Feature

KEY POINTS

- PSD2 safeguarding rules have room for improvement.
- A comparison of Dutch and Brazilian safeguarding rules enables an in-depth analysis of the level of protection.
- An objective criterion of assessment of safeguarding rules shows that the current safeguarding rules could – and should – be enhanced.

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PSD2 and the safeguarding of clients' funds: a comparative analysis with respect to funds of payment service users in the Netherlands and Brazil

This article concerns the protection of payment service users' funds in case of insolvency of a payment institution, ie a payment services provider that escapes the label of "credit institution", both in the Netherlands (representing the EU/EEA) and in Brazil.

INTRODUCTION

Payment institutions, introduced by Directive 2007/64/EC (PSD1 – later replaced by Directive 2015/2366/EU of the European Parliament and of the Council, or PSD2), operate in one of the most sensitive and important areas of the financial system. A failure in payments can have severe consequences, and thus payment institutions have to comply with rules to protect clients' funds. The protection of such funds is also necessary to enable the provision of payment services by payment institutions, and to ensure that the monies "deposited" in payment accounts are not lost or jeopardized in case of insolvency of payment institutions.

One of these rules is the rule set under Art 10 of PSD2, called "safeguarding requirements". Pursuant to this provision, EU/EEA member states shall require a payment institution to safeguard all funds received from payment service users or through another payment service provider for the execution of payment transactions. The provision allows for this safeguarding to be achieved in two ways. In the first approach, set forth under Art 10 (1) (a) PSD2, the funds shall not be commingled at any time with the funds of the payment institution and, where they are still held by the payment institution by the end of the business day following the day of receipt, they shall be deposited in a separate account in a credit institution or invested in secure, liquid low-risk assets, and they shall be insulated in accordance with national law in the interest of the payment service users against the claims of other creditors of the payment institution, in particular in the event of insolvency. In the second approach, set forth under Art 10 (1) (b) PSD2, the funds shall be covered by an insurance policy or some other comparable guarantee from an insurance company or a credit institution for an amount equivalent to that which would have been segregated in the absence of the insurance policy or other comparable guarantee.

Similar safeguarding requirements apply to electronic money institutions, both where it concerns funds received from payment service users or through other payment service providers and funds received in exchange for electronic money that has been issued. The latter funds shall be safeguarded by no later than five business days after the issuance of the electronic money (Art 7 Directive 2009/110/EC).

For the avoidance of doubt, it should be observed that the safeguarding requirement set forth under Art 10 (1) (a) PSD2 only pertains to the funds and not to the financial instruments in which the funds may be invested. These financial instruments will most likely be held in custody with a credit institution or an investment firm for the payment institution and will have to be safeguarded against such custodian's insolvency in accordance with Art 16 (8) MiFID II, but will not be protected against the payment institution's insolvency.

The movement in Europe towards a safer and more competitive payment system was followed by Brazil, in which jurisdiction Law 12,865/2013 followed the same approach seen in the EU/EEA since 2009. *Banco Central do Brasil* (*BACEN*), the Brazilian Central Bank, constantly issues and updates provisions regarding payment institutions and the protection of the payment system as a whole. In Brazil, the safeguarding requirements apply to *instituições emissoras de moeda eletrônica*. Literally translated, this means electronic money institutions. This could create the impression that the safeguarding requirements only relate to electronic money institutions and not to payment institutions. However, under Brazilian law these *instituições emissoras de moeda eletrônica* correspond to both electronic money institutions and payment institutions.

The problem discussed in this article concerns the protection of payment service users' funds in case of insolvency of a payment institution, ie a payment services provider that escapes the label of "credit institution", both in the Netherlands (representing the EU/EEA) and in Brazil. Our conclusions may be applied analogously to the protection of clients' funds at electronic money institutions.

HOW TO IMPROVE THE CURRENT FRAMEWORK?

Four key indicators could help us to get a better understanding of the current arrangements as well as reveal how the protection of payment service users could be improved:

- Who holds title to the funds?
- Can the funds be subject to security interests or set-off rights relating to obligations of the payment institution?
- How long does it take for funds to be recovered by the payment service users

in case of insolvency of the payment institution?

- What are the operational requirements that back the legal segregation of the funds from the payment institutions' assets?

TITLE TO THE FUNDS

The Netherlands

In the Netherlands, the solution most frequently applied in practice (regarding the method of safeguarding prescribed under Art 10 (1) (a) of PSD2) is the set-up of a separate "retention institution", a bankruptcy remote special purpose vehicle (SPV), mostly in the form of a foundation (*stichting*), to which the funds are entrusted. This SPV is generally referred to as a third-party funds foundation or a *stichting derdengelden*, the sole purpose of which is the receiving, managing and distributing of the funds.

In this set-up, legal title to the funds is with the SPV and the payment service users have a direct right against the SPV. It is the SPV and not the payment institution that holds the account in which the funds are credited at the account servicing credit institution. In this way, the funds do not form part of the assets of the payment institution and will not fall in the payment institution's insolvency estate. The SPV is set up as a bankruptcy remote entity, so the risk of it becoming insolvent is virtually zero.

Article 10 PSD2 is implemented in Dutch law in Art 3:29a of the *Wet op het financieel toezicht* (Financial Supervision Act) in conjunction with Art 40a of the *Besluit prudentiële regels Wft* (Prudential Rules Decree). These provisions merely paraphrase Art 10 PSD2 and do not prescribe the creation of an SPV nor do they provide for any other specific solution. It is up to the payment institution to make adequate arrangements to safeguard the rights of clients. However, from the explanatory memorandum to Art 40a of the *Besluit prudentiële regels Wft* and the explanatory notes to the licence application issued by *De Nederlandsche Bank* (the Dutch Central Bank, *DNB)* it can be deduced that segregation of clients' funds via the creation of an SPV is a valid method of insulating clients' funds against claims of other creditors of the payment institution.

Brazil

In Brazil, we should look at Art 12 of *Circular* 3,681/2013 of *BACEN*. The funds "deposited" in the payment institution by the payment service users are either kept in a special account at the Central Bank or invested in government bonds.

What is seen in practice is that the funds are normally invested in government bonds, such bonds qualifying as secure, liquid low-risk assets. The payment institution is the holder of the bonds' titularity. These bonds, in their turn, are in custody in a Central Securities Depository: *Sistema Especial de Liquidação e Custódia* (*Selic*), the Brazilian Special System for Settlement and Custody. Such custody is achieved through a credit institution (the path starts at the payment service users, which "deposit" funds in a payment institution; this institution then buys bonds and obtains the respective titularity; the payment institution needs a credit institution to hold the bonds ultimately at *Selic*). The clients of the payment institutions are not less protected in Brazil: Art 12 of Law 12,865/2013 affirms that the funds of payment accounts constitute a segregated estate, which shall not be merged with the payment institution's assets (especially in the case of insolvency of the institution).

SECURITY INTEREST

The Netherlands

In the Netherlands, title to the funds is with the foundation (*stichting*) set up for the specific purpose of safeguarding the funds. The foundation may not carry out activities other than the retention of clients' funds.
It may only dispose of any or all of the funds with a view to the execution of a payment transaction and only if the payment service user has given its consent. Therefore, although from a property law point of view the SPV would be entitled to vest a right of pledge on the funds, either in favour of the account servicing credit institution or of a third party, for the purpose of securing obligations of its own or of the payment institution, such pledge would be in contravention of the safeguarding requirements, because it could result in the SPV becoming unable to comply with its obligations towards clients. If the pledge would not be invalid for that reason, it would probably be voidable on the grounds of the SPV having acted *ultra vires* by having vested it.

The pledging of the claims of the SPV vis-à-vis the account servicing credit institution by the SPV should of course be distinguished from the pledging by the clients of their rights vis-à-vis the SPV. It is not uncommon for the clients to pledge these rights to the payment institution for the purpose of securing present or future, actual or contingent or prospective obligations of the client vis-à-vis the payment institution.

Brazil

In Brazil, according to Law 13,105/2015 (Brazilian Civil Procedure Code), monies and rights can be subject to a security interest (as laid down in Arts 831, 834 and 835). Almost all rights and goods can be vested in a security interest, with some exceptions (listed in Art 833). However, none of the exceptions apply to safeguarded funds.

Ergo, the answer to the question whether the funds of payment service users in payment accounts can be subject to a security interest is yes. However, Art 12 of Law 12,865/2013 states that the funds maintained in payment accounts cannot be pledged or encumbered by way of a security interest regarding debts undertaken by the payment institution. The funds and/or the bonds (as it is the common practice in Brazil) can be pledged if the underlying obligation relates to a debt of the payment service users, and not to a debt of the payment institution.

SPEED OF RECOVERY

The Netherlands

In the Netherlands, no rules corresponding to the speed of recovery are found under the *Wet op het financieel toezicht* or the *Besluit prudentiële regels Wft*.

Brazil

In Brazil, there are no provisions in the *Circulares* issued by *BACEN*, neither in Law 12,865/2013 nor in Law 6,024/1974 regarding time limits for the payment service users to see the recovery of their funds.

OPERATIONAL REQUIREMENTS

The Netherlands

In the Netherlands, the explanatory notes to the licence application issued by the DNB

(the central bank) suggest that the creation of a third-party funds foundation is the only way to comply with the safeguarding requirement under Art 10 (1) (a) PSD2 and provide a number of requirements that must be complied with in order to achieve proper insulation.

Amongst the most important rules are:

- the third-party funds foundation may not carry out any activities other than the receiving, managing and distributing of clients' funds;
- the third-party funds foundation may not engage in commercial activities, issue loans or enter into financial obligations;
- staff members of the payment institution involved in activities for the third-party funds foundation may not engage in activities for the business unit responsible for effecting payment transactions; and
- payment institutions must ensure that the liquid assets of the third-party funds foundation are at any time at least equal to the liabilities of the payment institution to payment service users.

With respect to the book-separation or the *stricto sensu* operational segregation, Dutch law does not contain any specific provisions, probably because PSD2 does not provide for such provisions either. There are no specific provisions as regards the identifiability of clients' funds, books and records to be kept and their accuracy, reconciliations between internal accounts and those of third parties by whom the funds are held.

Brazil

In Brazil, the organisational requirements stem from Art 12 of Law 12,865/2013, since this article prescribes the need to separate the payment institution's assets from the payment service users' assets. *BACEN* issued several *Circulares* concerning payment institutions and payment accounts.

Amongst the most important ones are:

- Article 4, *Circular* 3,680/2013: payment institutions must periodically review whether their registers are up to date;
- Article 6-A, *Circular* 3,680/2013: payment institutions have to adopt processes to verify the validity of the information given by the payment service users.
- Article 1, Annex I, *Circular* 3,885/2018 mentions the technical-operational plan, which encompasses all the operational mechanisms relating to the payment institution, the physical and technological infrastructure supporting the operations carried out by the payment institution, internal controls and periodical testing; and
- Article 12, tenth paragraph, *Circular* 3,681/2013: this provides that resources "kept" in payment accounts have to be entered under specific account headings for the purpose of registering the amounts safeguarded in *BACEN* or invested in the Government bonds. These account headings are described in *Carta Circular* (Circular Letter) 3,951/2019 of *BACEN*.

Although Brazil has a rule on operational segregation in place (represented by Art 12, par. 10 of Circular 3, 681/2013 and Circular Letter 3, 951/2019), it lacks the appropriate detail.

ENHANCING PROTECTION: THE BEST WAY FORWARD

Title to the funds

The Netherlands relies on the interposition of an SPV. In this set-up, the requisite insulation against claims of other creditors of the payment institution is achieved by entrusting the funds to a bankruptcy remote entity and giving the payment service user a direct right against this entity. However, this set-up is not carved in stone: the Netherlands is currently contemplating enacting specific legislation pursuant to which clients' funds may continue to be held by the payment institution itself and will constitute a legally segregated estate against which recourse can be taken by payment service users only and not by other creditors of the payment institution. In this scenario, the creation of an SPV will no longer be necessary to meet the insulation requirement.

Brazil lacks the "engineering insulation", relying on the operation of law, and the monies follow a short path from the hands of the payment service users to the payment institution, which (generally) buys Brazilian government bonds and is effectively the owner of these bonds (held ultimately at *Selic* through a credit institution in the name of the payment institution). Brazilian legislation expressly affirms that clients' resources can never be regarded as property of the payment institution (Art 12, items I and III, Law 12,865/2013), which means that they constitute a separate estate.

In our view both systems provide for adequate arrangements to safeguard the rights of clients and we see no reason to favour one approach over the other.

Security interest

In both countries, security interests over clients' funds enabling a third party to dispose of such funds in order to recover debts that do not relate to the client are not permitted. Clients' funds can be subjected to pledges relative to the obligations of the client, but can never be subject to, eg pledges relative to obligations *of the payment institution*.

In our view, it would be advisable for this limitation to be extended to set-off rights and to apply throughout the EU/EEA. To this end we suggest that Art 10 PSD2 be amended to the effect that member states ensure that security interests or rights of set-off over clients' funds enabling a third party to dispose of clients' funds in order to recover debts that do not relate to the client, are not permitted. A similar provision should be included in the Brazilian legal framework.

Speed of recovery

Both countries lack hard provisions of time limits that may be applicable in case of insolvency of the payment institution. This is an important feature that distances itself from the ideal framework. We consider it advisable to include a provision to this effect in Art 10 PSD2 and in Law 12,865/2013.

Operational requirements

Operational requirements are visible in both jurisdictions studied. What both countries lack are more detailed (and perhaps unified) rules at every level of the "chain" on how to book-separate the funds in every option that the payment institution has to safeguard, eliminating any doubts on how to operationally

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segregate the funds while keeping the legal segregation provisions. This would result in an optimised version of *Carta Circular* 3,951/2019 in Brazil (and in related amendments in Law 12,865/2013) and the *Besluit prudentiële regels Wft* in the Netherlands.

In this connection we propose that payment institutions should be obliged to keep records and accounts enabling them at any time and without delay to distinguish funds held for one client from funds held for any other client and from their own funds, that they must maintain their records and accounts in a way that ensures their accuracy and that the separate account held at the account servicing credit institution in which the clients' funds will be booked can easily be distinguished from any accounts used to hold funds belonging to the payment institution.

Time of safeguarding

Article 10 (1) (a) of PSD2 states "funds shall not be commingled *at any time* […]", but also affirms that payment institutions must take action to safeguard the payment service users' funds *only when the funds are held by the payment institution by the end of the business day following the day in which such funds were received*. This seems to open a gap of at least one day where the funds could be commingled.

"Three interpretations:

Article 10 (1) (a) of PSD2 affirms that funds "funds shall not be commingled *at any time* with the funds of any natural or legal person other than payment service users on whose behalf the funds are held *and, where they are still held by the payment institution and not yet delivered to the payee or transferred to another payment service provider by the end of the business day following the day when the funds have been received, they shall be deposited in a separate account in a credit institution or invested in secure, liquid low-risk assets* […]" [italics added].

Another way of looking at this provision is to assume that the non-commingling rule has to be obeyed at all times (time aspect), but at the end of the business day following the day in which the funds were received by the payment institution the funds have to be deposited in a credit institution or invested in secure, liquid low-risk assets (mechanism aspect). Accordingly, in the timeframe between the receiving of the funds and the end of the following business day, the funds may, as long as they are not commingled at any time, be invested in high-risk assets or kept in vaults, for example. The one-day gap could be seen as lacking only a mechanism-rule. The three interpretations regarding the time-mechanism dichotomy are as follows:

1. Deposit in credit institution or investing in secure assets and non-commingling must be complied with only by the end of the business day following the day in which the funds were received.
2. Deposit in credit institution or investing in secure assets and non-commingling must be complied with from the moment the funds are received by the payment institution.
3. Non-commingling must be complied with from the moment the funds are received by the payment institution, but the mechanism shall be at the discretion of the payment institution, and by the end of the business day following the day which the funds were received, then the payment institution must either deposit the funds in a credit institution or invest in secure assets."

The mere existence of three possible interpretations as to the time when the obligation starts is a source of legal uncertainty. In such a pivotal feature of the safeguarding rule, this uncertainty should not exist. Consequently, the Directive should be amended to clearly state when the safeguarding obligations begin.

CONCLUSION

To enhance the protection of the payment service users' funds, some minor – but important – adjustments are necessary.

In the optimal, ideal framework:

- a provision should be included to the effect that security interests or set-off rights over clients' funds enabling a third party to dispose of clients' funds in order to recover debts that do not relate to the client, are not permitted;
- a provision stating a time limit for the payment service users to recover the funds in case of insolvency of the payment institution should be inserted, as it would strengthen trust in such institutions;
- lawmakers and/or regulators should clearly define operational segregation rules and legal segregation rules, explaining how operational segregation must be handled to support legal segregation; and
- Article 10 (1) (a) PSD2 should be amended so as to make clear as to when the safeguarding obligation begins.

It would also be beneficial for payment service users if frameworks all over the world resemble each other since globalisation makes it easier for legal and natural persons to have business – and payment accounts – in several countries. This is perhaps a romantic goal, but a combined effort between countries to make rules closer and clearer could result in improved legal certainty and more movement of money amongst residents and companies of different countries.

The objective, after all, is not to determine a winner, but to enhance the protection of the funds of payment service users. ■

1 This article is based on the Advanced LLM thesis of the second author submitted in fulfilment of the requirements of the Master of Laws Advanced Studies Programme in Law and Finance, Leiden Law School (Leiden University).

Further Reading:

- Opening Pandora's Box?: PSD2, consumer control and combatting fraud (2020) 1 JIBFL 48.
- The Payment Services Directive: new payments legislation in the single market (2008) 2 JIBFL 78.
- LexisPSL: Practice note: The regulation of payment services providers – essentials.