SUBMISSION TO COMPETITION AND MARKETS AUTHORITY

On the provisional decision to make a Market Investigation Reference for personal current accounts and banking services to SMEs

From Ben Dyson and Graham Hodgson, Positive Money, 13th August 2014

OVERVIEW

About Us

Positive Money is a research and campaign organisation focussed on banking reform.

Support for Market Investigation Reference

We agree with the CMA's analysis of the features of concern for personal current account (PCA) and business current account (BCA) or SME banking services. **We strongly support the CMA's recommendation** that an MIR is held in respect of personal current accounts and banking services to SMEs.

Opposition to UILs

We do not believe the UILs offered by the largest UK retail banks will be sufficient to address the barriers to entry. Acceptance of UILs will simply create the illusion of competition between the 4-5 largest incumbent banks, whilst retaining the barriers to entry that face new entrants and potential competitors. Deeper structural reform is needed to remove these barriers to entry, requiring changes by the Bank of England. We have explained these necessary changes in this submission.

Opening the payments industry to competition

Payments and current accounts are ultimately a matter of information technology: they consist of databases (accounts) and networks that allow information about payments to be transferred and validated.

The industry should therefore be wide open for new entrants and competition from experienced technology firms, including developers of mobile phone apps.

Barriers to entry

However, there are huge and unnecessary barriers to entry to this market, which means that the incumbent banks are protected from innovative competitors.

From our research, we believe that **responsibility and blame for these barriers to entry lie ultimately with the Bank of England.** The Bank of England refuses to provide accounts ('settlement accounts') to entities that are not regulated as banks ('authorised credit institutions'). They therefore deny new entrants direct access to the Bank of England services, in a way that benefits the incumbent banks (as explained in more detail in this submission).

It would be possible to open the payments industry to competition from technology firms with no risk to financial stability, if the recommendations in this submission were followed. However, this would require buy-in from the Bank of England.

The MIR should further investigate these barriers to entry and recommend their removal.

Structure of the submission

We start by explaining how the best chance of improving competition in the PCA/BCA space is to open the industry up to competition from firms that *only* provide payments services (payments-only providers). These firms are most likely to come from the tech industry, rather than from other financial services firms.

We explain how payments-only providers are currently required to fit into the regulation for "electronic money issuers" (EMIs) although this regulation preserves some significant barriers to entry that make it impossible for such firms to have a credible chance of competing with the incumbent banks. We list six specific barriers to entry that result from the legislation, stemming from the actions of the Bank of England, and from the rules set by the various payment schemes.

We then make 4 recommendations that could eliminate these barriers to entry.

Finally, in the Appendices we address **a)** the process by which the incumbent banks operate and create money, and **b)** possible objections to these recommendations.

Further detail & contact

We have provided further detail below, and would be happy to discuss these issues with the CMA in person or by phone.

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IN DETAIL

1. Competition can be increased by enabling the entry of firms that *only* provide payment services

The CMA should investigate the potential of increasing competition by encouraging the rise of firms that *only* provide payments services through the provision for PCAs and BCAs. There is more opportunity to increase competition in this way than by trying to increase competition between the incumbent banks.

In an ideal world and in the absence of barriers to entry, a payments-only provider would:

a) **Provide payment services**
- Provide personal or business current accounts to customers
- Allow customers to make payments via:
    - BACS and Faster Payments
    - Debit card
- Allow customers to make cash withdrawals via Link ATMs
- Potentially also provide a range of mobile payment services, in which there is huge potential for innovation.

b) **Take no risk with customers' funds**

- A payments only provider would not make any loans, and therefore would not take any risk that could threaten the solvency of the provider. This means there is no risk to customers' funds.
- To safeguard customers' funds, they should be stored risk-free at the Bank of England. (In practice, this means there would be £1 in the provider's Bank of England settlement account for every £1 of customer funds held by the provider).
- In consequence, funds stored at a payments-only provider would be as safe as if they were stored directly at the Bank of England

c) **Face much simpler regulation**

- Because a payments-only provider would not take risks with customers' funds, the regulatory regime they face should be an order of magnitude simpler than those facing the large incumbent banks.

2. The greatest potential for competition around PCAs and BCAs comes from the tech industry

Payment services are ultimately just a technology service. They require a database that stores the balance of customer accounts, a protocol for allowing payments to be validated, and a network that allows different payment systems, payment terminals and banks to communicate with each other.

Consequently, it seems obvious that tech firms – whether 'Shoreditch startups' or firms like Google or Apple – would want to enter this space and launch innovative payment services that could compete with the incumbent banks.

However, this doesn't happen, due to design features of the UK payments system, which act as a huge barrier to entry and which protect the incumbent banks from innovative competitors. We'll analyse those barriers to entry shortly.

3. A payments-only provider would currently need to register as an "Electronic Money Issuer"

Currently the most appropriate structure for a payments-only provider is as an "Electronic Money Issuer" (EMI) under the Electronic Money Regulations (2011). However, the EMI structure maintains significant barriers to entry (discussed later).

Electronic money issuers can:

- Accept funds from other bank accounts on behalf of customers
- Provide the customer with an electronic balance
- Allow the customer to make payments to third parties

An EMI **must**:

- Repay the customer balance 'at par' (i.e. £1 for every £1 deposited, like a current account)
- 'Safeguard' customer funds, by either:
  - Storing them at a bank (an "authorised credit institution"), or
  - Investing them in very high quality 'safe' assets i.e. government bonds.

4. The Electronic Money Regulations preserve significant barriers to entry

The Electronic Money Regulations preserve six significant barriers to entry that make it difficult or impossible for new entrants (such as tech firms) to compete with the incumbent banks on a level playing field.

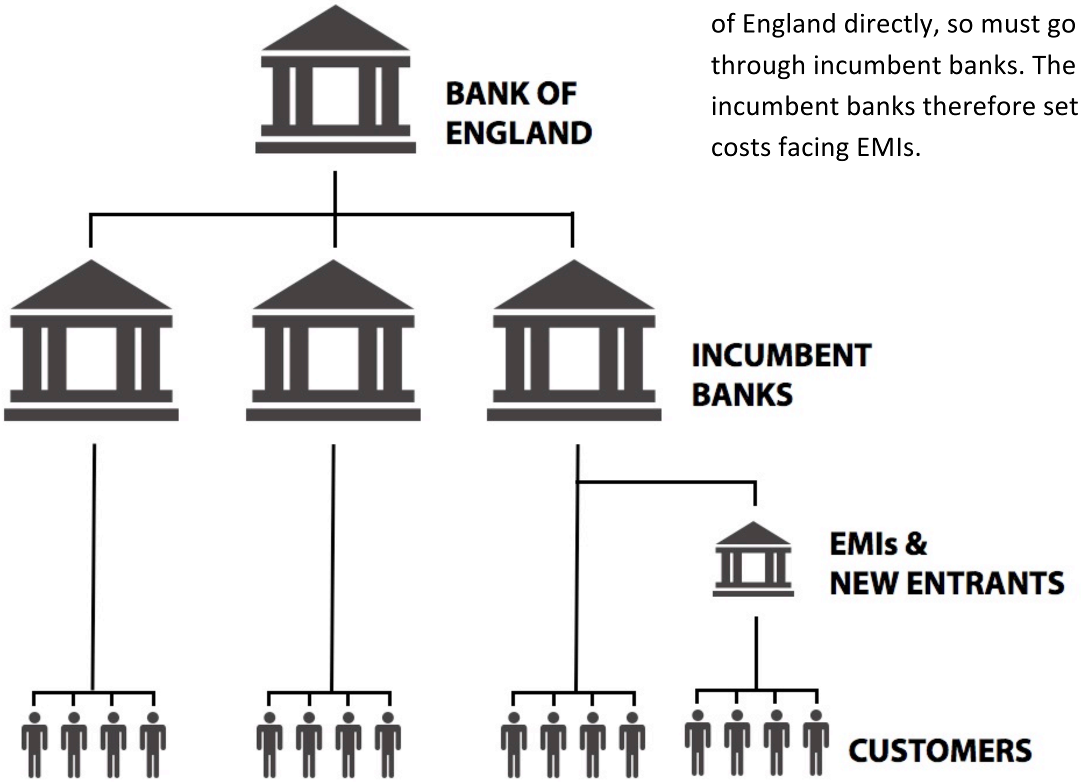
Barrier 1: The Bank of England does not provide settlement accounts to EMIs

The Bank of England provides certain 'settlement accounts' to banks and building societies. Ultimately, the entire UK payment system settles across these Bank of England accounts. As the Bank of England describes:

> "Reserves [i.e. settlement] accounts **are effectively sterling current accounts for commercial banks** - they are among the safest assets a bank can hold and are the ultimate means of payment between banks. Whenever payments are made between the accounts of customers at different commercial banks, they are ultimately settled by transferring central bank money (reserves) between the reserves accounts of those banks."

But accounts at the Bank of England are only available to central government and banks and building societies (specifically, firms that are "authorised credit institutions"). EMIs do not qualify for settlement accounts at the Bank of England, even though they hold money and make payments on behalf of customers. This makes it impossible for the EMI to store its funds at the Bank of England, risk-free. Instead, it must store customer funds at an 'authorised credit institution' i.e. at one of the incumbent banks.

Consequently, the incumbent banks are able to set the fees that provide the cost-base for EMIs. In other words, they can set the costs faced by any new entrants, who are their potential competitors. The fees can be many times higher than the actual cost to the bank.



EMIs are unable to access the Bank of England directly, so must go through incumbent banks. The incumbent banks therefore set the costs facing EMIs.

Barrier 2: EMIs are not covered by the Financial Services Compensation Scheme

If a customer stores their funds in a current account at Royal Bank of Scotland, they will be covered by the Financial Services Compensation Scheme (FSCS)[1]. This is the scheme that guarantees that if the bank fails, a customer will be reimbursed up to £85,000 of the balance of their account.

However, the FSCS scheme does not apply to EMIs. That means a customer who stores their funds at an EMI is completely exposed to the risk of the EMI failing.

In short:

- If a customer stores money at a new entrant EMI, the government provides no guarantee that the money will not be lost.

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[1] There are huge problems with the FSCS scheme, as it ultimately amounts to the state underwriting the risks taken by banks. Ideally the extent of coverage of FSCS should be *reduced* rather than increased. However, that is outside the scope of this submission. A detailed critique of the negative impacts of deposit insurance is given in *Modernising Money (2013) by Andrew Jackson and Ben Dyson.*

- However, if a customer stores funds at a bank which already has failed in recent history, the government promises to repay them if that bank fails again.

Because EMI customer funds would be segregated from the EMI's own operational funds, it is unlikely that the failure of an EMI's own operations would actually lead to significant losses to customers.

In practice, however, the actual risk is irrelevant compared to the perceived risk in the eyes of the public. The exclusion of EMIs from FSCS will have a negative impact on competition because any personal finance journalist or financial advisor will feel obliged to point out that storing money in an EMI is 'not as safe' as storing funds at a bank, due to the lack of FSCS.

This seems a hugely unfair exclusion, given the costs the incumbent banks have imposed on the taxpayer already, and the contingent risks they still impose, compared to the minimal risk from EMIs.

Barrier 3: EMIs are excluded from the wider payment networks

A settlement account at the Bank of England is a pre-requisite to becoming a participant/member of the following payment networks:

- CHAPS
- BACS
- Faster Payments
- Cheque & Credit Clearing

Because the Bank of England refuses to provide settlement accounts to EMIs, EMIs are automatically excluded from membership of any of the payment networks.

This is a prohibitive barrier to competition, as it limits the offering that EMIs can provide to customers. Specifically, an EMI is only able to provide the following transactions:

1. From a customer's existing bank account to their account at the EMI
2. From their account at the EMI to another user's account at the same EMI
3. From their account at the EMI back to their own personal account at an incumbent bank

But it is impossible for a customer to use the services of an EMI to make a payment to a customer of another EMI or bank. This means that EMIs are only useful to the extent that the customer wants to make payments to other customers of the same EMI. **EMIs are not granted access to the wider payments system. They cannot compete with the incumbent banks therefore, because they cannot offer the same service.**

In effect, the only opportunity for EMIs to compete against the incumbent banks is by building a 'closed loop' payment system, in which customers all have to have accounts at the same EMI to make payments to each other. However, this causes even further barriers to entry because every new EMI is competing for the same pool of 'early adopters' who would be willing to use an EMI as an alternative to a big bank. This competition makes it even less likely that any EMI would get a sufficient user base to become viable.

By excluding EMIs from the wider payment network, it guarantees that EMIs can never mount an effective challenge to the dominance by banking of PCA/BCA services.

Barrier 4: Payment system annual fees are flat regardless of the size of the bank

Even if the Bank of England were prepared to provide settlement accounts to EMIs enabling them to qualify for membership of the main payments networks, the annual membership fees for these are often fixed without regard for the size of the member. For instance:

- The annual fee for a settlement account at the Bank of England is £15,000. This is the same whatever the size of the bank or payments provider.
- The 'annual call' for the CHAPS member is £3.97 million divided by all members dependent on level of payment volumes. However, the minimum contribution that must be made by a member is 2% of this £3.97 million, in other words the minimum cost of being a member of CHAPS is £79,400 a year. (In practice, EMIs serving individuals and small businesses could function without CHAPS membership and would probably choose not to incur this cost.)
- BACS do not disclose their fee structure publicly, but the CMA may wish to ask them directly.
- Faster Payments charges no joining fee, and charges a membership fee proportionate to payment volumes, which is fair to new entrants.

Barrier 5: Incumbent banks are free to pay interest on customer funds

By law, EMIs are not permitted to pay interest on customer funds, even if those funds are stored at a larger bank that does pay interest or are invested in government bonds that pay interest.

The fact that no interest can possibly be earned on funds stored at EMIs, whilst incumbent banks are free to pay interest to depositors, acts to discourage customers from storing funds at EMIs.

Barrier 6: Incumbent banks can cross-subsidise their services

Incumbent banks can cross-subsidise their personal and business current accounts using revenue from their loan-making and trading activities. This allows them to offer free-if-in-credit current account payments services and even pay interest at times, undercutting EMIs which, by providing only payment services, are unable to do this and instead must charge fees that directly recover the cost of providing the payments services.

5. Recommendations: Removing the Existing Barriers to Entry

Recommendation 1: The Bank of England should be required to offer settlement accounts to all providers of payments services.

This would remove barriers 1, 2 & 3. This is by far the most important recommendation and the one that would have the greatest impact on increasing competition.

If the Bank of England were required to offer settlement accounts to all payment service providers:

- EMIs would no longer have to store customer funds with a larger bank, and therefore the incumbent banks would not be able to set the fees faced by their new entrant competitors.

- Customers' funds would be stored at the Bank of England risk free, rather than stored at one of the incumbent banks. There would therefore be no disadvantage in the fact that the Financial Services

Compensation Scheme does not cover EMIs, since customers' funds would be completely free of risk anyway (i.e. as safe as having an account at the Bank of England).

- EMIs with settlement accounts would no longer be denied membership of other payment settlement networks (e.g. BACS, Faster Payments etc.)
    - Therefore customers of EMIs would be able to make payments to non-customers who bank with other banks (or with other EMIs). This means EMIs would be able to provide PCAs and BCAs that are comparable to those provided by the incumbent banks, and to compete on a much more level playing field.

Recommendation 2: Payment schemes should be obliged to charge membership fees that are proportionate to the size of the member (as judged by payments volume).

This tackles barrier to entry 4.

Recommendation 3: Incumbent banks should be required to recover the costs of providing payments services directly from the users of those services.

This addresses barriers 5. It would further level the playing field if the incumbent banks were not permitted to cross-subsidise their payment services and therefore had to charge account fees that accurately reflected the cost of providing account services. This would increase transparency in charging and make it easier for customers to see which service providers offer the best value.

Recommendation 4: The payment of interest on balances held in current (payments) accounts should be prohibited.

This addresses barrier 6. Prohibiting banks from paying interest on current accounts would level the playing field with payments-only providers who cannot cross-subsidise their costs of service from investment income or from, say, unauthorised overdraft fees.

Appendix 1: How Banks Create New Money

Banks create new money, in the form of the numbers (deposits) that appear in bank accounts, through the accounting process used when they make loans. In the words of the Bank of England:

"When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. ***At that moment, new money is created.****" (Bank of England Quarterly Bulletin, 2014 Q1)*

Conversely, when people use those deposits to repay loans, the process is reversed and money effectively disappears from the economy. As the Bank of England describes:

"Just as taking out a loan creates new money, ***the repayment of bank loans destroys money****. … Banks making loans and consumers repaying them are the most significant ways in which bank deposits are created and destroyed in the modern economy." (Bank of England Quarterly Bulletin, 2014 Q1)*

More than 97% of the money used by people and businesses in the UK is created by commercial, or 'high-street', banks in this way. Less than 3% (i.e. bank notes and coins) is created by the state or the Bank of England. A similar situation exists in most countries around the world.

The full Bank of England paper explaining the process is available here: http://www.bankofengland.co.uk/publications/documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf

The modern payments systems – CHAPS, BACS, Faster Payments – allow the deposits created by banks to be used to make payments. This means those deposits function as money. If a bank issues further loans, it creates additional new money. A consequence of this process is that the banks' revenue-earning lending operations themselves create the deposits which form the basis for their payments settlement services.

In contrast, an EMI in the form recommended in this submission would not create new money; they would simply transfer existing (Bank of England) money from A to B. Independent payments-only service providers, in contrast, have to persuade customers to actively transfer money from their bank deposits in order to use their services, and charge them for doing so in order to cover their costs.

It is the banks' privileged situation that their liabilties serve as money guaranteed by the government which ensures that banks hold an effective monopoly on payments services, and yet it is this very monopoly which threatens to bring down the payments system when banks get into trouble, and this is what makes them too important to fail. Opening up the payments system to non-bank competitors with a different business model will mitigate this systemic threat posed by the nature of banking, but to do that will require the dismantling of the barriers to competition discussed above.

Appendix 2: Probable objections to the recommendations

Settlement Accounts at the Bank of England

Our core recommendation is that the Bank of England should be required to provide settlement accounts to all providers of payments services. Currently these settlement accounts are only available to 'authorised credit institutions' i.e. banks and building societies.

There are a few potential reasons the Bank of England may give for refusing to widen access to settlement systems. We have suggested a few, with counter-arguments, below.

1. **"Settlement accounts provide banks with access to borrowing facilities and other Bank of England schemes. Therefore widening access to settlement accounts would expose the Bank of England to financial risk."**

In the current scheme, access to settlement accounts also gives the bank or building society certain other advantages, such as access to borrowing facilities and liquidity support. The Bank of England is unlikely to allow new entrants access to such schemes, and **there is no reason for them to do so. Payment-only providers and EMIs do not need access to these facilities.** All they need is a way to store funds at the Bank of England, and pay these funds to banks and building societies through the payment schemes' settlement processes. Specifically:

- EMIs would not need liquidity support. They are 100% liquid by virtue of the fact that they only make payments using funds previously supplied by customers on whose behalf the payments are made. An EMI can only make a payment instruction if they have first received funds, therefore for every £1 of an EMI customer's account balance, the EMI would hold £1 at the Bank of England. This is in contrast with the incumbent banks, who make payments on behalf of borrowers from whom no funds have been received and whose stock of settlement reserves (funds at the central bank) is considerably less than the payments that their current account holders may call upon them to make.

- EMIs do not need to acquire funds at the central bank (central bank reserves) through Open Market Operations or any other Bank of England scheme. They acquire funds only when customers of other banks transfer their funds to the EMI or make payments to customers of the EMI.

- EMIs do not need access to any other Bank of England schemes. Again, they simply need an account into which they can receive deposits from other banks' settlement accounts, on behalf of those banks' customers who are making payments to customers of the EMI or who are transferring funds to their own accounts at the EMI.

The Bank of England should therefore provide a single 'restricted' settlement account for each EMI. The account would accept deposits and make payments through the existing payment schemes (BACS, Faster Payments etc.) but would not entitle the EMI to any other Bank of England schemes.

2. **"The IT implications of providing extra settlement accounts at the Bank of England justify requiring small banks and EMIs to operate through larger 'agency' banks."**

Concerns about the IT difficulties of providing settlement accounts should be challenged.

Firstly, the technical task of connecting the systems of new settlement account holders to the Bank of England's RTGS system is handled by VocaLink, which manages the infrastructure supporting Bacs, Faster Payments and the ATM network. The burden on the Bank of England of adding 100 or so new accounts should be no greater than that faced by any of the incumbent banks when creating 100 or so new accounts.

Secondly, the extra 50-100 accounts that would be needed for EMIs and new entrants would have very low payment volumes relative to the 5 largest incumbents. And transactions that are made between the settlement accounts of the EMIs are transactions that would otherwise have been made through the incumbent banks, so the overall increased load on the Bank of England's IT infrastructure is zero.

Naturally the Bank of England's payment systems are critically important, as they underpin the national payments system. But the IT systems should be designed to support an innovative national payments system that serves customers. Right now, allowing barriers to entry to persist in order to avoid creating work for the Bank of England's IT developers means that the industry is held back. The tail is wagging the dog, in other words.

We therefore believe there are no strong reasons for refusing settlement accounts to EMIs, other than organisational inertia.

Abolition of cross-subsidies and interest on current accounts

The ability of incumbent banks to cross-subsidise and pay interest derives from the banks' privileged position *vis-a-vis* the payments systems in that the banks' current account deposit liabilities constitute the government-guaranteed means of payment. Banks do not need to pay interest in order, for example, to attract deposits for lending on to others, since as explained in Appendix 1 bank lending creates its own deposits. Rather banks offer interest to attract new customers to whom they can cross-sell other products such as personal loans, credit cards and insurance. In the same way, the provision of free-if-in-credit current accounts subsidised by overdraft charges and other revenue is a loss leader made possible by the facts that banks can generate fee and interest revenue by creating deposits for borrowers and that, for all practical purposes for the time being, people *must* have current accounts at banks in order to engage to any extent in economic activity. Misrepresenting the true costs of providing these essential payments services, such that alternative service providers are unable to enter the market, is an abuse of banks' privileges.