Title: The Regulation of Payments Networks **IA No:** N/A **Lead department or agency:** HM Treasury **Other departments or agencies:** N/A	**Impact Assessment (IA)** **Date:** 20/03/2013 **Stage:** Development/Options **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** Dan Turnbull, HM Treasury 020 7270 4819

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
-£25.47m	-£25.47m	£2.56	Yes	IN

What is the problem under consideration? Why is government intervention necessary?

The regulation and governance of payment networks does not enable them to respond to current and future challenges in the most effective way. Given the fundamental importance of the money transmission system to the economy, any inefficiency has a significant impact on economic welfare. The Government has accepted the recommendations of the Treasury Select Committee to extend regulation in this area, so that decisions that affect everyday users of payment services, for example, on access terms, the development of new services or the withdrawal of existing services, fully takes their views into account.

What are the policy objectives and the intended effects?

The main policy objective is to ensure that the operation of the payment systems is not a barrier to competition in the provision of payment services, and in the wider UK financial services market. It will also ensure that decisions about the operation and development of UK payment systems are made with the views of all stakeholders, including end-users, being properly taken into account, and that adequate investment is made to act on the results of these decisions. The intended effect is that the UK has reliable, efficient and innovative payments networks, that support competition in UK financial services.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

In July 2012, the Government issued a consultation, 'Setting the strategy for UK payments', which presented two main options: 1)To build on the present approach to UK payments strategy by making a series of changes to the operations of the Payments Council. 2) To introduce a new public body, the Payments Strategy Board, to set strategy across the UK payments industry. The costs and benefits of these options were considered in the accompanying impact assessment.
Since the July 2012 consultation the Government has decided that full utility-style regulation of the payments industry is necessary to deliver the Government's objectives. Therefore the Government has decided to give the responsibilty for utility-style regulation of UK payment systems and services to an existing regulator - either the FCA or one of the economic regulators. This impact assessment explores the costs and benefits of this option only.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 07/2013

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: ______________ Date: 25/03/2013

Summary: Analysis & Evidence — Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2014	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** 25.47

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional	1	Optional	**Optional**
Best Estimate	3.46		3	**25.47**

Description and scale of key monetised costs by 'main affected groups'

The key costs will be for the existing regulator given the responsibility for regulating the operation of UK payments systems. The main expected elements are initial set-up costs, staff and recruitment costs, additional office costs (rental and services) and IT costs. The regulator's costs will be funded by an annual levy on the regulated population - payment systems operators and direct members/participants. These bodies will also face regulatory compliance costs.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised benefits by 'main affected groups'

There are substantial benefits that cannot accurately be quantified. The figures included in the benefits section of this IA are therefore for illustrative rather than definitive purposes. In view of the large volume and value of payments handled by payment networks, which is measured in trillions of pounds (table 1.1 in the evidence base) the smallest marginal improvement in efficiency or effectiveness will have significant economic welfare benefits.

Other key non-monetised benefits by 'main affected groups'

An independent regulator will facilitate greater competition, both in the payments industry and in the wider retail banking market, which will have dynamic benefits for the industry and for UK financial services.

Greater competition will also encourage innovation in payment systems, which will provide benefits both in terms of reducing cost and of enabling new services for consumers.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 2.56	**Benefits:** n/a	**Net:** -2.56	Yes	IN

Evidence Base (for summary sheets)

Evidence base

“Competition in retail banking: A report to the Chancellor of the Exchequer”. Don Cruickshank. March 2000.
“Final report of the Payment Systems Task Force”. OFT. February 2007.

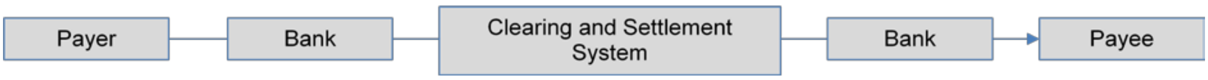
“Review of the operations of the Payments Council: A follow-up to the work of the Payment Systems Task Force”. OFT. March 2009.

“The future of cheques: Eighteenth Report of Session 2010–12 Volume I: Report, together with formal minutes, oral and written evidence”. Treasury Select Committee. HC 1147 24 August 2011.

“The future of cheques: Government and Payments Council Responses to the Eighteenth Report from the Committee Twenty–third Report of Session 2010–12”. Treasury Select Committee. HC 1645. 16 November 2011.

Background: Payment networks

The money transmission system can be considered in the same way as any public infrastructure like water, gas and electricity distribution. The mechanisms by which money is transmitted between payers and payees are known as payment systems and the whole end-to-end process constitutes the payments network.



The Government aims to enhance the ability of the payments industry to deliver the type of payments networks that the Government would like to see in the UK. This impact assessment is concerned with payment networks in the UK, and how they respond to the changing needs of the UK economy. The principal networks depend on rules and clearing and settlement systems run by:

- The LINK interchange network for ATM transactions;
- Plastic card schemes for debit, credit, prepaid and charge cards;
- BACS, for bulk transfers like direct debits and standing orders;
- CHAPS for large value payments;
- Faster payments – for automated real time electronic payments;
- The Cheque and Credit Clearing Company – for cheques and paper credits.
- The principal UK card networks: American Express, Diners Club, JCB International, Maestro, MasterCard and Visa

The scope of the proposals does not therefore extend to commercial trading platforms, like CREST, or to messaging platforms like SWIFT. There are other niche players providing retail money transmission services to UK customers. They include, for example, money remitters and bill payment service providers. As these operators account for a very small proportion of money transmission in the UK (under 0.5%), and are unaffected by the proposal, they are not considered further in this impact assessment.

In 2010, the principal payment networks handled the following volume and value of payment transactions (table 1.1):

Table 1.1

Volume and Value of payment transactions in 2010		
	Volume Bn. transactions	Value £ billion
Interbank clearing (BACs, CHAPs, Faster Payments and cheques)	6.97	66,609.4
Plastic cards	11.6	651.0
ATM withdrawals	2.8	185.8
Source: UK Payment Statistics. Payments Council. 2011. Tables 1.1; 6.2; 6.3 and 22.1		

What is the problem under consideration?

There has been a long-standing view among stakeholders in the payments industry that the Payments Council, the strategy setting body for the payments industry, is not working optimally. These concerns were brought into the spotlight when the Payments Council took the decision to abolish cheques. Considerable concerns were raised that this would have a disproportionate impact on older people and small businesses, including charities, which continued to use cheques.

In its report on the future of cheques[1], the Treasury Select Committee said "The Payments Council is an industry-dominated body with no effective public accountability. It should not have unfettered power to take decisions on matters, such as the future of cheques that are of vital personal importance to millions of people. The Treasury should make provision in the forthcoming Financial Services Bill to bring the Council formally within the system of financial regulation."

The Payments Council is currently the body that sets the strategy for UK payments. The Payments Council is a voluntary membership body, with payment service providers reaching threshold volumes of payments eligible for full membership. The Payments Council also offers associate membership (at lower cost, but with correspondingly fewer rights) to organisations with an interest in the payments industry.

In its response to the Treasury Select Committee's report on the future of cheques[2], the Government broadly accepted the Treasury Select Committee's recommendation. Setting the strategy for the future path of payments networks is assuming increasing importance because the payments landscape is changing more quickly than at any time in the past. Payment networks must anticipate and respond to the growing demands of the economy, particularly for new digital services, and to new competitors that are throwing up new challenges to incumbents. The needs of the end-users of payment services (the public, private and third sectors and individuals) continue to expand and evolve. Strategy setting and the future development of payments networks (where collaboration between the participants is essential) must be put in a condition to satisfy these diverse needs and wants; and they must take into account the interests of all constituencies when taking strategic, wide reaching and long term decisions.

The Government therefore wants to place the regulation and governance of payment networks on a footing that will enable payment networks to respond to current and future challenges in a more effective way for the benefit of individuals, businesses and the economy as a whole.

The previous consultation '*Setting the Strategy for UK Payments',* published in July 2012, considered alternative options for improving regulation of the payments industry. This allowed the Government to take consideration of the public's views on the best way to regulate the payments industry.

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1 "The future of cheques: Eighteenth Report of Session 2010–12 HC 1147 24 August 2011

2 The future of cheques: Government and Payments Council Responses. Twenty–third Report of Session 2010–12. HC 1645

The first of these options was to work with the current self-regulatory strategy setting structure of the Payments Council, to negotiate voluntary changes to the governance and operation. This option was discounted because the Government, and the majority of consultation respondents, felt that it did not go far enough.

The second, and preferred, option considered in the July 2012 consultation, was to introduce a new public body, the Payments Strategy Board (PSB) to set strategy across the UK payments industry. The consultation document therefore focussed on this option in the main, setting out in detail how the Government intended a PSB to work. The majority of the responses to the consultation supported this option.

In the July consultation, however, the Government did not fully explore the alternative approach of creating a new regulator to oversee payments systems. At the time of publication, the Government considered that a Payments Strategy Board might well go far enough in addressing the problems identified with the governance of the payments industry without needing to impose the extra costs and regulatory burden that would be imposed by a full utility-style regulator.

In the period between the consultation on '*Setting the Strategy in UK Payments'* closing and today however, there have been a number of developments which have led the Government to decide that full utility-style regulation of the payments industry has become a necessity. Therefore, having made this decision, the Government has two remaining options. The first of these would be to create an entirely new stand-alone payments regulator. The option of creating an entirely new, stand-alone regulator would face significant difficulties. In particular, this option would leave the new regulator unable to take advantage of synergies with its existing functions and expertise; as a result, this would be a more expensive way of proceeding. This option would also be more difficult and take longer to set up.

The other remaining option is to give regulatory powers to an existing regulator. The Government now prefers this approach, and will give either the FCA or one of the existing economic regulators these regulatory powers. This Impact Assessment therefore explores this option only.

The Case for Change

The Government considers that there are weaknesses in the current governance and decision-making process of UK payment networks, and that these weaknesses present obstacles to the realisation of the Government's vision for the future of the payments industry.

The Government wants the UK to have world-class payments networks that are stable, reliable and continuously improving, that meet the needs of payment service providers, business-users and consumers, and benefit the wider economy. The Government wants to;

- respond to the governance and decision-taking problems identified by the Treasury Select Committee;
- help meet the growing demands of payments end-users; and
- ensure that the operation of the payment systems is not a barrier to competition in the provision of payment services; and
- encourage innovation and competition in the payments industry; and
- support the UK's competitive advantage in the internet economy, which is expected to grow at an annual rate of 11 per cent, compared with a projected 5.4 per cent in the US, 4 per cent in Germany and 3.4 per cent in France[3].

There are three key areas of concern that need to be addressed by the new regulator:

[3] Boston Consulting Group

(i) Competition

Payment systems exhibit strong network effects, meaning that they tend towards natural-monopoly or oligopoly market structures. These effects are compounded by the fact that several of the payment systems are owned by overlapping groups of the big incumbent banks, who are also their largest users. This market structure creates the potential for the incumbents to take actions that inhibit competition in a number of ways, for instance by:

- acting to prevent competition between payment systems where this might otherwise be feasible, and blocking innovation and development;
- erecting unnecessary barriers to direct membership of the payment systems; and
- failing to offer indirect access to the payment systems on fair and transparent terms.

(ii) The independence of the Payments Council and the responsiveness of payment networks to the needs of their users.

The Treasury Select Committee has said that: "The Payments Council is dominated by the banks and other payment industry members . . . Consumers are entitled to be suspicious of the motives of a body with such a composition proposing measures that are in the financial interests of its members." The Government agrees with the TSC's findings that the voice of payment service users, including consumers, should be given greater weight in setting the strategic direction of payment networks. They have a major stake in strategic decisions about the future development of the payments industry. The Government would also like to see a greater range of players, including challenger banks, smaller institutions and innovative, non-bank players helping to shape future strategy to a greater extent than they currently do;

(iii) Decision-making and collaboration

The Government is concerned that the governance of payments networks has not been as effective as it could have been in driving forward or promoting innovation, when institutions have to collaborate in the development of payment systems and services. There are a number of reasons for this. The Payments Council currently works by consensus which slows development, and has no effective enforcement mechanisms once decisions have been taken. In practice this means that one or two institutions that oppose or are slow in complying with a decision can hold up progress for the rest of the industry. Slow progress can be a significant cause of detriment for end-users and the economy as a whole. Funding for specific development projects can also pose difficulties. For example, much Payments Council funding is on a short term footing which may make long term project planning more difficult.

The Government believes that, together, these areas of concern require the creation of a system of utility-style regulation for the operation of payment systems. The Government's previous proposal to establish a Payments Strategy Board would be insufficient to tackle these problems, particularly around competition, due to its lack of enforcement powers and its likely susceptibility to industry influence.

Policy options

Baseline – do nothing scenario

In the baseline scenario the government would take no action. This baseline used to measure the costs and benefits of taking the action described in the Government's preferred option (option 1). The costs and benefits of the option to take no action are zero as nothing will change.

Option 1:

Either the FCA or one of the economic regulators will be given the role of independent regulator for the UK payments industry. They will be a competition focussed, utility-style regulator, with the remit to hold accountable the operators and direct members/participants of payment systems and services in the UK.

The regulator will operate according to an established model for economic regulation, and will have a duty to ensure payment systems operate in the interests of present and future consumers, where appropriate through supporting competition and innovation. In particular, it will seek to ensure that the operation of the payment systems is not a barrier to competition in the provision of payment services, and in the wider UK financial services market. It will also ensure that decisions about the operation and development of UK payment systems are made with the views of all stakeholders, including end-users, being properly taken into account, and that adequate investment is made to act on the results of these decisions.

It is important to emphasise that all the costs in this section are estimates. At consultation stage, it is difficult to quantify definitive costs. However, the upcoming consultation process will allow the Government to gain a better and more detailed understanding of the costs that the regulator will face.

Table 1.2

Summary of option 1 nominal costs £000		
	Transitional	Ongoing annual
Regulator admin costs		
Staffing and operations	2,500	2,260
Accommodation	630	630
IT	30	10
Firms costs		
License application	300	50
Reporting and compliance	0	50
Total	**3,460**	**3,000**
Total Regulator Admin Costs	3,160	2,900
Total Firms Costs	300	100
The present value of these costs discounted over 10 years at 3.5% is shown on the summary page for option 1		

Background

This option would make either the FCA or one of the economic regulators the independent regulator for the UK payments industry. The Government believes that there are good arguments in favour of each of these options.

Regulatory Model

The proposed model for the new regulatory system is based on the prevailing model of utility regulation, as displayed in the cases of Ofcom, Ofgem, Ofwat and other sectoral economic regulators.

The Government intends that the regulator will licence both payment system operators and their direct members/participants, and enforce compliance with their licence conditions. The Government envisages that, in the first instance, the regulated systems will be the cheque clearing systems; automated payments systems (Chaps, Bacs, Faster Payments); the LINK ATM network; and three and four-party card schemes.

The regulator will have a primary duty to promote the interests of present and future users of payment systems, where appropriate through promoting competition and innovation. This will be subject to a requirement not to act in a way that would materially damage financial stability. The regulator will also be subject to a number of secondary duties, in line with BIS's principles of better regulation.

The regulator will have concurrent competition powers over the payment services market, to enforce the prohibitions against anti-competitive agreements and abuse of a dominant position, and to make market investigation references to the Competition Commission (or its successor body, the Competition and Markets Authority, once it has been established in April 2014).

The regulator will also have a number of regulatory enforcement powers, including:

- to gather information;
- to remedy a breach of licence conditions;
- to impose financial penalties for breach;
- to share information;
- to create advisory bodies;
- to levy the regulated population to fund its own activities; and,
- to amend the licence conditions

COSTS

The costings in this Impact Assessment provide indicative additional costs to the existing regulator given powers to regulate the payments industry, regardless of whether this is decided to be the FCA or one of the economic regulators.

Again, it is important to emphasise that all costings are estimates. The upcoming consultation period will help the Government to gain a more detailed understanding of costs, and will therefore allow costings to be more accurately updated.

The main additional costs are estimated to be:

(i) transitional administrative set-up costs for the regulator;

(ii) ongoing administrative costs for the regulator;

(iii) initial licensing costs for payment systems and credit institutions;

(iv) ongoing license renewal and compliance costs for regulated firms.

(i) Transitional set-up costs for the regulator

The costs incurred by the regulator would be recovered an annual levy paid by regulated persons. The regulated persons would be the owners and operators of payment systems; and direct and indirect participants in the operation of payment systems who are mostly banks and building societies.

The main transitional costs to the regulator are estimated to be: staff and recruitment costs, office costs (rental and services) and IT costs. The main year 1 cost elements (based on estimates of the regulators role and responsibilities, and the structure of other existing regulators) are estimated to be:

Staffing

Table 1.3

Staffing - Roles		Pay Band
Director	1	A
Secretariat	2	C
Strategic developments (policy)	2	B
Research and analysis	4	D
EU and global	2	B
Standards and regulatory developments	4	C
Monitoring and enforcement	6	C
Information management	1	E
Communication, publications	2	D
Legal	2	C
Accountancy, audit	2	D
Support	2	F
Total	30	

This estimate is based on assessment of the number of staff required to sufficiently fulfil the aims and responsibilities of the regulator. It is also guided by examination of other regulators, for example:

- The Civil Aviation Authority (CAA), employ around 15 staff for their regulatory functions. We anticipate that a regulator for the payments industry may require a staff of around twice this size, given the number of entities in the regulated population.

- Phone Pay Plus, an agency of Ofcom, who regulate premium rate mobile phone services, had an annual staff cost in 2011/12 of £2.38m. We anticipate that payments industry regulation may require a similar staffing profile, given the number and nature of entities in the regulated population.

<u>Year 1 recruitment and staffing cost</u>
(FTE all in cost including NICs, pensions, bonus etc) by notional salary bands:

Table 1.4

Recruitment and staffing cost by notional salary bands			
Band	Salary	Implied cost	Number of Staff
Band A	£175,000	£175,000	1
Band B	£100,000	£400,000	4
Band C	£80,000	£1,120,000	14
Band D	£50,000	£400,000	8
Band E	£30,000	£30,000	1
Band F	£20,000	£40,000	2
Total salary		£2,165,000	
Add recruitment costs (15%)		£324,750	
Add training costs (£1,000 pp)		£30,000	
Total		£2,519,750	30
The total is rounded to £2.5 million in the summary cost table 1.2			

Accommodation

This section works on the assumption that the estimated 30 additional staff would not be able to be absorbed into the existing accommodation of either the FCA or one of the economic regulators, instead assuming that the staff for the new regulatory function would need additional accommodation, and would be physically located close to the other regulators and payment systems companies in the City.

It has been assumed that 200 square feet per person will be required. The regulator may expect to pay in the region of £45 per square foot for accommodation in the City or Docklands.

The estimated year 1 and on-going accommodation cost is therefore estimated to be:

<u>200 square feet x 30 persons x £45 = £270,000 pa</u>

<u>Services such as business rates, gas, electricity, telephone, and other infrastructure may add a further £12,000 per employee pa.</u>

<u>30 employees x £12,000 = £360,000</u>

The total annual accommodation costs are therefore estimated to be:

Table 1.5

Annual Accommodation Costs	
	Cost
Office rental Office services	£270,000 £360,000
Total	£630,000

IT costs

It is not envisaged that the regulator will need to develop bespoke software systems, at least not initially. This will be an economic regulator, so it will need to collect detailed, commercially sensitive information. In year one, however, It will need a full suite of office, database and publishing applications.

It is estimated that IT hardware and software can be provided at a set-up cost of around £1,000 per employee on a purchase and installation basis. The Impact Assessment published with the June 2012 consultation, assumed IT costs of around £2,000 per person for a new, independent regulator. This Impact Assessment assumes this to be reduced by half based on synergy savings from giving payment regulatory powers to an existing regulator.

<u>IT costs are therefore estimated to be:</u>

<u>30 employees x £1,000 = £30,000</u>

(ii) <u>Ongoing administrative costs for the regulator</u>

The ongoing administrative costs are assessed on the same basis as the year 1 costs, less any one-off costs. This means that costs for staff and accommodation are the same, minus initial recruitment costs for 30 staff and initial IT costs. The following reduced IT and recruitment cost estimates have instead been added:

- <u>IT Costs: IT depreciation and maintenance costs of £500 pa per person = £15,000 (rounded to £10,000 in summary table 1.2)</u>

- Recruitment Costs: A turnover recruitment figure, which assumes a 16% annual turnover, based on turnover data from the *Phone Pay Plus Annual Report 2011/2*. These costs are estimated in the calculation below:

Ongoing Recruitment Cost Calculation:

(30 staff *0.16 staff turnover) = 4.8, equalling to an average annual staff turnover of 5 when rounded

(Yearly staff cost £2,165,000/5 staff recruited)*0.15 recruitment cost = £64,950 ongoing turnover recruitment cost. (Rounded to £65,000)

The total ongoing administrative costs are estimated to be:

Table 1.6

Ongoing administrative costs	
	Cost
Staffing (30 FTEs + turnover recruitment + training Accommodation and services IT (depreciation and maintenance 30 x £500)	£2,260,000 £630,000 £15,000
Total	£2,905,000
The total is rounded to £2.9 million in the summary cost table 1.2	

(iii) Transitional costs to the owners and managers of payment systems, and participants in payment systems.

The population of potentially affected firms is as follows:

Table 1.7

Transitional costs to the owners and managers of payment systems	
Firm type	Number
Payment systems (e.g. CHAPs, BACs, CCL, FPS, Link, Visa, MasterCard) Credit institutions	9 200
Total	209

Authorised payment institutions, authorised electronic money institutions, small electronic money institutions and small payments institutions will not be affected. They are therefore not included in table 1.7 above.

(a) Payment systems: The main transitional costs to payment systems are likely to be the cost of preparing and submitting license applications. The principal elements would be submitting documentation about the ownership and management, including systems and controls, and vetting of the owners and managers of payment systems by the regulator.

Based on feedback from consultants on the costs of submission of an application by a payments institution to be authorised by the FSA (the nearest cost equivalent in the absence of any information about the new regulator's procedures and requirements), it is estimated that the costs of submitting a licence application would average 60 hours of senior management time and 120 hours of mid-level management time.

Using information from the "Real Assurance Risk Management report on the Estimation of FSA administration burden", June 2006 – the hourly rate is c. £140 for a senior manager and £75 for a mid level manager, after adjustment for inflation and overhead costs.

(b) Credit Institutions: It is anticipated that the costs to credit institutions of preparing and license applications would be significantly smaller than for payments systems, due to assumptions that the requirements for licensing credit institutions would be less detailed.

It is therefore estimated that the costs of submitting a licence application would be an average of 10 hours of mid-level management time, and not require any senior-level management time.

The total cost of applying for licenses for payments systems and for credit institutions is therefore likely to be:

Table 1.8:

Cost of applying for licenses	
9 payment systems x £140 per hour x 60 hours 9 payment systems x £75 per hour x 120 hours 200 credit institutions x £75 per hour x 10 hours	£75,600 £81,000 £150,000
Total	£306,600
The total is rounded to £300,000 in the summary table 1.2.	

(iv) Ongoing compliance costs for regulated firms.

There are likely to be three main types of ongoing costs:

(i) Keeping license information up to date;

(ii) Meeting regular and ad hoc information reporting requirements;

(iii) Implementing decisions made by the regulator relating to the development of payment systems (for example, adhering to certain standards or guidelines, or engaging in required investment activity).

Keeping license conditions up to date for example entails notifying changes to board membership or systems and controls. Based on the methodology in table 3.7 this is estimated to take 24 hours of mid-management time per year for payments systems and 2 hours of mid-management time per year for credit institutions:

9 payment systems x £75 per hour x 24 hours = £16,200
200 credit institutions x £75 per hour x 2 hours = £30,000

Total = £46,200

(Rounded to £50,000 in summary table 1.2)

Meeting regular and ad hoc information reporting requirements

Firms might need to make some fairly minor admin changes to staffing, processes and systems in order to meet precise, identifiable regulatory requirements such as information returns. It is intended to minimise these impacts by requiring the regulator to coordinate and share information with other financial services regulators. The additional information that the regulator might require is not thought to exceed the information that firms already provide to the Payments Council and to existing regulators. In the absence of any new regulatory processes having been developed, this impact assessment assumes that firms would not be asked to provide any information that they currently provide to other recipients. Nonetheless there might be some duplication of reporting or some additional costs in meeting the regulator or reformatting existing information.

This is hard to estimate in the absence of new regulatory reporting requirements. This impact assessment therefore sets aside a provisional sum per firm. Based on the methodology for keeping license conditions up to date (above), this may take in the region of 24 hours of mid-management time per payments system per year, and 2 hours of mid-management time per credit institution per year.

<u>9 firms x £75 per hour x 24 hours = £16,200</u>
<u>200 firms x £75 per hour x 2 hours = £30,000</u>

<u>Total = £46,200</u>

(Rounded to £50,000 in summary table 1.2)

Implementing decisions made by the regulator relating to the development of payment systems (for example, adhering to certain standards or guidelines or engaging in required investment activity).

This is hard to assess without a sense of what the regulator may require. The regulator will be required to consider the overall social costs and benefits of changes it requires to be made, and to proceed only if they are positive. Therefore, this impact assessment does not seek to quantify the costs/benefits of these decisions. However, it is anticipated that the responses to the consultation will help the Government to gain a better grasp of these costs and benefits.

<u>BENEFITS</u>

This approach will fill in a gap in the current regulatory framework. It will promote competition both in payments and in retail banking more widely, address weaknesses in the current governance of UK payment networks and remove obstacles to effective collaboration on the future development of payment networks.

<u>Key Benefits</u>

Effective regulation in the payments industry will:

(i) **Encourage competition in the banking sector**, through constraining the ability of the biggest banks to use payment systems as barriers to entry to downstream activities. This will help challenger banks to compete in the banking sector.

(ii) **Encourage innovation in payments systems**, which will have benefits for industry and for consumers in terms of cost and service.

(iii) **Lead to greater efficiency in payments systems**, through more timely and more effective decision-making, and better prioritisation of development projects. The weaknesses in current Payments Council regulation would be removed, enhancing the responsiveness of payments networks to the needs of their users.

Substantial benefits to the payments industry and to end users will be generated. It is extremely difficult to accurately quantify what these benefits may be in monetary terms. Thus, all figures below are for illustrative rather than definitive purposes.

(i) <u>Encourage Competition in the banking sector</u>

As stated in the Independent Commission in Banking White Paper, the Government is committed to fostering a strong, diverse and competitive banking sector to ensure that the UK economy can benefit from banking products and services at efficient prices.

The Impact Assessment for the consultation, *A Competition Regime for Growth: A Consultation on Option* for Reform, published by the Department for Business Innovation & Skills in March 2012, provided a short literature summary of the benefits that improved competition can bring to an economy. Financial services accounted for 9.6% of GDP in 2011, so improvements to competition in this market will have a significant effect on the performance of the UK economy as a whole.

The evidence below serves to highlight the benefits to the UK economy that can be brought about by improved competition. Effective regulation of the payments industry can help to bring about these dynamic benefits of competition to the UK banking sector. For example, if the regulator can constrain the ability if the biggest banks to control downstream activities (for example in the development of ATM services), this will reduce the potential for the erection and maintenance of barriers to entry and expansion for smaller and challenger banks.

'A Competition Regime for Growth: A Consultation on Option for Reform' Impact Assessment, competition literature:

(1) Competition is a key driver of productivity growth both within and across firms. Competition forces firms to improve management techniques and innovate, and it also encourages improvements in the resource allocation between firms. It ultimately benefits consumers through greater choice, better quality and lower prices. This is particularly important in the context of the current economic climate and the Governments' aim to stimulate growth.

(2) In the short term competition generates efficiency gains within firms by forcing firms to allocate resources more efficiently and putting downward pressure on costs. In the long term, competition generates dynamic benefits as the best performing firms expand, the worst performers exit and new firms enter the market, leading to increased aggregate productivity. The static benefits from increased allocative efficiency have been shown empirically to be substantial, but it is widely believed that the dynamic benefits exceed the static benefits. Harris and Li (2007) used data from 1996 to 2004 to examine the factors affecting productivity growth. They found that 42% of UK total factor productivity growth comes from reallocation between firms, 37% from exit and entry of firms and 22% from intra-firm productivity growth.

(3) Competition also encourages innovation of new products and production processes and R&D investment as firms need to remain competitive in order to retain customers and survive. Griffiths et al. (2006) analysed the impact of the EU single market programme. They found that competition increased innovation by incumbents, but if anything decreased the incentive for new firms to innovate.

(4) Market forces can sometimes fail to deliver effective competition, if for example, mergers lead to a high degree of concentration or if high barriers to entry prevent new and innovative companies from accessing markets. By setting the market frameworks, Government can therefore help to ensure markets are conducive to productivity growth.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31414/12-644-competition-regime-for-growth-final-impact-assessment.pdf

(ii) <u>Encourage innovation in payments systems</u>

It is difficult to accurately quantify the benefits in innovation that would be brought about by effective regulation in the payments industry. For illustrative purposes, we can consider the vast potential savings brought about by the Faster Payments System. The Faster Payments System is a UK banking initiative, which reduces payment times between different banks customer accounts, and has been fully operational since 2009.

In the final report of the Office of Fair Trading's (OFT's) *Payments Systems Taskforce* (February 2007), it was stated under the assumptions made in the made in the 'ELLE' model, in the *BACS Innovation Working Group Report*, the value to the United Kingdom economy (when expressed as the value that it is worth to consumers and businesses) could be in the range of £498 to £1,108 million over ten years.

There has been no monetary calculation of the benefits of Faster Payments since its implementation. However, the predicted saving of £498-£1,108m through the Faster Payments System highlights that innovation can create large monetary savings in the UK payments industry. Effective regulation should encourage greater innovation, and as such, further monetary savings are likely to be more frequent.

(iii) Greater Efficiency in Payments Systems

Given the very large volume and value of payment flows, even a small improvement in efficiency would have a significant impact. These effects cannot be measured in advance. However, for illustrative purposes, an improvement of 0.001p in the efficiency or price of an automated payment transaction is likely to generate aggregate savings of £7 million pa.

Effective regulation should help create an environment where efficiency savings are more likely to be achieved. One area in which efficiency savings may be found is Multilateral Interchange Fees (MIFs). MIFs are a fee paid between banks for the acceptance of card based transactions. The European Commission (EC) found that MIFs restrict competition and that there is no indication that consumers receive an appropriate share of any efficiency gains.

The total value of interchange fees in the UK is estimated to be around £1.7bn. Therefore, for example, a 0.1 per cent gain in efficiency could generate savings of £17m pa. Effective regulation could help to ensure that any such efficiency gain is passed on to the end-users of payments systems.

One-in-Two-Out Regulatory costs

This option falls within the scope of the One-In--Two-Out calculation of new regulatory burdens. The option creates new domestic regulation which will have a cost on business. The option will also impose a new fee on regulated firms to cover the cost of the new regulation.

Equalities Impact

This option will ensure that the regulator is responsible for enforcing equalities law as the law applies to regulated firms.

There are known issues affecting the use of specific payment methods by those who suffer from social or physical barriers, such as the elderly, those reliant on carers, on carers themselves, and those who are physically impaired (cf The Way we Pay by Age Concern 23 June 2011). For example, some people cannot use ATMs, or payment cards that require a PIN number to be entered. Others may depend on carers to withdraw money or make payments. Migrants, travellers or those with no fixed address, or who live chaotic lives, may also experience difficulties and may be financially excluded altogether.

Religion, gender, pregnancy and maternity, race and sexual orientation are not thought to generate significant payments issues.

The Government expects this option to ensure that equalities law is policed effectively, and that all views are systematically taken into account. The equalities impact is therefore positive.

Small firms

Small firms are not expected to be directly affected because they do have direct access to payment systems, other than as end users.

Competition

This proposal is based around improving competition in the market, or taking action to improve consumer outcomes where the market structure prevents competition from functioning effectively. The regulator would assume concurrent competition powers in the market. The transfer of responsibility from the OFT to the new regulator is not expected to have any quantifiable cost impacts, but an effective regulator can be expected to take a more systematic approach to supervising the industry than the OFT, for example through more regular market studies and reports.