The role of non-banks in retail payments

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Outline

1. Non-banks : a new role in the payment chain
2. What risk implications ?
3. A challenge for European regulators and overseers
Non-banks in retail payments

Academic research especially since 2003
- Joint studies from the Fed Kansas City-ECB since 2006 about the non-banks involvement in retail payment services and the risks induced
  - US and 15 European countries (incl. 10 in the euro area)
  - Instruments considered: credit transfers, direct debits, payment cards, truncated cheques, e-money and other pre-stored value instruments

3 mains issues:
- What roles do non-banks play in the payment chain?
- What impacts in terms of risks?
- Is the current supervision of non-banks appropriate?

What are non-banks?

- Non-banks: any entity that is not a bank and which is involved in payment transactions
  - In the European context, non-banks include all entities that are not fully licenced as credit institutions. For example, electronic money institutions or payment institutions.

- Non-banks include:
  - technical service providers: data processors, network managers, security vendors…
  - non-bank financial institutions (depending on national law): money remittance service providers…
  - other institutions: mobile phone companies, large retailers…
1. Non-banks play multiple roles in the payment chain

Presence of non-banks in payment processing, often due to outsourcing by banks: data processing, file transmission, network services (gateway provision and switching services, authorization services, risk and fraud management services)

Both in the US and Europe, non-banks’ role is increasingly important and visible throughout the whole processing chain except settlement (remains a bank’s activity)

The Fed / ECB study does not differentiate between the technical and financial functions performed by non-banks, or their importance (operational role only…)

Role of non-banks in Europe and in the US

<table>
<thead>
<tr>
<th>Europe</th>
<th>US</th>
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<tbody>
<tr>
<td>Significant variations among countries:</td>
<td>Prevalence of non-bank in almost all payment instruments and almost all steps of payment processes apart from settlement.</td>
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<td>- large involvement: AU, DE, NL, IT</td>
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<td>- in-between: BUL, CY, CZ, GR, LT, PT</td>
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<tr>
<td>- limited role: FIN, FR, LV, SI</td>
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<td>Important presence for card payments, apart from FR.</td>
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Growing prospects in Europe due to industry and regulatory developments (rise of cashless payments, SEPA project, new legal frameworks (PSD, new EMD)…)

- New non-banks actors, consolidation process in parallel with a fierce competition, widening markets
2. Impact of non-banks on risk: a changing environment

- **Blurring borders between payment instruments:** innovative ways/application to initiate payments, new products (mobile payments, near field communication/contactless transactions)...
- **Cross-channel risk:** same infrastructure/providers serving different markets or market segments
- **Increased dependency of banks on non-banks for risk control and mitigation**
  - operational risk, following outsourcing to critical actors and specialised players
  - fraud risk, following involvement of non-banks in on-line payment data authentication and payment authorisation

Operational risk in the new environment

- Traditional banks gate-keeping function to payment systems
- Modern payment networks:
  - More complex (infra)structure,
  - Different and increased number of players,
  - More complex interactions
- Open access technology, not under direct control of banks:
  - Use of open networks, off-the-shelf/open source applications,
  - Dissemination of sensitive data in multiple places
- Potential new vulnerabilities and channels for fraud
  - often in steps of the payment chain outside direct control of banks
Acceleration of traditional risk exposure for banks

- Risks related to the settlement activity
  - Card payments: ACH, or bilaterally, or centrally in commercial bank money
- Credit and liquidity risks outside the settlement stage
  - Initiation of crediting or debiting of the parties’ accounts
- Reputational risks
  - Resonance in the media beyond the actual point of failure

⇒ More international cooperation needed

A new challenge for the NCB’s oversight function

Some risks categories have become more prominent:

- Operational risks (business continuity, data security, fraud,...)
- Possible relevance of scheme-wide impacts due to higher concentration of processing at critical players (depends on industry structure)
- Members of certain payment schemes (e.g. international 4-party card payment schemes) may be exposed to settlement agent credit risk (also potential for moral hazard)

Risk safeguards, and particularly regulations, are mainly directed towards banks

⇒ Even if some of the risk issues do not all directly depend on the bank or non-bank status of the actor, controlling risk has become more challenging
3. The European response: a new harmonised legal framework

The Payment Services Directive (2007/64/EC) of 13 Nov. 2007, transposed in most EU countries by Nov. 1st, 2009 and in the course of 1H2010

- **Aim**
  - to clarify and harmonise the legal framework for all payment instruments within the EU
  - to facilitate the implementation of the SEPA project (Single Euro Payments Area)

- **Access of new actors to the payment market**
  - Payment services providers (PSPs) include a new category: « payment institutions »
  - those non-banks are allowed to carry other activities and provide payment services (such as provide credit if certain requirements are met, and set up payment accounts)
  - « Pure » technical service providers are excluded (= TSP which do not enter at any time into possession of the funds to be transferred)

- **Harmonised rules**
  - Reinforced information requirements
  - Harmonisation of the respective rights and obligations of the PSPs (irrevocability, settlement cycle, contestations...)

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The European legal framework has been harmonised

<table>
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<tr>
<th>Categories of PSPs</th>
<th>Banks</th>
<th>E-money licenced institutions (non-banks)</th>
<th>Payment institutions (non-banks)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Services permitted</td>
<td>-Taking deposits &amp; granting credits -Providing payment services</td>
<td>-Issuing &amp; managing e-money -Providing payment services</td>
<td>Providing payment services</td>
</tr>
<tr>
<td>Prudential regime</td>
<td>-PSD -other texts</td>
<td>-PSD -E-money directive *</td>
<td>-PSD</td>
</tr>
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</table>

* New EMD to be transposed by end of April 2011, alignment with PSD
The Eurosystem has a statutory competence over non-banks

Co-responsibility of NCBs within the Eurosystem

- Art. 105(2) of the Treaty and 3.1 of the ESCB Statute: basic task is « to promote the smooth functioning of payment systems »

Eurosystem Oversight Policy Framework (February 2009)

- « A separate oversight approach [for non-banks] has not been defined. The activities of non-banks can, in part, be subsumed under the oversight for payment instruments or they can be treated as third-party services »

→ Clear statutory competence for the oversight of all payment systems and instruments covering banks and non-banks irrespective of their status

→ Definition of Eurosystem cooperative oversight frameworks (cards – 2008; credit transfers, direct debits – 2010)

Banque de France’s oversight covers an extensive field

- Responsibility established by French law (Everyday Security Act – 2001)
  - Art. L. 141-4 of the Monetary and Financial Code: « Banque de France shall ensure the security of means of payment, other than cash, and the suitability of the relevant standards »

→ Broad oversight perimeter: all issuers, be they banks or non-banks

- Covers issuing and administering means of payments and outsourcing. Banque de France is entitled to ask vendors/providers of credit institutions about safety and efficiency issues.

- Power of information and on-site inspections of all relevant entities
  - Art. L. 141-4 of the Monetary and Financial Code: “In performing these missions, the Bank of France carries out the necessary inspections and obtains from the issuer or another party involved the relevant information concerning the means of payment and the terminals or other technical devices associated therewith.”
On-site inspections of non-banks have been carried out

- For instance, third-party service providers such as data processors have been submitted to on-site inspections by Banque de France’s inspection teams:
  - Either directly,
  - Or as part of an investigation regarding a bank that outsources some operational or technical functions

→ Recommendations to issuers

Art L. 141-4 of the Monetary and Financial Code: “if the Banque de France considers that any such means of payment offers insufficient guarantees of security, it may recommend that its issuer take all appropriate measures to remedy such insufficiency.”

→ Follow-up on their implementation

Conclusion: coming challenges for central banks

- **Fully take into account those less traditional actors from an oversight and a regulatory perspective**
  - An example on the current EU agenda: overlay services providers

- **Further study non-banks according to their functions (technical / financial) and hence their risks**

- **Give particular attention to critical actors with scheme-wide implications**

- **Increase regional and international cooperation**
  - In EU, creation of the European security forum for retail payments

- **In Europe, take into account the oversight of:**
  - newly introduced payment institutions
  - upcoming e-money institutions licensed under the new regime set out by the revised EMD

  ... And in the next 2/3 years, pay attention to the anticipated PSD/EMD merger and its consequences
Research papers and studies

- Conference sponsored by the Federal Reserve Bank of Kansas City, Santa Fe, New Mexico, May 2-4, 2007:
  - B. Hall, “Innovation in Nonbank Payment Systems”

Thank you for your attention

Questions?

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