

# *The Payments Revolution*

*- it pays to be prudent*



27 March 2009

The new Payment Services Regulations (the “PSRs”) will impose two types of regulatory obligation upon payment service providers: “prudential” requirements and “conduct of business” (COB) requirements. While the COB requirements are applicable to all types of payment service provider, the main prudential requirements will only apply to authorised payment institutions. These key prudential requirements are the focus of this briefing paper.

## **Prudential requirements – what are they?**

The prudential requirements of the PSRs broadly comprise initial and on-going regulatory capital requirements, requirements for safeguarding customer funds and other requirements that seek to ensure market confidence in the stability, efficiency and fitness of authorised payment institutions (such as controls over the outsourcing of important operational functions and requirements for record-keeping).

## **Who do they apply to?**

Only authorised payment institutions are required to comply with the main prudential requirements, such as those relating to regulatory capital and the safeguarding of customer funds, that are imposed by the PSRs. However, payment institutions that are taking advantage of the transitional provisions of the PSRs, so as to be deemed to have been granted authorisation pursuant to regulation 121 (“deemed authorised payment institutions”), are *not* subject to the prudential requirements of the PSRs. Further, certain authorised payment institutions that are included within the consolidated supervision of their parent for regulatory capital purposes are also excluded from the scope of the requirements.

Small payment institutions may choose to comply with one or more of these key prudential requirements in order to, for example, give comfort to their customers as to the safety of their funds prior to execution of their payment transaction.

An authorised payment institution must be incorporated under the law of a part of the United Kingdom and have its head office (and, if it has a registered office, that office) located in the UK. Similar location requirements apply to small payment institutions, so that they must have their head office, registered office or place of residence in the UK.

## **Authorised payment institutions: capital requirements**

The initial and on-going regulatory capital requirements of the PSRs are set out in regulations 6(3) and 18 and Schedule 3.

Before a relevant payment institution may be authorised, it must satisfy the FSA that it holds “initial capital” of an amount at least equal to the relevant “initial capital requirement”

## **Key client points:**

- *Authorised payment institutions will be subject to initial and on-going regulatory capital requirements under the PSRs*
- *They will need to identify one of three methods that best determines their on-going "own funds" requirement*
- *They will be required to maintain procedures to safeguard customers' funds*
- *The FSA has the power to impose regulatory sanctions for non-compliance with prudential requirements*
- *In certain cases, "private persons" may have a right to bring an action to recover damages for loss suffered as a result of non-compliance*

(see 1 below). Further, a relevant authorised payment institution must, at all times, maintain “own funds” of an amount at least equal to its “own funds requirement” (see 2 below).

Box 1 (at the end of this paper) sets out the components which are potentially eligible to make up an authorised payment institution’s “initial capital” or “own funds” for regulatory capital purposes.

### 1. *Initial capital requirement*

“Initial capital” for the purposes of the initial capital requirement comprises the Group 1 items of column (i) in Box 1. Before a payment institution can be authorised to provide its payment services in the United Kingdom, it must hold the amount of initial capital set out in the table below which corresponds to the category of payment services it will provide. Where you provide more than one category of payment services which each require different initial capital amounts, you must hold a minimum amount of initial capital that corresponds to the category with the higher initial capital amount. For example, if you are a money remitter and also a non-bank credit card issuer, you would need to hold initial capital of at least EUR 125,000 before you could be authorised as a payment institution.

| Category of payment services  | Initial capital amount |
|---|------------------------|
| Money remitter  | EUR 20,000             |
| Executed payment transactions where the consent of the payer to execute the payment transaction is given by way 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 customer and the supplier (e.g. some mobile phone payment services) | EUR 50,000             |
| All other categories of payment services  | EUR 125,000            |

It is expected that authorised payment institution applicants will be able to use bank statements, audited accounts or Company House annual returns as proof of their initial capital, although this will be subject to any further documentation required by the FSA during the authorisation application process.

### 2. *Own funds requirement*

The on-going own funds requirement of the PSRs requires an authorised payment institution to hold “own funds” equal to or in excess of the greater of: (a) the initial capital amount applicable to its payment services; and (b) the own funds requirement calculated in accordance with one of three methods:

Method A - based on the authorised payment institution’s level of fixed overheads;

Method B - based on the authorised payment institution’s volume of payment transactions; or

Method C - based on the authorised payment institution’s level of income.

Worked examples of how to calculate an authorised payment institution’s own funds requirement using each of the three methods are set out in Box 2. Although the FSA has the final say on which method an authorised payment institution must use in order to calculate its own funds requirement, it is expected that authorised payment institution applicants may choose and submit their preferred method to the FSA as part of their application packs, with justifications for the chosen method based on the applicant’s business model.

The FSA may direct an authorised payment institution to hold own funds up to 20% higher or lower than the amount calculated using the selected method of calculation. The FSA’s decision will be based on its assessment of the authorised payment institution and, where the FSA considers it appropriate, any risk-management processes, risk loss database or internal control mechanisms of the authorised payment institution. The FSA may also charge a fee on the authorised payment institution for conducting this evaluation.

### **Authorised payment institutions: safeguarding requirements**

The safeguarding requirements generally apply to customer funds that an authorised payment institution receives in advance of

executing a payment transaction on behalf of the customer (e.g. a regular migrant remittance transaction) or funds that it receives from a customer for the execution of a payment transaction (e.g. a credit transfer, such as a standing order).

The safeguarding requirements of regulation 19 require authorised payment institutions to keep customer funds which are in excess of £50 (per customer) either segregated from their own funds (see 1 below) or covered by an eligible insurance policy or guarantee from an eligible insurer or credit institution (see 2 below). In either case, in the event of the authorised payment institution's winding up or administration, the claims of the customers have statutory protection and must be paid from the ring-fenced asset pool in priority to all other creditors. The authorised payment institution must also maintain organisational arrangements which minimise the risk of the loss or reduction of customer funds or assets through fraud, misuse, negligence or poor administration.

All of the safeguarding requirements also apply to small payment institutions that voluntarily safeguard customer funds in accordance with regulation 19 and to authorised payment institutions that choose to safeguard customer funds of £50 or less.

### *1. Segregating customer funds from any other funds*

Where an authorised payment institution elects to keep customer funds segregated from any other funds that it holds, if it continues to hold those funds at the end of the business day following the day of receipt, it must do one of two things. It must either: (a) deposit the funds into one or more separate, designated client bank accounts with an "authorised credit institution" (funds of different customers can be held in one bank account on a pooled basis, so long as the bank account is solely held for the purpose of safeguarding customer funds); or (b) invest such funds in FSA-approved secure and liquid assets, such as cash deposits, ensuring that those assets are placed in a separate, designated account held with an "authorised custodian".

An "authorised credit institution" is essentially any bank that is either authorised by the FSA to accept deposits in the UK or is an EEA credit institution. However, it is not possible for an authorised payment institution to deposit relevant funds with a bank in the same corporate group as the authorised payment institution.

An "authorised custodian" is essentially a custodian that is either authorised by the FSA to safeguard and administer investments belonging to a third party in the UK or is an EEA investment firm that holds investments for clients under regulatory standards which are at least equivalent to the organisational requirements imposed by Article 13 of MiFID. There is no prohibition under the PSRs on such an authorised custodian being in the same group as the authorised payment institution.

The authorised payment institution must also keep a record of segregated funds, relevant funds placed in a bank account with an authorised credit institution and relevant assets placed in a cash or securities account with an authorised custodian. In accordance with regulation 22 of the PSRs, such records must be maintained and kept for at least five years from the date they were created.

### *2. Eligible insurance policy or guarantee*

Where an authorised payment institution elects to cover customer funds by an eligible insurance policy or guarantee, it must ensure that the funds are covered either by an insurance policy with an "authorised insurer" or a guarantee from such an insurer or an authorised credit institution. An "authorised insurer" is essentially a person either authorised by the FSA to effect and carry out contracts of general insurance in the UK or is an EEA general insurer. An authorised insurer cannot be in the same corporate group as the authorised payment institution.

The terms of any such insurance policy or guarantee must provide that its proceeds are payable upon the occurrence of an "insolvency event" in relation to the authorised payment institution, including the making of a winding-up order, the passing of a resolution for its voluntary winding-up or its entry into administration. The proceeds of such insurance policy or guarantee must be paid into a separate, designated account held by the authorised payment institution for the sole purpose of safeguarding customer funds in accordance with regulation 19 and for holding the proceeds of such an eligible insurance policy or guarantee.

### *3. No third party interest*

No third party may have any right or interest in any bank, cash or securities account to which funds, proceeds or assets are credited in accordance with the safeguarding requirements; save that the provider of the account may reserve and exercise set-off and security rights to the extent of any fees and expenses incurred by the authorised payment institution in relation to the operation of the account. Save to this limited extent, the claims of the authorised payment institution's customers must be paid from segregated assets and any funds, cash or securities held in such an account in priority to all other creditors. In particular, such claims are not to be subject to the priority of the expenses of an insolvency proceeding except in respect of the costs of the distribution of the asset pool to the customers.

### Consequences of breaching the prudential requirements

If an authorised payment institution no longer meets, or is unlikely to continue to meet, its on-going own funds requirement, the FSA may, subject to giving the payment institution a prior warning notice, cancel its authorisation and remove it from the FSA register of authorised payment institutions. You will be committing a criminal offence if your authorisation is cancelled and you continue to provide payment services in the UK.

The FSA also has the power to take any of the regulatory actions available to it under regulations 84 to 90 of the PSRs if an authorised payment institution breaches (or, in certain cases, there is a reasonable likelihood that it will breach) *any* requirement imposed on it by or under the PSRs – which would include a breach of any of the regulatory capital or safeguarding requirements outlined above.

- Regulation 84 (public censure) - the FSA may (subject to giving a warning notice) publish a statement specifying that you have breached one or more requirements.
- Regulation 85 (financial penalties) - the FSA may (subject to giving a warning notice) impose a financial penalty (recoverable as a debt by the FSA) of any amount that it considers appropriate, although it cannot require you to pay a penalty under this regulation and also cancel your authorisation as a payment institution.
- Regulation 87 (injunctions) - on the FSA's application, a court may make orders (a) restraining you from breaching the relevant requirement(s), (b) requiring you (and any other person who appears to have been knowingly concerned in the breach) to take steps to remedy the breach and/or (c) preventing you (or any other such person) from disposing or otherwise dealing with any of your (or their) assets.
- Regulation 88 (restitution) - if you have breached any requirements (or been knowingly concerned in the breach of the requirements) and have either accrued profits as a result of that breach or caused, for example, customers to suffer loss (or otherwise be adversely affected by the breach), the FSA may (subject to giving a warning notice) require you to distribute an amount (determined at the FSA's discretion) to those adversely affected by your breach.
- Regulation 90 (restitution orders) - on the FSA's application, a court may make an order requiring you to pay the FSA a sum determined by the court to reflect any profits that you have accrued or any loss suffered by one or more persons as a result of your breach of the relevant requirement(s) or your being knowingly concerned in such a breach; the FSA is then required to pass any amount paid under the restitution order to those who have suffered the loss or to whom the profits are attributable.

You have a right of referral to the Financial Services and Markets Tribunal in relation to the FSA's decision to enforce any of regulations 10 (cancellation of authorisation), 84 (public censure), 85 (financial penalties) and 88 (restitution).

### Right to bring actions for breaching safeguarding requirements

"Private persons" have a right to bring an action against an authorised payment institution for the loss they have suffered as a result of the payment institution's breach of certain prudential requirements - including a breach of the safeguarding requirements.

For these purposes, a "private person" is:

- any individual (except where the individual suffers the loss in the course of providing payment services themselves); and
- any person who is not an individual (except where that person suffers the loss in the course of carrying on business of any kind).

The right to bring such actions is not available to customers that are a government, local authority (in the UK or elsewhere) or an international organisation.

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**Box 1 - Capital requirements – Meaning of “initial capital” and “own funds”**

"Initial capital" for the purposes of the "initial capital requirement" (relevant to the initial authorisation of a payment institution) comprises the Group 1 items of column (i) below.

"Own funds" broadly means the items set out in the table below in column (i) (qualifying items of capital), subject to the deductions specified in column (ii) (deductions from “own funds”) and to the limits specified in column (iii) (limits on qualifying items of capital).

An authorised payment institution must *not* include in its “own funds” calculation any item relating to any non-payment services that it might provide or any item used in an equivalent calculation by an authorised payment institution, credit institution, investment firm, asset management company or insurance undertaking in the same group.

| <b>(i) Qualifying items of capital</b>   | <b>(ii) Deductions from “own funds”</b>   | <b>(iii) Limits on qualifying items of capital</b>   |
|--|---|--|
| <p><i>Group 1 items</i></p> <ul style="list-style-type: none"> <li>• paid-up capital (excluding amounts from cumulative preference shares)</li> <li>• reserves (excluding certain reserves, such as revaluation reserves)</li> <li>• profit or loss (subject to certain conditions)</li> </ul> <p><i>Group 2 items</i></p> <ul style="list-style-type: none"> <li>• revaluation reserves</li> <li>• general or collective provisions meeting certain conditions e.g. the provisions must be freely available to the authorised payment institution to cover normal payment services risks where revenue or capital losses have not yet been identified</li> <li>• securities of an indeterminate duration and other financial instruments (subject to certain conditions)</li> <li>• cumulative preference shares (other than fixed-term cumulative preference shares in Group 3 below)</li> </ul> <p><i>Group 3 items</i></p> <ul style="list-style-type: none"> <li>• where an authorised payment institution is set up as a co-operative, the commitments of its members e.g. the payment institution’s uncalled capital</li> <li>• where an authorised payment institution is organised as a fund, the joint and several commitments of its borrower e.g. the payment institution’s uncalled capital</li> <li>• fixed-term cumulative preference shares and subordinated loan capital (subject to certain conditions)</li> </ul> | <p><i>Group 1 items</i></p> <ul style="list-style-type: none"> <li>• own shares at book value held by the authorised payment institution</li> <li>• intangible assets (e.g. goodwill)</li> <li>• material losses of the current financial year</li> </ul> <p><i>Group 2 items</i></p> <ul style="list-style-type: none"> <li>• holdings of shares in credit institutions and financial institutions exceeding 10% of their capital and, where this item applies, certain Groups 2 and 3 items in column (i) that are held in the relevant credit institution or financial institution must also be deducted from “own funds”</li> </ul> <p><i>Group 3 items</i></p> <ul style="list-style-type: none"> <li>• holdings of shares or certain Groups 2 and 3 items in column (i) that are held in other credit institutions or financial institutions and do not otherwise fall in Group 2 of this column (ii)</li> <li>• an authorised payment institution’s participations held in insurance and re-insurance companies</li> <li>• certain types of instruments (e.g. premiums) held in insurance or re-insurance companies in which the authorised payment institution holds a participation</li> </ul> <p>The FSA may direct that any or all of the items in Groups 2 and 3 of (ii) are not to be deducted from “own funds” where shares held in another entity are temporarily held to financially assist and save that entity.</p> | <ul style="list-style-type: none"> <li>• A must not exceed B</li> <li>• C must not exceed 50% of B</li> <li>• After applying the above limits, 50% of the total of the Groups 2 and 3 items in column (ii) must be deducted from A and the remaining 50% must be deducted from B; also, the amount, if any, by which the amount to be deducted from A exceeds A must be deducted from B</li> <li>• The FSA may, in temporary and exceptional circumstances, direct that an authorised payment institution may exceed one or more of the limits specified in this column (iii)</li> </ul> <p><u>Key:</u></p> <p>A = Total of Groups 2 and 3 items in column (i)</p> <p>B = Total of Group 1 items in column (i) less Group 1 items in column (ii)</p> <p>C = Total of Group 3 items in column (i)</p> |

**Box 2 - Worked examples of calculating on-going "own funds" requirement** (*taken from HM Treasury's consultation document headed "Implementation of the Payment Services Directive: a consultation document, December 2007"*)

**Method A**

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

How it works:

- The amount of own funds 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, its own funds must be 10% of the fixed overheads projected in the firm's business plan.

**Example 1:**

Money transmitter has fixed overheads of €500,000

**Firm must hold "own funds" of at least €50,000**

**Example 2:**

Money transmitter has fixed overheads of €100,000

**Firm must hold "own funds" of at least €20,000** (as the "own funds" requirement is the greater of the amount calculated in accordance with Method A and the "initial capital" requirement of €20,000 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:  

$$\text{Payment Volume} = \frac{\text{total value of payment transactions executed by the firm in the preceding year}}{12}$$
- **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, multiply 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 transmitter 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 €5m (€5m to €10m slice)  | = | € 125,000  |
| 1% of €90m (€10m to €100m slice) | = | € 900,000  |
| TOTAL                            | = | €1,225,000 |

• **Step 3:** x 0.5 = € 612,500

**Firm must hold “own funds” 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 Income Indicator is reached:

| Income Indicator (€ million) | Multiple of Income Indicator (%) |     |      |
|------------------------------|----------------------------------|-----|------|
| 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, multiply 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:**

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

• **Step 2:**

|                                   |   |            |
|-----------------------------------|---|------------|
| 10% of €2.5 m (€0 to €2.5m slice) | = | € 250,000  |
| 8% of €2.5m (€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

**Firm must hold “own funds” of at least €825,000**

**Disclaimer**

Please note that the contents of this note provide an overview only. This note is guidance only and should not be relied upon as legal advice. Clients' circumstances will differ in each case. If you would like to receive specific advice on the new regime for payment services, please contact:

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