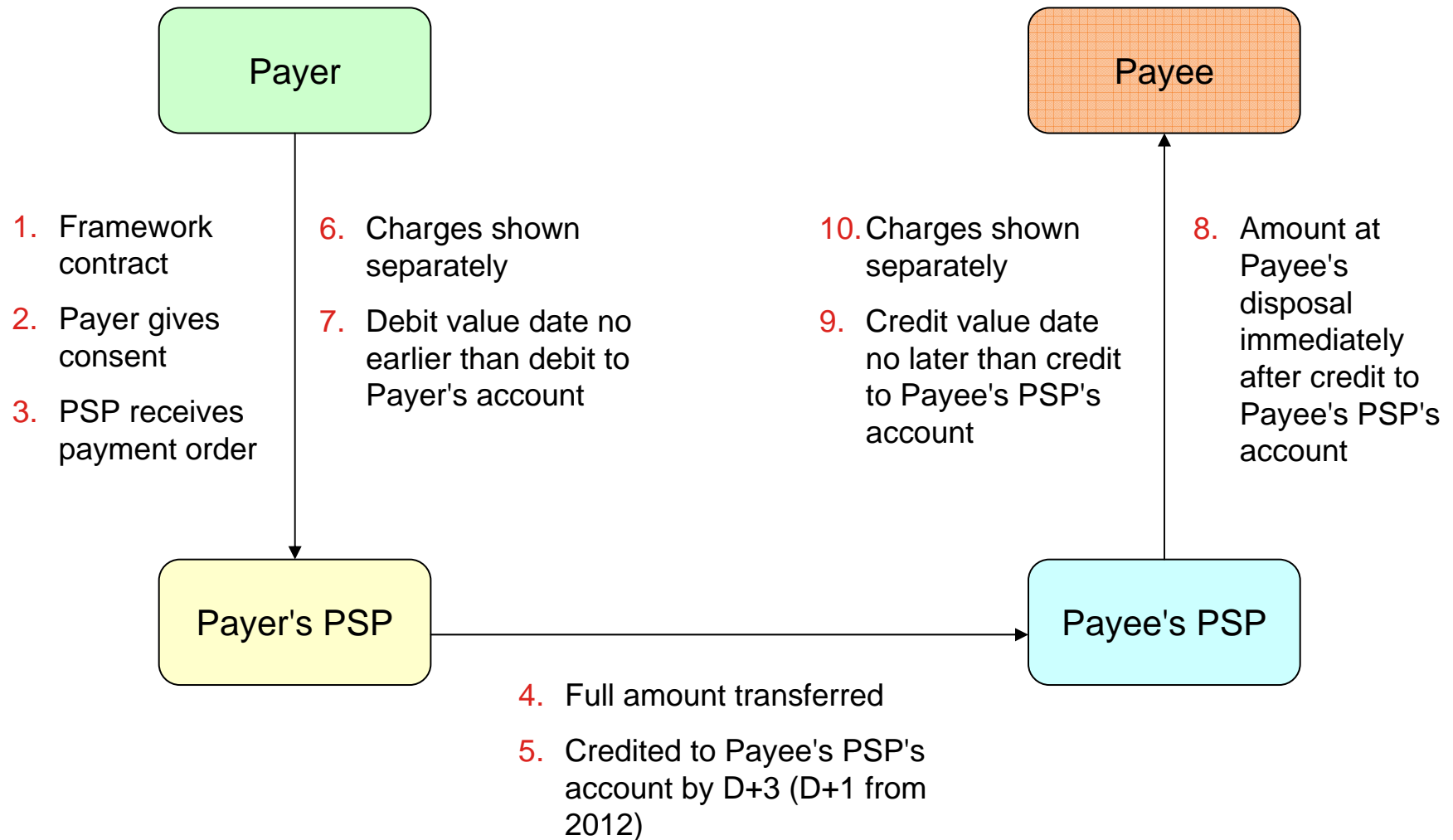
- With the aim of enhancing competition the PSD creates a new lightly regulated entity called a “Payments Institution”, allowing non-banks to handle payments and join the bankers’ payment schemes and associations.
- The PSD also defines conduct of business rules for all payment service providers covering the end to end payer to payee relationship.
- The PSD will have a revolutionary impact on the legal framework between banks and their customers setting stringent rules for information disclosure, conduct of business rules and service provision
- Harmonised refund rules have been established to support SEPA Direct Debits, while unique identifier primacy ensures for enhanced levels of straight-through-processing.
- Central Bank Reporting requirements for Euro transactions across the EEA still constitute a barrier to the free flow of SEPA transactions.
- Every credit institution that provides payment services will have to comply to PSD conduct of business rules by the 1st of November 2009 when national PSD legislation is expected to be in place.

Timeline of Market and Regulatory Initiatives

The PSD intends to provide a comprehensive legal framework for payments in Europe



PSD Requirements – Process Flow



Discussion of Key Principles (1)

- Use of SHA(RE) instead of BEN or OUR charge codes
 - Required where no currency conversion involved
 - Payee free to request a charge or offer a reduction for different payment instruments
- 'Full amount' principle
 - Obligation falls on Payer's PSP to ensure Payee receives the full amount transferred (with no deduction of charges, including by any intermediaries)
- Value dating
 - Principle is that "non-transparent pricing methods should not be allowed" and specifically "the use of value dating to the disadvantage of the user should not be permitted"
 - Parties not free to agree otherwise
 - Mirror image approach:
 - debit value date for Payer's payment account must be no earlier than the point in time at which the amount is debited to that account; and
 - credit value date for Payee's payment account must be no later than the business day on which the amount is credited to the Payee's PSP's account

Discussion of Key Principles (2)

- Execution time
 - Maximum execution times mandated for specified transactions – all euro payment transactions, all national payments in national currency (e.g. Sterling within UK) and cross-border euro to national currency where conversion takes place outside euro-zone country – which also apply to all other in-scope transactions unless user and PSP agree otherwise
 - D+1, but until 2012, Payer and his PSP can agree a max of D+3
 - Additional business day permitted for paper-initiated payment transactions
 - For purely national payment transactions, Member States can provide for shorter execution times
 - Measured:
 - from point in time of receipt of payment order by Payer's PSP
 - to credit to Payee's PSP's account
 - by reference to "business days"
- Liability
 - Execution per specified unique identifier
 - Payer's PSP is liable for correct execution unless he can prove that the Payee's PSP received the amount involved and regardless of liability must make "immediate efforts" to trace the payment transaction and notify the payer of the outcome

PSD Interpretation Challenges (1/4)

Risk of unintended consequences by going beyond the scope of the PSD

Ongoing discussion in the Member State Transposition WG indicate significant risks around PSD interpretations: risk of 30 PSDs and cost of fragmentation for the banking industry

Some examples:

1) Why include Leg-Out transactions?

- Conscious political decision to create a Single Market for payments (EEA)
- PSD covers only intra-EU/EEA payments (with the exception of Article 73) in EU/EEA currencies
- The concept of one leg-out, applied in relation to Article 73, covers payments where one PSP is outside the EU/EEA (Article 2.1) and is further limited to EU/EEA currencies (Article 2.2)
- Goal of full harmonisation: Member States should have the same PSD-transposed provisions
- Review Clause and requirement for an Impact Assessment (A87)

PSD Interpretation Challenges (2/4)

Why leg-out transactions are not practical to be included in the PSD

- **Legal concerns:** *Additional legal uncertainty during transposition*
 - It appears that some Member States may choose to extend the leg-out concept to further articles beyond Article 73
 - A further legal concern would be if any of those Member States went beyond Article 2.2 to include non-EEA currencies within their definition of one-leg-out transactions
 - Limitations regarding extraterritorial obligations: no ability to legally enforce PSD beyond EEA borders
- **Practical concerns**
 - Uncertainty in relation to non-EEA currencies
 - Compliance overhead - imbalance of costs and benefits compounded by risk of fragmented approach
 - Risk that PSPs may withdraw services - consequent market concentration
- **Examples of specific problem areas:**
 - Execution Times
 - Full amount end-to-end
 - Currency Conversions
 - PSD Liability Regime

Don't open Pandora's Box!

PSD Interpretation Challenges (3/4)

Need for consistent clarifications regarding key interpretations

2) Value date (A73)

- Definition of business day is a cornerstone of the PSD and fundamental to all aspects of the execution cycle (A64, A69, A73).
- Logical requirement is for funds received at the PSP on a non-business day to be credited and made available to the PSU no later than the following business day and for funds debited at the PSP on a non-business day to be value-dated same day for the PSU: need to inform all clients in detail about when the PSP is open for business

3) Refund for unauthorised transactions (A60)

- Maximum period of 10 business days allowed for refunding an authorised transaction (A63)
- Contrasts with the suggestion that A60 might imply the need for ‘immediate refund’ of unauthorised transactions
- While the general principle of a short refund period for unauthorised transactions can be welcomed, the ability for a PSP to investigate prior to refund whether a transaction is unauthorised is essential in respect of corporate transactions generally – and also in respect of consumer transactions in cases where there is suspicion of fraud

PSD Interpretation Challenges (4/4)

No need to over engineer the PSD

4) Non-execution/defective execution (A75)

Example of how the PSD can be easily misread:

- The PSD Expert Group welcomes the implications of the Commission's recent clarification (answer to FAQ no. 95) with regard to 'defective execution'. In this context we note that delayed, and hence defective payments, do not need to be refunded.
- Delayed payments can not be considered as 'defective' in the sense of requiring a refund, as otherwise PSUs would benefit from a refund despite the payment having been received by the payee, which would result in the unintended consequence of undue enrichment
- Only reimbursement of related charges/interest is relevant in those instances – as envisaged in A75(3)

Risks of Non-Harmonised PSD Implementation

30 PSDs???

- In most EU markets national laws adopting the PSD have not yet been drafted, where the majority of Europe PSD legislation is expected to be passed by national parliaments by mid-2009 to enter into force on the 1st of November 2009.
- The number of national discretions provided by the PSD will allow Member States to vary elements of the PSD, which ultimately risks to lead to market inconsistencies across Europe, which means costs for the banks.
- To tackle the risks associated with such a non-harmonised PSD implementation, Citi has proactively taken steps to ensure a clear interpretation of the PSD at European and Member State level, where Ruth Wandhöfer is leading the ongoing negotiation with the EU Commission and Member States as part of the transposition process.

PSD: How Should Banks Prepare Themselves? (1/2)

Planning of PSD compliance is crucial

For those who have not yet kicked-off their PSD compliance project, here are some recommendations to get started:

- An appropriate PSD project governance structure is crucial.
- A clear implementation plan as well as budget and resource requirements need to be identified.
- All product owners within the organisation need to carry out an impact assessment against an agreed interpretation of the PSD.
- Ongoing PSD implementation at national level needs to be monitored, e.g. through local banking associations and public consultation efforts.
- A detailed review of terms and conditions in line with the requirements of the PSD needs to be performed, leading to a new set of payments specific terms and conditions for every client.

PSD: How Should Banks Prepare Themselves? (2/2)

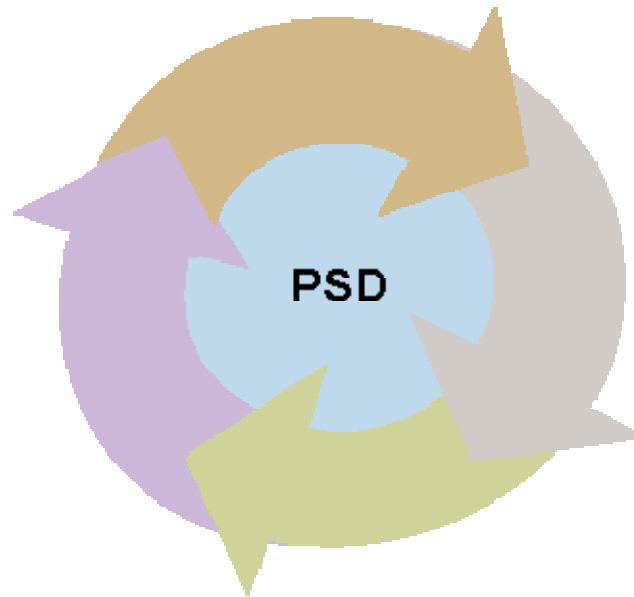
Part of the solution is to get the approach right

- To ensure IT compliance, current information collection, storage and access processes have to be assessed against those stipulated in the PSD.
- As cross-border competition is expected to increase with the PSD as well as SEPA, an internal review of products that appear most vulnerable should be conducted.
- Carefully plan customer communication.
- Banks are also advised to examine all third party relationships, including payments intermediaries, in order to ensure that the significant liability shift on sending payment services providers in the PSD can be complied with in the most efficient way.

PSD – Practical Planning Considerations

Title 1.
Range of
businesses/
services impacted?

Title 3.
Impact on customer
Terms and
Conditions?



Title 4.
Impact on payment
processing?

Title 4.
Balance of liabilities
between PSPs and
PSUs

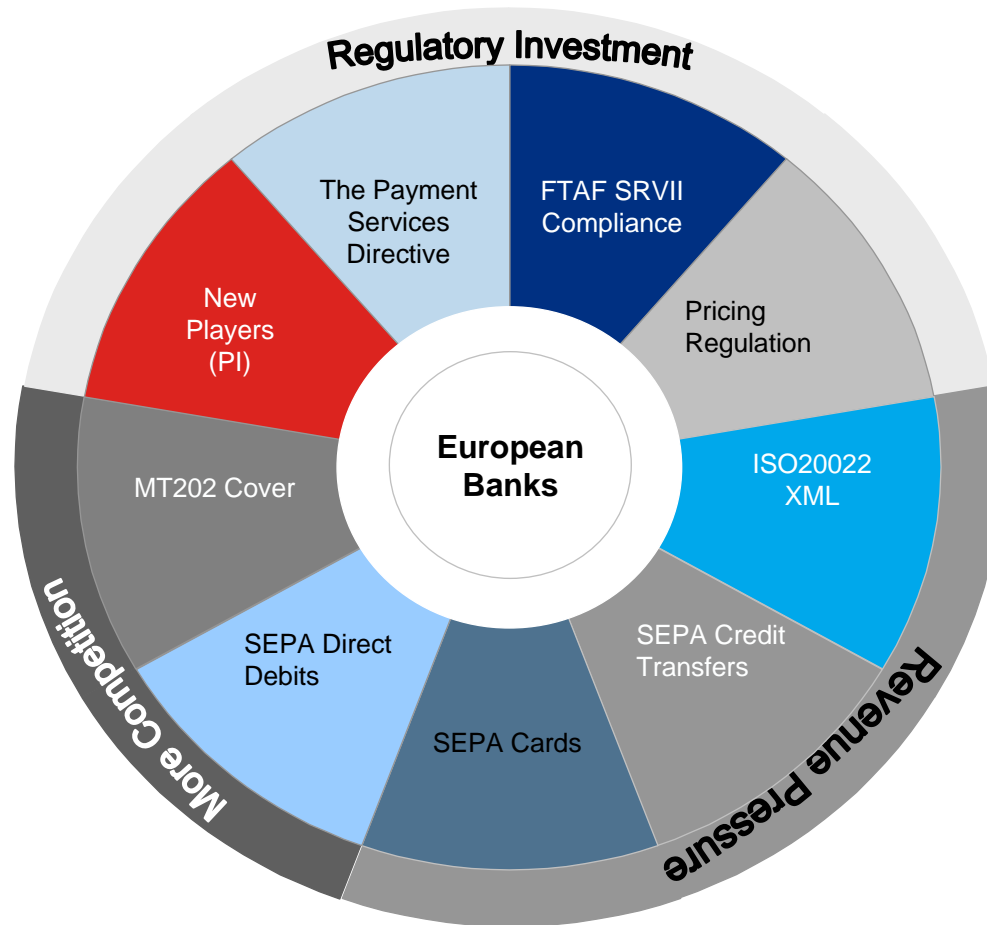
PSD: Anticipated impacts on Financial Institutions in Europe

European Banks must reconsider their payment strategy

- The PSD will have a substantial impact on European banks from both a revenue and competition angle.
- Any bank providing payment services within the EU/EEA today needs to assess whether payment services, in light of PSD compliance and enhanced competition, including SEPA, shall remain a core activity.
- Competition is expected to increase with the arrival of payment institutions, which will benefit from non-discriminatory access to payment systems.
- In order to maintain a competitive edge compliance will not be enough. Investments will also need to be made in PSD-compliance value added products and services.
- While the majority of larger institutions expects to be ready for November 2009, every player needs to be aware of the potential impacts of the PSD on their customers and operations.

“Implementing the PSD could cost larger European financial institutions over €6bn in the next 18 months”, PSE Consulting, July 2008

European Banks Under Pressure



PSD: Anticipated Impacts on Financial Institutions Outside Europe

Banks outside the EU/EEA need to be aware of the market change

- The direct impact of the PSD will be on European payment service providers for payment transactions executed within the 30 countries, covering those Member State's currencies.
- This will mean that banks located outside the Single Market will not be affected by any compliance requirements emanating from the PSD.
- Enhanced standardisation with SEPA will help accelerate both competition and commoditisation of core euro payments services. This could lead to massive consolidation in the European payments space.
- The PSD's consumer protective measures limiting value dating and charging practices that are to the detriment of any user could become a best practice model for banks outside the Single Market regulated space.
- A number of European banks will have the tendency to explore revenue opportunities with regard to payments that are fully or partly outside of the Single Market. This could have a negative impacts on banks outside of Europe.

PSD: Potential Impacts on Clients

Enhanced consumer protection but limited corporate user choice?

- The PSD primarily delivers consumer protection
 - Increased transparency and hence choice to switch provider
 - Enhanced legal protection across the whole of Europe
 - Increased efficiencies with shorter average execution cycles for x-border payments
- Benefits will derive from increased consistency of payment services with the harmonised set of conduct of business rules across Europe
- PSD rules on charging and value dating will also require a change of practice in the corporate client space
 - Pricing models incorporating float will have to be changed to direct pricing
 - 'OUR' choice charging option removed
- Opportunity for clients to play in the payment space
 - Any one, be it a corporate or a natural person, can decide to obtain a licence under the PSD
 - Natural persons can file for a license to provide domestic services only
 - Legal persons (businesses) can obtain a European PSD passport
 - Pure Payment Institutions vs. Hybrid Payment Institutions

The Future of European Payments

PSD and SEPA as the next step towards *Lisbon*

- The PSD does deliver the required harmonisation to allow for the roll-out of SEPA Direct Debits in November 2009
- In addition, the PSD raises the service level benchmark for all payment services in the Single Market.
- Standardisation of business rules combined with standardisation in the inter-bank SEPA space will significantly increase competition and efficiencies with the anticipated consequence of long-term consolidation in the European payments industry.
- Banks need to review their business models, leverage the increased levels of transparency in terms of accessing new markets and seek new opportunities to cope with the combined challenge of the PSD and SEPA.
- While the goal of a Single Market for Payments with SEPA in its centre is not yet in sight, the foundation has been established to allow for this evolution.
- Risk that banks outside EU/EEA will suffer to the degree that EU/EEA players need to recover their lost revenues elsewhere.

Conclusions

PSD: challenge and opportunity

- The PSD will be a major challenge for European Banks
 - Detailed conduct of business rules to comply with
 - Reduced revenue from reduction in charging and float income
 - Increased liability
- Potential legal fragmentation with 30 national PSDs
 - In addition to explicit derogations throughout the text, the PSD is additionally open for non-harmonised implementation via Article 86
 - More work to be done to ensure Member States arrive at a shared and coherent interpretation of the PSD scope and key provisions
 - Multi-country banks are particularly at risk
- Competition will increase with new non-bank players in the market
- Potential impacts on banks outside the EU/EEA
- To reduce the PSD challenge:
 - PSD compliance has to be planned now
 - Collaboration and partnering could be the solution to support your requirements

Useful Information

Citi can help to master the PSD challenges

- European Banking Industry PSD Expert Group
 - Key authority, leading the banking industry-wide negotiation with EU Commission and EU Finance Ministries
 - Objective: ensure max. harmonisation and feasibility of legal provisions; market best practice
 - Preparation of banking industry guidance on the PSD; planned for Q1 2009
- EU Commission DG Market
 - FAQ website: http://ec.europa.eu/internal_market/payments/framework/transposition_en.htm
 - Objective: public FAQ around PSD questions; answers reflect the Commission's opinion and are in most instances not legally confirmed, nor necessarily legally valid
 - Caution!!!
- Euro Banking Association (EBA) PSD guide
 - EBA Association prepared a PSD guide in Q3 '08
 - Objective: provide EBA members with PSD information;
 - Caution!!! This guide is not 100% correct and does not come from an authoritative source
- For inside information on PSD developments please contact Citi

Questions & Answers

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