Welcome to the May 2018 edition of Knowledge Transfer, our regular advisory update for the Payments sector. Payments firms face a host of opportunities and challenges and this newsletter will keep you up to date with matters you will need to consider to help you run your business successfully.

PSD 2 – a gamechanger for the sector

Whilst authorised firms grappled with registering for the new Payments Services Directive (PSD2), perhaps the most significant change brought about by the Directive was over-looked by many: payment institutions and electronic money institutions (so-called 'non-bank PSPs') can now directly access payment systems.

Following the introduction of PSD2, non-bank PSPs are able to open settlement accounts at the Bank of England, subject to appropriate safeguards. Having a settlement account with the Bank of England is one of the key criteria to become a participant in a payment scheme.

Having a settlement account allows a non-bank PSP to become a direct settling participant in payment schemes that settle at the Bank. Getting direct access to a payments scheme means that non-bank PSPs do not have to rely on a third party to either submit payments or settle on their behalf. The payment schemes that non-bank PSPs may want to use include Faster Payments Scheme (FPS), BACS, CHAPS, Cheque & Credit and LINK.

Before these changes, non-bank PSPs have only been able to participate in these schemes as a direct non-settling participant or as an indirect participant.

The UK is a world leader in payments innovation, which is reflected in the large number of UK-authorised non-bank PSPs. These institutions are competing with banks to provide payment services. However, until now they have only been able to access the UK payments schemes indirectly, through the very banks that they are competing with.

Opening up access to the UK's payments systems will allow the non-bank PSPs to compete on a more level playing field. They will be less dependent on competitors and will be able to offer a wider range of payment services.

On 13 April 2018 the first non-bank PSP, TransferWise, was admitted to the Faster Payments Scheme and at the same time opened a Real-Time Gross Settlement account with the Bank of England.

It won't be the last to do so.

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What is the purpose of the initial and on-going capital requirements?

Ensuring that a firm complies with its capital requirements is essential for compliance with the new Payments Services Directive (PSD2).

Other things being equal, the greater the amount of capital that a firm has, the greater the protection that is provided to its customers. This is because certain elements of capital can only be repaid to the shareholders on liquidation of the firm meaning that it is always there acting as a buffer, providing protection.

Why do the initial capital requirements vary between types of firm?

The table below shows that the initial capital requirement varies depending on the type of payment service being offered. The greater the capital requirement, the greater the perceived risk attached to customer funds. So, with money remittance firms, the initial capital requirement is a modest €20,000. This reflects that customer funds are generally held for very short periods of time by these firms. The initial capital requirement for e money institutions, however, is significantly greater at €350,000, recognising that customer funds will be held longer in electronic wallets and prepaid cards.

Type of payment service	Minimum capital
Account information services	Nil
Money remittance (authorised firms)	€20,000
Payment initiation services	€50,000
Issuing payment instruments	€125,000

Electronic money institutions (authorised firms)	€350,000

In addition to the initial capital requirement outlined above, there are on-going capital requirements. There are different methods of calculating the on-going capital requirement. Depending on the type of payment service that you offer, you may have a choice of method that you use. The on-going capital requirement held must not fall below the level of initial capital. The on-going capital requirements generally require more capital to be held the greater the volume of business that is handled. Again, this reflects risk. The greater the amount of customer funds that a firm handles, the greater the customer risk and the greater the capital requirement.

There are different classifications of capital. The main classification is called Tier 1. This includes capital instruments (e.g. ordinary shares), share premium accounts, retained earnings, accumulated other comprehensive income and other reserves.

It is somewhat surprising (and generous) to see that retained earnings and other reserves are included in the definition of Tier 1 capital as they can be potentially withdrawn from the company by means of dividends and so are not necessarily fixed or permanent.

How should firms monitor compliance with the capital requirements?

As part of a firm's monthly reporting, the accounting team should provide information to management relating to the capital that a firm has, compared to the amount that it is required to hold.

However, information regarding historic compliance is of limited value. If you have a deficit, it's too late. There has already been a fundamental breach of PSD2.

Capital requirement reporting should also be performed on a prospective basis. That is, you should look at forecast results and calculate the capital requirement based on them. This will enable you to identify any points in time when the firm may be in breach of the capital requirements – giving you an opportunity to deal with issues in relation to capital before they occur. Your forecast results should be amended for material events, so that it remains relevant and the predicted capital requirement amounts are reliable.

The satisfaction of the capital requirements at all times is a condition of your authorisation. If you breach the requirements you need to do two things immediately; rectify the deficit and inform the FCA.

How can you deal with a forecast shortfall of capital?

The simplest solution is to issue more shares to the existing shareholders to cover the existing deficit and any forecast deficit. However, this may not always be possible.

If a company is in deficit because of losses incurred and is part of a group and a company in that group is financing the losses by means of loans, there are two possible alternative options:

- To convert the inter-company debt into equity
- To write-off the inter-company debt with the agreement of the financing group company

Before considering whether either of the above two options is suitable, a firm should take into account the possible tax consequences. These will vary from case to case and, in terms of the loan write-off, the consequences need to be considered from both the perspective of the borrower and the lender. There may also be legal consequences of a write-off if the lender itself is insolvent. In that the write-off may be considered to be an unlawful return of capital by the lender.

Where shares are issued to either existing shareholders or new shareholders and this causes the shareholders to cross control thresholds of 10%, 20%. 30% or 50%, prior clearance is required from the FCA before the additional investments can proceed. The FCA states that it will take up to 60 working days to consider a change in control application.

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PKF Escalate – introducing a new approach to tackling commercial disputes

Pursuing a commercial dispute tends to be a costly, lengthy and risky undertaking, which is why many businesses decide against pursuing a claim and reluctantly write-off what they are owed.

Our Escalate dispute resolution service takes a completely fresh approach. It prioritises your cash flow by focussing on a quick settlement and removing upfront costs. Escalate offers:

- No financial risk – you don't pay out unless we reach a successful settlement
- No initial outlay - we pay for all of the up-front costs
- Rapid results – we aim to get your money back in just three months; if we can't settle quickly, we can support you all the way to a High Court resolution
- A fixed fee – complete transparency from the start

There are no restrictions on the size or complexity of the cases we can deal with, and we can look at cases going back three years.

For more information, please contact Azhar Rana on **arana@pkf-littlejohn.com** or + 44 (0)80 7516 2232.

We hope you've found this issue useful. If anyone within your business would like to receive future issues, please send their details to Julia Krol (jkrol@pkf-littlejohn.com).

Our specialist team is here to help. If you would like advice on any of the issues discussed in this newsletter, please contact us.

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