

New payments regulation will hinder innovation: the debate

Robert Courtneidge, Global Head of Cards and Payments at Locke Lord LLP, and recently placed No. 1 in the Payments 2015 Power 10 rankings, which recognises top contributors to the payments industry through nominations from the international payments community, took part in the Payments Punch Up debate held on 10 June at PayExpo 2015 and stood in opposition to a statement - 'New payment regulation initiatives will do nothing but hinder innovation' - the debate around which is very close to his heart. Obviously, Robert was responsible for arguing against the motion but as a lawyer he takes a very balanced view. In this article Robert presents both sides of the debate.

The arguments have been split into five rounds and the topic for each round is: Round 1 - The regulators; Round 2 - Bitcoin; Round 3 - European Commission speed of regulation; Round 4 - Interchange; and Round 5 - Access to payment systems.

Round 1 - The regulators

For the motion

The regulators in the majority of cases really do not understand how payments work let alone the best way to regulate it. Many of the regulations are drawn up in Europe in a spirit of compromise rather than in the best interests of growing the payments industry and promoting better competition with the incumbents: the large banks. It is not that the regulators have any particular agenda, just that with the limited knowledge of payment systems they have, coupled with a fear of international terrorism and money laundering as well as the protection of the banking infrastructure, they don't always make the best laws and regulations. How many international crime syndicates have been caught as a result of the implementation of anti-money laundering ('AML') laws? Yet fines continue to grow. In a recent article by Kaufman/Rossin (February 2015), Bao Nguyen says:

'Total monetary settlements levied for money laundering, sanctions and tax evasion by the regulators and law enforcement agencies surpassed \$13.4 billion for the year, data shows.

The sum includes fines and settlements imposed by the Office of the Comptroller of the Currency (OCC), FDIC, the Federal Reserve, the Financial Crimes Enforcement Network (FinCEN), the Office of Foreign Assets Control (OFAC), the U.S. Justice Department, and New York state and municipal agencies, minus redundant

penalties that were concurrently imposed. Four international banks paid U.S. authorities more than \$300 million each, with some shelling out significantly more [...]

By contrast, financial regulators in the United Kingdom had a quiet year, with only one AML-related enforcement action: the Financial Conduct Authority's 7-million pound settlement with Standard Bank Plc in January 2014.

But that's not to say that British regulators have gone soft on financial crime. Rather, the FCA is focusing more on the issue in general and increasingly looking at compliance controls intended to stop money laundering, bribery and sanctions violations.'

The key thing to note from a cynical viewpoint is AML enforcement action does not and never has caught the villains; it is very much a tool for the regulators to go in and collect revenue from fines: 'shutting the door after the horse has bolted!' In another cynical view of this we can look at the German regulator's attempt to kill the prepaid industry by imposing greater levels of AML than the rest of Europe in 2012, because they felt that they knew what would work. They reduced the maximum amounts allowed for simplified due diligence well below the rest of Europe and those suggested in the Directive, in the belief that this would reduce money laundering being carried out on prepaid cards. Luckily due to a lot of pressure from the industry and the European Commission they fell short of a complete ban on SDD products but it had a massive impact on the prepaid industry.

Hence the regulators are stifling innovation by raising the bar of compliance too high for many of the new and innovative players to come into the market and making the cost of entry well above

anything all but the big banks can truly afford. And the penalties will equally scare new players from coming through with the fear of fines and imprisonment for failure.

Against the motion

We have all heard the stories of bad regulation and bad regulators many times but that is neither the full nor the balanced picture. There will always be examples given of the bad regulators and regulations whose drafting has been badly effected by compromise leading to unintended consequences - but let's for a moment look at the massive leaps forward the regulators have made in embracing innovation and increasing competition. In the UK the Financial Conduct Authority ('FCA') has launched Project Innovate. In the words of Martin Wheatley, Chief Executive of the FCA, in May 2014:

"Project Innovate - [...] one of the most important pieces of work currently emerging at the FCA: a project to help support industry innovation: from smaller start-ups to mass market with new models.

Three broad questions here that we're bringing together.

First, how do we encourage innovation in the financial service market?

Second, do we do enough to promote competition and create room for new entrants into the market, particularly those with novel business models?

And, third, does FCA regulation more broadly serve the needs of innovative businesses?

In scope here, a number of important areas, including: digitalisation; big data analytics; venture capital; virtual currencies, crowd funding; and peer-to-peer - many of which are (or indeed have already) transformed finance in improbable timescales."

This is a real desire from the FCA

to promote innovation. Indeed this project reflects the FCA's real drive to understand the payments market and, even where there are laws and regulations (which may have unintended consequences) deal with players in the industry as fairly as possible within the constraints of such regulation, and help the industry to drive forwards. Equally the regulators around the world embrace organisations like the Prepaid International Forum ('PIF') and the Network Branded Prepaid Card Association ('NBPCA') and reach out to us for guidance and insight into the industry.

Most recently the UK has brought in Hannah Nixon to be the first Managing Director of the Payment Systems Regulator. She states:

"Our approach will bring change to the payments industry, injecting competition and innovation where it is needed most and putting the interests of the people and businesses that use payment systems front and centre."

She spent the first year pre-launch having stakeholder meetings to find out what the payments industry needed from her and her approach has been unique for a regulator, listening to the industry before doing anything. This is the future of payments regulation and it looks bright.

Round 2 - Bitcoin

For the motion

Bitcoin has been a much needed dose of salts for the payments industry, giving it a real difference never previously experienced. It is a decentralised cryptocurrency. Transactions are verified by network nodes and recorded in a shared public ledger called the blockchain. Because it is a public ledger it has complete transparency. You can move

Bitcoin seamlessly across the globe in real-time using the blockchain ledger system. The blockchains are 'mined' by Bitcoin 'miners' who solve complex algorithms using masses of computing power. They are set such that each block takes approximately 10 minutes to solve and then the miners validate all Bitcoin transfers and store them in that block. Once you are three blocks down the blockchain it is virtually a mathematical impossibility for the blockchain to be broken and the Bitcoin exchanges only validate a transfer once six blocks are created so they are unimpeachable records of the transfer.

The world is split on Bitcoin with some countries outlawing it completely (in Bangladesh, for example, it is a criminal offence with a 15 year prison sentence for anyone caught trading in Bitcoin) to those like the US that appear to be embracing it, with the first BitLicenses now being available in New York. The problem is that the ethos behind the licensing defeats the object of Bitcoin by requiring authentication of buyers and sellers and the imposition of a central register of transfers, which will necessarily take away from the efficiency of the system and make it follow the existing payment systems. It is the internet of payments today but tomorrow it could become just another archaic payment system.

Against the motion

Bitcoin has had so much bad press caused by its many issues that the only way for it to survive and become mainstream is to regulate it. Do you really want paedophiles, slave traders, drug dealers, illegal arms dealers, terrorist groups and international organised crime to have an easy way to move their assets around the globe without anyone seeing them? That is what

they have today with our Bitcoin cryptocurrency. Yes, it may be the internet of everything including payments, but, surely just a minimal amount of good regulation can stop all these issues. We need to know who is moving money and who is receiving it and we need to have an organisation whether it is a government or a globally trusted third party as the repository for the ledger. Without this there could be anarchy in our payment systems. Indeed, it has been seen over the last couple of years that it has no real stability as a currency, with fluctuations ranging from \$40 to over \$1,000. You can't really spend in a currency that is so volatile. There is, however, a good case for using the blockchain as a ledger for all currency transactions whether in cryptocurrencies or fiat currencies as this could be a very transparent way in which to enable verification and its impeachable nature would give confidence to the transactions. However, without a strong and reliable form of regulation to back it, it will always be a challenge for people to use it.

Round 3 - European Commission speed of regulation

For the motion

The speed with which everything on the internet moves today is daunting. Moore's Law, an observation made in 1965 by Gordon Moore, co-founder of Intel, stating that the number of transistors per square inch on integrated circuits will double every year since the integrated circuit was invented has been shown to be true with greater computing capacity on a mobile phone today than on a super computer that took up an entire warehouse in the 1980's! The same is true in the world of payments with so many new initiatives from

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electronic wallets and electronic money to contactless payments and Bitcoin. Payments advances wait for no man and they certainly do not wait for the law to catch up. This is particularly true in Europe where there are three key institutions involved in proposing, debating, amending and finally passing European Union laws. They are:

- a) the European Commission ('EC') - the executive body that prepares the proposals;
- b) the European Parliament - the elected body that debates the proposals, may put forward amendments, and reject or accept the proposals; and
- c) the European Council - made up of member government ministers, they may accept or reject the European Parliament's amendments and may put forward their own. Once the Council approves a proposal it becomes law.

Approval of a proposal by the Council is the last stage in the EU legislative process, and Member States are then obliged to pass their own domestic legislation to enact the European act within the timescale set. This process can take upwards of two years to complete with the directive finally being published in the official journal and then having a two year implementation period. Typically therefore you have around four to six years from a directive being put together and it coming into force. Add to this the fact that generally they wait two years to consult on changing an existing directive and you can see that European Commission laws are at least eight years out of date when a new directive comes into force and a new directive is at least four years out of date from the time it was drafted!

How can this ever be a way to regulate such a fast moving

industry as payments?

Against the motion

Whilst it is true to say that legislation takes a long time to go from debate and discussion to published directive and law that is a good process. The debates held over this period ensure that all affected parties can have their say and ensure that the final laws work for the industry and because they are tested throughout there should be little or no unintended consequences. In countries where laws are brought in more quickly this can lead to parties not properly consulting and hence bad laws.

The question of the laws not keeping up with the industry is also a false one because laws and regulations are based on the core principals of payments and all products, however innovative they are, can be distilled down to their core elements. It is these core elements that will be subject to the law and regulation and in pretty much all cases the laws will work even if they need a little bit of a hand in interpretation.

Round 4 - Interchange

For the motion

The latest regulation passed down from the ivory towers of the European Commission on merchant interchange fees will adversely affect many of the payment businesses in Europe that rely on interchange to fund their issuing businesses. The regulations were brought about by the large supermarkets lobbying in Europe and persuading the authorities to take their viewpoint. It has been seen from places where interchange reductions have been mandated, like Australia, that whilst the merchants say it is so that consumers will be treated properly in fact prices do not get reduced in line with interchange and nor do

services improve. In fact the only true beneficiaries of a reduction in interchange are the merchants. Hence in this case it is clear that this new regulation will hinder innovation because innovation is funded by monies received by issuers out of interchange!

Against the motion

Once again it is regulation not competition that is being stated as a cause of reduction in innovation. It has long been the case that the competition authorities have been looking at the fairness of the interchange system run by the schemes. It appears to have been set up to distribute part of the merchant services fee charged by the merchant acquirers onto the issuers. Traditionally these funds were used by the issuers to fund loyalty schemes and other marketing initiatives to win more customers.

The new European regulations were drafted after much consideration in an attempt to bring fairer competition into the payments sector. It was believed that the interchange fees charged did not fairly reflect the cost of issuing but went far beyond that and that if funds were needed to offer rewards and other benefits these should come from the cardholders not the merchants who received no direct benefit from the higher interchange. Once again the law and regulation in this area is all about promoting a fair and level playing field for all the players.

Round 5 - Access to payment systems

For the motion

This is the last of the issues but one which has caused the biggest issues in the UK let alone the rest of the world. The main financial institutions have, for too long, been relying on AML laws and

regulations to stop players accessing payment systems. Most recently following a number of large fines for breaches of AML by the large financial institutions a push to close accounts of money service businesses ('MSBs') has occurred and now it is very difficult for such businesses to get bank accounts. The regulators have simply turned away protests by the MSBs, stating it is a commercial decision for the banks as to whether such accounts are viable. The banks state that the cost of AML compliance for such businesses by far outweighs any commercial benefits of running them and hence they cannot continue to offer them save for a few larger ones. The Payment Services Directive ('PSD') requires access to payment systems for regulated payment institutions ('PI') and e-money institutions ('EMI') but again the hurdles to entry on commercial terms has meant it is still difficult for many new payment businesses to get in the door. Once again regulation is stifling innovation.

Against the motion

Whilst it is true to state that many MSBs have lost their bank account in recent years it is not fair to place the blame for this at the feet of the regulators and the law. There are very good reasons as previously stated for our AML laws and the fact that it is difficult to monitor many of the smaller MSBs is a true reflection of the kind of business they are in.

On a positive note there are the provisions in the PSD that give rights to PIs and EMIs to have access to payments systems and these are being acknowledged by the payments schemes who are granting direct membership to their organisations now. In addition the new Payment Systems Regulator is keen to promote

access:

"We want those who use payment systems to be able to access them on a fair, open and transparent basis and be able to choose the form of access that best suits them.

Currently payment service providers (PSPs) can access a payment system through either direct access (where they have a direct relationship with the payment system operator) or indirect access (where a direct PSP acts as their sponsor).

PSPs with significant payment volumes usually prefer direct access. Smaller firms and non-banks typically rely on sponsor banks for their indirect access.

We want to see both forms of access improved and explain how we intend to do this in our Policy Statement."

This is all very positive for the industry and shows how much the regulators want innovation and competition in the payments industry.

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