

## **MODULR reply to the European Commission Targeted Consultation on the review of the Directive on settlement finality in payment and securities settlement systems**

The following are the preliminary comments of Modulr FS Europe Limited (MODULR)<sup>1</sup> with regard to the European Commission's targeted consultation on the review of the Directive on settlement finality in payment and securities settlement systems (SFD), which was published on 12 February 2021.

MODULR is the payments and banking-as-a-service Application Programming Interface (API) platform for digital businesses. While MODULR is not a bank, it provides payments and accounts infrastructure as an alternative to traditional banking infrastructure. MODULR allows businesses to automate payment flows, embed payments into their platforms and build entirely new payment products and services themselves, all managed in real-time, 24/7 from one API.

In 2016, Modulr FS Limited (FRN 900573) was authorised as an Authorised Electronic Money Institution, regulated by the Financial Conduct Authority, UK.

In 2019, Modulr FS Limited became one of a few non-bank Financial Institutions to be a directly connected participant of Faster Payments (instant payment system) and BACS (batch payment system) schemes and is able to hold and settle funds at the Bank of England.

In 2020, Modulr FS Europe Limited (638002) was authorised by the Central Bank of Ireland as an Electronic Money Institution for access to the EEA market.

In 2021, to further its European expansion strategy, Modulr established a new entity, Modulr Finance BV, in the Netherlands from which it will also serve European Economic Area (EEA) customers. To further these objectives, Modulr Finance BV has submitted an EMI application to De Nederlandsche Bank.

MODULR supports the European Commission's objective, as set out in its Retail Payment Strategy<sup>2</sup>, to extend, in its review, the scope of the SFD to include e-money and payment institutions, subject to appropriate supervision and risk mitigation, in order to ensure a level playing field and provide legal certainty in a cross-border context. We would like to note that in the public consultation on the EU's retail payments strategy, nearly 43% of respondents thought that direct participation in SFD qualifying systems should be allowed for such entities and at MODULR we believe such direct participation will increase competition and open access to payment systems across Europe. Furthermore, adding e-money and payment institutions to the list of (direct) SFD participants would open up the possibility to allow their participation in TARGET2. In our view, this could reduce credit and liquidity risk arising from settlement in commercial bank money.

We anticipate that this should allow companies such as MODULR to grow faster and offer innovative solutions. We would also hope that this will drive greater competition and customer choice and ultimately better customer outcomes.

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<sup>1</sup> Modulr FS Europe Limited (a company incorporated in the Republic of Ireland under Company Number 638002) is authorized as an EMI by the Central Bank of Ireland (CBI) in the Republic of Ireland (**Modulr EU**).

<sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0592>

We would like to respond to some of the specific questions addressed in the Consultation Document, with the aim of outlining policy actions which we believe are needed in the context of the SFD review to achieve a well-functioning and competitive European market for payments.

## **Issues for discussion under the Consultation Document object of this consultation**

**Question 2.1 Should the list of currently eligible SFD participants be either limited or extended or otherwise modified? Please explain your reasons for each type of participant where relevant.**

No need for modifications

Should be extended

Should be limited. Some participants should no longer be eligible

Should be otherwise modified

Don't know / no opinion / not relevant

### **Question 2.1.1 Please specify how it should be extended:**

We are aware of the clear intention of the European Commission to increase competition in the Financial Services market in Europe and in particular to support the development of non-bank institutions such as e-money institutions. PSD2 advanced this agenda. However, given the scale and influence of the banking industry we believe it will not be a level playing field until non-bank institutions such as e-Money and payment institutions are eligible SFD participants.

We believe that direct participation for e-money and payment institutions should be allowed, as dependency on banks, which in some circumstances are competitors, does not aid competition in the market and can impact on the competitiveness of e-money and payment institutions. More precisely, we believe that direct access to TARGET2 for non-banks is very important to the success of e-money and payment institutions, as indirect participation implies competition issues, while direct access permits the full embedding of non-banks in payment schemes.

Moreover, access via banks brings complexities and would have non-banks bound to that institution – including in cases where issues arise relating to public relations, insolvency, regulatory censure and challenges around aligned risk appetite.

In general e-money and payment institutions access to payment systems are at the control of larger organisations who hold considerable power in the relationship. This has impact on pricing which ultimately increases the cost to the customer when including the banks margin. It creates an uncertainty for the e-money and payment institutions where for instances there are examples of larger banks changing their strategy and exiting the service leaving e-money and payment institutions with disruption. Having this mutual dependency also creates a higher risk of IT failure for customers where, for example, the e-money and payment institutions are dependent on the IT resilience of their banking partners and technical issues arising or outages create a chain reaction.

We would like to note also that Modulr FS Limited (a company registered in England & Wales under Company Number 09897919), which is an electronic money institution (EMI) authorized by the Financial Conduct Authority (FCA) in the UK, has direct access to the Bank of England and has dealt with the associated administrative obligations. Such a direct participation entails that Modulr FS Limited is technically connected into the Faster Payments Service (FPS) and holds an account in the Bank of England's Real-Time Gross Settlement (RTGS) system so it can settle directly with other participants. Direct access avoids phenomena such as de-banking taking place.

**Question 2.3.1 What is your opinion about *payment institutions* being (potential) participants?**

Should not be direct participants

Should be direct participants (only)

Should only be indirect participants who may be considered direct participants, if that is justified on the grounds of systemic risk

Should be direct participants and indirect participants who may be considered direct participants, if that is justified on the grounds of systemic risk

Other

Don't know / no opinion / not relevant

**Question 2.3.2 What is your opinion about *e-money institutions* being (potential) participants?**

Should not be direct participants

Should be direct participants (only)

Should only be indirect participants who may be considered direct participants, if that is justified on the grounds of systemic risk

Should be direct participants and indirect participants who may be considered direct participants, if that is justified on the grounds of systemic risk

Other

Don't know / no opinion / not relevant

**Question 2.4 Please state your opinion on the following:**

**a) If payment institutions and e-money institutions are added to the list of participants, they should be subject to a specific risk assessment.**

1 - Disagree

2 - Rather not agree

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.4 a)**

MODULR would like to share with the European Commission its experience of direct participation in payment systems as an e-money institution (EMI).

Through our UK entity we have experienced the range of payment scheme participation, starting with indirect access, and moving in 2019 to direct participation in the main UK payment schemes and, alongside this, direct settlement at the Bank of England. We believe our experience and learning are valuable to share with the Commission, as we would like to replicate the success of this with our EU entities.

We experienced that the criteria for direct access to the UK payment schemes and holding a settlement account at the central bank (BOE) was well balanced to open up access and competition, whilst still ensuring adequate safeguards for security and integrity of the system.

Amongst the criteria for direct access is a requirement for completion of an initial enhanced supervisory assessment by the FCA (NCA). There is also a requirement for non-bank PSPs holding a settlement account at the Bank to be subject to ongoing, strengthened supervisory oversight to assess their continuing compliance with the regulatory requirements. We believe this provided the correct balance between opening up access and lowering risk/ensuring system integrity.

Whilst we support a risk assessment process and can see its role, it is important that any risk assessment be based only on the adherence to existing regulatory or operational requirements, and not adding new requirements or requirements solely for EMI's / PI's. Any risk assessment should also be relevant and proportional to the functions and role of the EMI /PI.

We believe that in the UK in the range of 5 - 10 of the larger EMIs, including MODULR, have obtained settlement accounts at the central bank and joined schemes directly in the last 3-4 years.

As far as we are aware, no adverse settlement issues have occurred due to EMI participation during this time. We believe this is due to:

- a) The general requirement for EMIs to hold 100% of client funds safeguarded;
- b) The requirement for enhanced supervision of client funds security and processes by NCA;
- c) the requirement to hold funds available for settlement at the central bank equivalent to the maximum exposure in any net settlement cycle (this is applicable for all scheme participants).

In our experience, it is critical for the success of EMIs' direct access to have a method of securing funds that is 100% sufficient for any scheme settlement exposure, but not in excess of this. This is due to the fact that EMIs are generally covering the settlement exposure at the central bank with safeguarded client funds, and typically have high inflows/outflows vs held balances. We would welcome further direct discussions to share our experience of how this was initially set up in the UK and how it is envisaged to introduce change to remove a disadvantage for EMIs.

We currently believe that Modulr is the largest direct settling non-bank PSP in the UK Faster Payments scheme, processing over 1% of all scheme transaction volume. Volumes of payments processed are approx. 4.8 million transactions and represent a value of 2.5 Bn GBP (2.85 Bn Eur) per month.

Modulr FS Limited has also joined the BACS scheme as a direct member in 2020 to offer further payment types to its clients.<sup>3</sup>

We believe that the situation in the UK supported by the Bank of England creates an important precedence in supporting competition in the Payments market and this model should be adapted with all of the appropriate controls outlined above in the Eurosystem.

**b) Payment institutions and e-money institutions should only be made eligible SFD participants if 'warranted on grounds of systemic risk'.**

- 1 - Disagree
- 2 - Rather not agree

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<sup>3</sup> <https://www.modulrfinance.com/blog/what-direct-access-to-the-bank-of-england-means-and-why-you-should-care>  
<https://www.modulrfinance.com/blog/modulr-joins-faster-payments-and-becomes-one-of-a-small-number-of-non-banks-to-hold-a-settlement-account-at-the-bank-of-england>  
<https://www.modulrfinance.com/blog/modulr-unlocks-an-easier-simpler-and-reliable-service-for-its-customers-with-direct-participation-to-bacs-1>  
<https://www.bankofengland.co.uk/-/media/boe/files/markets/other-market-operations/accessforonbankpaymentserviceproviders>

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.4 b)**

The stability of the payment systems in Europe is of primary importance from an economic and political point of view. It is natural that changes to the Settlement Finality Directive to broaden participation beyond existing European banks will create an appropriate level of concern given the importance of these systems. We fully support that access should be warranted on grounds of systemic risk and our experience of the oversight by the Bank of England as outlined in our response to question 2.4 was appropriate in providing a risk-based assurance for this significant and important change. Any risk assessment should however be proportional, based on existing regulatory and operational requirements, and not used as a means to exclude compliant and well managed EMI's and PI's from participation.

**c) If payment institutions and e-money institutions are added to the list of participants, no particular risk assessment is needed.**

1 - Disagree

2 - Rather not agree

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.4 c)**

Please see comments above in item b.

**Question 2.5 Which risks should be considered in a specific risk assessment (mentioned in question 2.5.) for payment and e-money institutions?**

**How could such risk assessment look like?**

**Please state your opinion on the following:**

**a) IT risks should be considered.**

1 - Disagree

2 - Rather not agree

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.5 a):**

The ability of the institution to operate IT systems and manage IT risk is important in ensuring confidence. However, this is perhaps best achieved through existing EMI/PI regulations and standards, and in payment system joining requirements rather than specifically the criteria for participation in SFD.

**b) Operational risks (other than IT risks) should be considered.**

1 - Disagree

2 - Rather not agree

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.5 b):**

The ability of the institution to manage operational risks is important in ensuring confidence. However, this should be restricted in this instance to specific operational requirements of managing a central bank settlement account. Other operational risks are already evaluated by the NCA.

**c) Credit risk should be considered.**

1 - Disagree

2 - Rather not agree

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.5c):**

EMI's and PI's are not subject to the same credit risks that credit institutions are as they do not take market risks with client funds. Provided that the appropriate safeguarding processes are in place and well managed, the issue of credit risk should not affect the settlement ability of EMI's and PI's.

**d) Liquidity risk should be considered.**

1 - Disagree

2 - Rather not agree

3 - Neutral

4 - Rather agree

5 - Fully agree

Don't know / no opinion / not relevant

**Please provide some comments/explanations on your opinion to proposal 2.5 d):**

MODULR is keen to ensure that in any future review of the revision of the prudential regime for electronic money institutions no measures which would have an adverse effect on customer protection should be taken and would not like to see, for example, safeguarding requirements reduced. Any payment scheme specific settlement/liquidity risk should be managed by the payment scheme rules and operation, which should prevent the ability of a participant to create an exposure greater than the available funds in the settlement account. At the same time due to the nature of operation of EMI/PI accounts it is important not to require EMI's and PI's to hold extra funds in reserve or collateral accounts over and above the funds available for the current settlement exposure.

**e) Other, please specify:**

**Question 2.6 In case a risk assessment is deemed useful: How often should risks be assessed?**

Annually (and ad hoc when necessary)

Every two years (and ad hoc when necessary)

As defined by a competent authority

Don't know / no opinion / not relevant

**Question 2.6.1 Please elaborate on your answer to question 2.6:**

In conclusion, MODULR believes that our approach to bringing payments innovation to businesses is applicable in all the markets we operate in. We would be fully supportive of measures by the European Commission to open up direct access to payment schemes in the EEA.

We believe direct access in the UK created a level playing field for all responsible regulated entities and has allowed us to innovate around instant payments, bring new products to the corporate market and challenge existing players and incumbent banks. Our success in growing the volume of transactions processed by us is due to being able to compete effectively with incumbent bank Financial Institutions.

The key benefits we have found for our customers and ourselves in having direct access are:

- Security of access. Accessing through another financial institution is anti-competitive and allows a competitor to be in control of a key element in an indirect participants product access/supply chain. There have been instances in the industry and in our own experience where access has been withdrawn at short notice due to a change in policy or business strategy by the institution providing access – this possibility creates uncertainty and when realised can be detrimental for indirect participants’ business models and also have material consequences for end customers.
- Price competition. Access through other financial institutions and their internal costs and mark-ups being added to direct scheme costs disadvantage non-bank Financial Institutions in terms of being able to compete in a cost- effective manner. This can result in end-users paying more if they want to use a different and more efficient provider for their payments.
- Product innovation. Direct access allows product innovation that is not subject to oversight of a competitor that may scrutinise and limit business models and products before allowing a non-bank Financial Institution to access through its direct connection.
- The creation of more diverse payment arrangements with fewer single points of failure.

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MODULR would be happy to discuss these issues and their implications further in the near future, as required. If you need more information on any of the points raised above, please contact Richard Buckley at MODULR or Monica Monaco [monacom@trusteuaffairs.com](mailto:monacom@trusteuaffairs.com).