**Deputy Governor**

Jerusalem

May 7, 2023

Attn: MK Ohad Tal

 Public Projects Committee Chairperson

**“Regulation of Payment Services Occupation Bill, 5782-2022”**

**Stance regarding the proposal to enable payment service providers to pay interest on deposits**

Dear Sirs:

The “Regulation of the Payment Services Occupation Bill, 5782-2022” is one of the products of the Joint Committee that was appointed in June 2015. The Committee’s goal was to examine ways to enhance the competition in common banking and financial services. Due to this Committee, a subcommittee was established in March 2016, the goal of which was to promote the regulation of the activity of nonbank entities that engage in providing payment services, based on international regulation in accordance with the directives set in Europe regarding payment services[[1]](#footnote-2) (the directive known as PSD2) and regarding entities engaging in e-money[[2]](#footnote-3) (the directive known as EMD).

The Bank of Israel, which was a member of the Committee mentioned above, sees great importance in promoting competition in the financial system overall, and in the payment services areas in particular. Within this framework, the Bank has advanced very important and significant reforms in recent years.[[3]](#footnote-4)

Alongside promoting competition in the financial system, there is the utmost importance in protecting the public and ensuring that “shadow banking” doesn’t develop in Israel. This is liable to develop when financial entities are permitted to provide banking services, with all the systemic risks deriving from that, but are not subject to the same strict regulation imposed on banks, which is intended to minimize the probability that these risks will materialize, as well as the systemic adverse impact derived from them if they do materialize. The existence of shadow banking creates a broad range of risks, from consumer-related risks for the depositing public to the systemic risks in view of the loss of the public’s trust in the financial system.

In fact, regulation worldwide works to minimize the probability of the development of shadow banking and establishes appropriate directives related to the activity of payment service providers. Thus, for example, the European directive establishes rules related to the manner of protecting the money customers deposit with those payment service providers; it imposes a prohibition on using those funds in order to extend credit; and it determines limitations related to the type of credit that those entities will be able to provide from other sources.

The bill being discussed was promoted in recent years along these lines, and was constructed by “brakes and balances”—the payment service provider occupation is regulated, but at the same time, directives are established that are intended to minimize the systemic risks that are liable to derive from their activities. The original version that was sent to the Knesset reflects a reasonable balance between the interest of advancing competition and the interest of protecting the public and preventing systemic risks.

However, within the framework of the discussion of the bill in the
“Public Projects Committee” that you head, on Thursday May 4, a significant amendment was made, and the section prohibiting payment service providers from paying interest on the deposits they receive from their customers was removed from the draft.

**The noted amendment is in opposition to the accepted international standard on the issue; it incorporates risks that are liable to become material, and was made without investing the professional work required in outlining the risks deriving from it and in examining if and how they can be minimized.**

First, the European Directive dealing with electronic money issuers that are payment service providers (the EMD) unequivocally prohibits them from paying interest to customers who deposit money with them.[[4]](#footnote-5)

Thus, Article 12 of the EMD determines that:

*"Member state shall prohibit the granting of interest or any other benefit related to the length of time during which an electronic money holder holds the electronic money".*

The directive does allow granting benefits that are not dependent on the length of time that funds are deposited with the payment service providers in order to reduce tariffs and fees. The logic underlying the prohibition derives from the approach that paying interest on deposits is an activity reserved for entities holding a banking license, that are subject to strict regulation, among other things, from the perspective of managing market risks. As will be detailed below, deviating from this principle is liable to create various types of risk—consumer and systemic, and therefore the Bank of Israel’s stance is that we should not make a decision setting a global precedent nor deviate from the international standard on the issue, particularly when it is clear and unequivocal.

In addition, a proposed deviation from the international standard cannot be reached in a rushed manner, and without being supported by comprehensive professional work outlining the risks inherent in it and in examining if and how to avoid them.

In actuality, there is a broad range of issues and risks that should be extensively studied before reaching a decision on the matter. Below, we will note some of them.

First, paying interest on deposits is an additional commitment for the payment service provider and it is liable to increase the probability that it will encounter difficulties. A payment service provider entering into difficulty—particularly if it is viewed as a bank and/or if it has a significant volume of activity, is liable to impact broadly on the overall financial system (the materialization of what the literature terms “contagion risk”). A notable example in this regard is the collapse of SVB in the US, against the background of the regulation imposed on it being lenient relative to the banking one[[5]](#footnote-6), and the Federal Reserve had to intervene rapidly in order to prevent the realization of systemic risk.

The proposal is even liable to impact on the general equilibrium in the credit market. Paying interest on deposits could provide the public with an incentive to deposit funds at payment service providers. However, in contrast to banks, payment service providers will not be able to leverage the deposits they receive in order to extend credit. Thus, the proposal actually is liable to lead to a contraction in the supply of credit in the economy. This issue also requires careful consideration and professional analysis before reaching a decision.

The proposal is also liable to increase the probability of the materialization of the consumer related risks for the depositing public, who from their perspective may mistakenly think that the entity paying them interest on their deposits is a bank, which is under stricter regulation than that imposed in actuality on the payment services provider. In addition, the amendment is also liable to impact on the manner in which the payment services provider manages its market risks.

There are in fact aspects in the issue being discussed in which it is easy to reach a decision at first glance as well. Thus, it is clear that in order to protect the customers’ funds deposited with the payments company and on which interest is paid, they have to be separated from the business activity of the payment services provider, to be held in a designated trustee account, and to be invested only in very liquid assets with low levels of risk. In addition, it is clear that the possibility of holding customers’ funds (to take deposits) derives mainly from the need to allow rapid and smooth operation of payment services. The proposal is liable to lead to a situation in which payment service providers are established, for which their main business model is paying interest on deposits. In this regard, we note that within the framework of the discussion in the Knesset, various proposals were raised regarding the highest level of a deposit for which payment service providers will be able to pay interest. However, not one of them was based on any data. Clearly an informed decision on said interest rate cannot be based on “feelings” or “intuition”, and it requires comprehensive and professional analytical work. In conclusion, it is clear that in order to protect the depositor public, under no circumstances should a *guaranteed yield* to depositors be allowed, but rather, at most, *participation in the return* that the payment service provider accumulated within the framework of the deposits’ investment.

In conclusion, **the Bank of Israel’s stance is not to deviate from the international standard that clearly determines not to allow payment service providers to pay interest on deposits.** This is particularly when the deviation from the international standard in this case is liable to create a broad range of risks in the financial system, including consumer and systemic risks. A proposal to deviate from the international standard in this regard should have been accompanied by comprehensive professional analysis with an outline of the ramifications and risks deriving from it and a formulation of a proper response to each one of them. The current time frame in which the legislation is being advanced does not allow carrying out the required analysis work. Given that despite the claims brought in this paper, the decision reached in the Public Projects Committee was to deviate from the international standard on the issue and against the background of the marked risks involved in this decision and the absence of professional analysis work that would have been appropriate in reaching this type of decision, we saw it as necessary to bring to your attention the current document and to detail the risks incorporated in the step.

Sincerely,

Andrew Abir

Deputy Governor of the Bank of Israel

CC: Governor of the Bank of Israel, Prof. Amir Yaron

 Director General of the Prime Minister's Office, Mr. Yossi Shelley

 Director General of the Ministry of Finance, Mr. Shlomi Heizler

 Chair of the National Economic Council, Prof. Avi Simhon

 Supervisor of Banks Mr. Yair Avidan

 Bank of Israel Legal Counsel, Adv. Tida Shamir

1. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32015L2366&qid=1683466763424> [↑](#footnote-ref-2)
2. <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32009L0110> [↑](#footnote-ref-3)
3. The Bank of Israel just recently reached agreements with the Capital Market, Insurance, and Savings Authority, according to which entities that receive a license form the Capital Market Authority and that comply with additional requirements relevant to their payment service activity and that were established by the Capital Market Authority, will be able to connect to the controlled payment systems in all types of participation, including direct participation, without depending on banks as intermediaries. [↑](#footnote-ref-4)
4. Based on the European directive, electronic money issuers in their activity as payment service provides, may provide benefits, the size of which does not depend on the amount of time the customer’s funds are held with them. [↑](#footnote-ref-5)
5. Until 2015, SVB was subject to tight regulatory supervision, designated for banks with assets exceeding $50 billion. In 2015, after pressure was placed on US regulators, the supervisory authorities decided to increase the threshold for supervision over medium sized banks to $250 billion. Thus, SVB received lenient regulation, which exempted it from carrying out strict stress test, a notable easing with regard to capital and liquidity requirements from the bank, and reduced the scope of supervision over it. It is reasonable to assume that keeping the strict supervision in place would have prevented its failure. [↑](#footnote-ref-6)