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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:** 20/08/2013 **Stage:** Final **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**
-£24.74m	-£24.74m	£2.49m	No	OUT

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, in order to tackle the multiple competition issues inherent in the payments market. This will have the knock-on effect of creating a more consumer-focused, innovative payments industry.

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. By tackling anti-competitive elements in this 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 the FCA. 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:** 2018

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.

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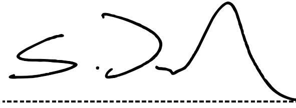
Signed by the responsible SELECT SIGNATORY:  Date: 10/10/13

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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: -24.74**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	1	Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	3.2		2.7	**24.7**

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; 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 expected benefits that are impossible to quantify, given that the policy focus is on removing barriers to competitive market forces; 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)

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Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: 2.5	**Benefits:** n/a	**Net: -2.5**	No	OUT

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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.

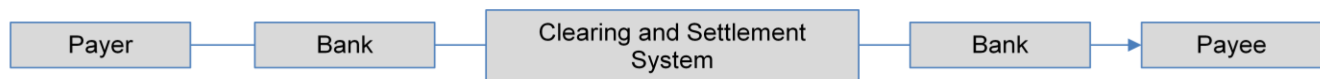
"The future of cheques: Eighteenth Report of Session 2010–12 Volume I: Report, together with formal minutes, oral and written evidence". Treasury Select Committee. HC 1147 24 August 2011.

"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.

"UK payment systems: How regulation of UK payment systems could enhance competition and innovation." OFT. July 2013.

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

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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 2012, 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 2012		
	Volume Bn. transactions	**Value £ billion**
Interbank clearing (BACs, CHAPs, Faster Payments and cheques)	**7.1**	**77,073**
Plastic cards	**13.4**	**713.2**
ATM withdrawals	**2.9**	**193.6**
Source: UK Payment Statistics. Payments Council. 2013. Tables 1.1; 6.2; 6.3 and 22.1		

What is the problem under consideration?

Under the existing governance regime for UK payment systems, headed by the Payments Council (the strategy setting body for the payments industry) the payments industry is not delivering the type of payments networks that the Government would like to see in the UK. This is due to a lack of effective competitive pressure on payment systems providers to innovate and improve.

The Office of Fair Trading's recent report, *UK Payment systems: How regulation of UK payment systems could enhance competition and innovation*, echoes this view, and states:

"… the development of UK payment systems appears to have been slowed by the fact that, when acting as members, owners and users of payment systems, retail banks do not have significant incentives to generate competition and drive innovations. Consequently, consumers experience few innovations that drive service and improve the payment experience."

This lack of competition within the market for inter-bank payment systems also has knock-on consequences for the level of competition in the UK financial services industry more widely. Reliable access to payment systems is paramount for any bank or building society wishing to compete in providing personal current accounts or business current accounts. Under the current system, smaller, new entrants to the retail banking market can only gain access to these payment systems via incumbent banks. In practice, this means that smaller banks are dependent on a service delivered by their competitors to complete day-to-day business, which puts incumbent banks in an influential position.

HM Treasury's recent consultation, '*Opening Up UK Payments*', found issues with the terms of access set by incumbent banks when negotiating access. Respondents said that charges for access via incumbent banks are not transparent, and so different to compare. Respondents said that charges for

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access to payments infrastructure via could be up to 10 times higher through the agreement with another bank, than if the smaller bank had direct access.

Recent history has also shown that this lack of competitive pressure has led to the payments industry taking decisions that are in the best interest of market players rather than the customers they serve. For example, the Payments Council took the controversial decision to abolish cheques in 2009. 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."

In its response to the Treasury Select Committee's report[2], the Government broadly accepted the Treasury Select Committee's recommendation and launched its consultation, '*Setting the Strategy for UK Payments',* published in July 2012. This consultation 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.

In the July 2012 consultation, 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 – namely the problems of innovation and responsiveness to consumer needs - 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, a number of developments led the Government to realise that problems with the payments industry were wider and deeper than initially considered. For instance:

- it became clear that the problems we have seen in the market around innovation and responsiveness to consumer needs are merely symptoms of a more deeply-rooted, underlying problem – the market structure itself creates the potential for the incumbents to take actions that inhibit competition from new payment service providers, so a body with strong powers would be needed to tackle this; and
- the process within the current governance model for taking decisions on developing payment systems does not give providers the incentive to compete. The Payments Council currently works by consensus, which slows development, and means that single institutions are able to hold up progress for the rest of the industry if it serves their purposes.

The Government has therefore decided that full utility-style regulation of the payments industry has become a necessity to address these structural competition issues.

Given that the Government has decided to pursue this option, it has also taken the decision that the scope needs to go beyond the main interbank payment systems to also include the three- and four-party card schemes (e.g. Visa, MasterCard and American Express) and the so-called no-party schemes (e.g. Paypal, Google wallet).

The first reason for this is of competitive neutrality. In order to ensure that competition works effectively, it will be important that the regulator is able to exercise its powers over all payment systems that could

[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

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exercise market power in the UK payments market; if this was not the case, regulatory intervention could actually result in worsening competition. This point was made strongly in the OFT report, which noted the vital importance of neutrality between networks. Through drawing the net of payment systems that may be brought into regulation widely, then designating systems to actually be regulated as they acquire market power, this will give the regulator the ability to target its regulation where it is required in order to allow it to create a level playing field.

The second is that while the main problems exhibited by interbank systems, around innovation and responsiveness to consumer needs, are not in evidence, different problems have emerged around the card schemes. In particular, there has been longstanding concern, both at domestic and international level, about the setting of multi-lateral interchange fees (MIFs) by the four-party card schemes.

The MIF is a fee, set centrally by the card scheme, which is paid from the merchant acquirer to the card issuer, as a percentage of each transaction made by the card-holder. The reason for the existence of this transfer is that merchants are willing to pay to be able to accept card payments, but, in many cases, customers are not willing to pay to have a credit or debit card. Therefore, the MIF is there to compensate the card issuer for the costs of recruiting and servicing cardholders.

However, there is a lack of competitive pressure to bring down the price of the MIF. It is in the interests of the card schemes to bid up the level of the MIF as that will attract more card issuers to issue their cards, so helping to grow the penetration of their network. There is little that merchants can do to prevent the value of the MIF being passed onto them, however, as for many merchants the main card schemes are “must take”. There is therefore insufficiently checked upward pressure on these charges, which must be absorbed by merchants or passed on to consumers.

There is currently a great deal of discussion in this area. In particular, on 24 July 2013 the European Commission proposed a regulation of interchange fees that would cap the level of the fees across the European Economic Area. However, there has been little progress made since the proposal was published, with European Council working groups yet to be established. It therefore remains uncertain when the regulations will be agreed. In the OFT’s most recent report, it highlighted these inherent uncertainties around legislative processes and the fact that the content and scope of European regulation is far from being settled. The OFT therefore recommended that the UK government consider how best card networks can be regulated within the UK to ensure that the position domestically tackles the problems with card networks in light of the outcome of the European process.

Having made the decision to create a regulator, the Government considered two options around how to do so. 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 has decided to give these regulatory powers to a body under the FCA. This Impact Assessment therefore explores this option only.

The Case for Change

The Government considers that the lack of competitive pressure on payment service providers presents obstacles to the realisation of the Government’s vision for the future of the payments industry, and also has negative knock-on effects on the Government’s ambition to create a more competitive and better-functioning banking sector. A competitive payments industry is key to the UK being able to foster 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’s **primary objective** for the new payments regulator, therefore, **is to ensure that the operation of payment systems is not a barrier to competition in the provision of payment**

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services. 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.

The Office of Fair Trading published figures in its 2013 Personal Current Account Review, which show the effects of this lack of competition. It found that the market share of the four largest current account providers was 77 per cent in 2010, which is among the highest levels of concentration in the world.

The regulator will be given powers to take action in each of these areas, with the objective of enabling the increase of the number of market players that will be able to provide payment services.

The lack of a competitive pressure in the industry has given rise to knock-on concerns:

(i) Less effective competition in the wider market for UK financial services

Challenger institutions, both in responses to the HMT consultation and in wider contact with ministers, have noted that access to the payment systems is one of the foremost barriers in competing in the current account market in the UK. Without access to the inter-bank payment systems it is impossible to provide a commercially-viable current account offering. The current account market is extremely concentrated, and marked by low levels of customer switching. The current account market is a key one in UK financial services, as it provides the gateway for consumers to a range of other financial products, such as credit cards, mortgages, personal loans and insurance products.

At the moment, the only option for smaller institutions to gain access to the inter-bank payment systems is via an agency agreement with one of the established players. In practice challenger institutions report that they may have a choice of only one or two providers, which obviously diminishes the competitive pressures in this market. The effects of this lack of competition are that challenger institutions often receive worse service (e.g. earlier transaction processing deadlines), more expensively, and without security of service supply. This impacts on the ability of challenger banks to provide the service they want for their customers, and increases the proportion of their resources they need to devote to providing basic payment services. Both of these factors reduce the ability of challenger institutions to compete on a level playing field with established banks.

(ii) A lack of innovation in the payments industry

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. There are a number of reasons for this. The payment systems are a shared resource, so no single bank gains an advantage over the others from investing in the systems to develop them. This lack of competitive pressure creates perverse incentives, leading to under-investment in the systems. This means that the UK could be missing out on innovations that would be potentially valuable, or having them delivered in a way that fails to realise their full benefits in a timely manner. While

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there have been some innovations in recent years, such as the development of Faster Payments, this has only been achieved at the strong urging of government, and at the slowest pace.

The regulator would have the power to re-organise the industry so as to create proper competitive pressures, and to direct investment where needed to drive this. A more competitive industry overseen by the regulator would incentivise providers to develop new innovative products in order to stand out from their competitors.

(iii) A lack of focus on delivering services that meet the growing demands of payments end-users

Another knock-on effect of lack of competition has been that the payments industry has lacked adequate incentives to deliver against the legitimate demands of consumers. This has been reflected in the aborted decision to abolish cheques and the time it has taken to realise the full benefits of Faster Payments, by having a uniform, high transaction limit among providers.

The Treasury Select Committee 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. Under the regulator, a greater range of players, including challenger banks, smaller institutions and innovative, non-bank players will not be restricted from helping to shape future strategy.

Through creating more effective competition in the payments market, the regulator will create conditions where players in the market must be attentive to consumer needs for fear of losing transaction volumes to competitors.

(iv) Lower pressures for efficiency in payment systems

There are some pressures for efficiency in payment systems arising from the fact that banks generally provide payment services as an non-chargeable service to their customers, as part of their free-if-in-credit current account offerings. As a result, the unit costs of payments represent an un-recoverable cost for the incumbent banks, so it is in their interests to exert pressure through the payment schemes, which they collectively own, to reduce the costs of processing transactions.

This, however, does not take into account the fact of the extensive legacy systems inside the incumbent banks, which they use to "plug in" to the payment systems. In some cases, a more efficient way to make changes to the payment systems would be to do so in a way that requires changes to, and investment in, the systems inside the banks, so they can connect to the payment systems in a different way. However, the fact that the payment schemes are owned by the incumbent banks, means that they will be incentivised to opt for solutions that minimise the costs to those banks, even when this is not the most efficient solution overall.

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Additionally, within the payment cards market, the regulator would be able to take action to counteract the effects of lack of competitive pressure which creates perverse incentives to bid up MIFs.

Policy options

Baseline – do nothing scenario

In the baseline scenario the government would take no action. This baseline is 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:

The FCA 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. For example, there will be a duty imposed on operators of payment systems to observe principles of fair access and transparency, and the regulator will possess a range of powers to facilitate a more competitive payments environment, including competition powers held concurrently with the OFT. 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.

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		
Reporting and compliance	0	50
Total	**3,160**	**2,950**
Total Regulator Admin Costs	3,160	2,900
Total Firms Costs	0	50
The present value of these costs discounted over 10 years at 3.5% is shown on the summary page for option 1		

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Background

This option would make the FCA the independent regulator for the UK payments industry.

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 to implement a 'designation' approach, mirroring that in Part 5 of the Banking Act 2009, as an alternative to a licensing model. The designation approach will involve an umbrella definition of 'payment systems', but only those meeting a specified threshold (defined in terms of market power and impact on end-users) would actually fall into scope and be subject to the regulator's powers. The Government envisages that, in the first instance, the designated (and therefore 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. Once a system is designated, the regulator will then be able to use its powers over the scheme company that operates the system, providers of infrastructure to the system, and participants in the system (members, card issuers and merchant acquirers).

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 publish details of a compliance failure;
- to impose financial penalties in respect of a compliance failure;
- to share information;
- to create advisory bodies;
- to levy the regulated population to fund its own activities; and,
- to order a divestment of an ownership stake in a payment system, subject to the prior agreement of HM Treasury

COSTS

The costings in this Impact Assessment provide indicative additional costs to the existing FCA from being given powers to regulate the payments industry.

Again, it is important to emphasise that all costings are estimates.

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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) transitional costs for regulated firms; and

(iv) ongoing compliance costs for regulated firms.

(i) Transitional set-up costs for the regulator

The costs incurred by the regulator would be recovered via 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 regulator's 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	

Source: 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.

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Year 1 recruitment and staffing cost:
(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 the FCA, 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:

200 square feet x 30 persons x £45 = £270,000 pa

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

30 employees x £12,000 = £360,000

The total annual accommodation costs are therefore estimated to be:

Table 1.5

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

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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.

IT costs are therefore estimated to be:

30 employees x £1,000 = £30,000

(ii) Ongoing administrative costs for the regulator

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:

IT Costs:

IT depreciation and maintenance costs of £500 pa per person = £15,000 (rounded to £10,000 in summary table 1.2)

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

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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.

The Government has chosen to pursue a designation, rather than licensing, approach to the regulation. This means the major transitional cost that might be expected for payment systems – the cost of preparing and submitting licence applications – will not be incurred. Therefore the transitional costs to payment systems are zero in the summary table 1.2.

(iv) Ongoing compliance costs for regulated firms

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

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

(ii) 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).

(i) 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.

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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 a methodology for keeping license conditions up to date (Impact Assessment, March 2013, *Opening up UK payments* consultation), 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.

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

Total = £46,200

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

(ii) 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)

It is clearly impossible to apply a firm monetary value to the cost of implementing decisions of the regulator, as it is impossible to know in advance what kind of developments the regulator may require industry participants to undertake. However, 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. A reasonable illustrative figure, however, may be the estimated total cost to the payments industry of introducing the Faster Payments System, which the Payments Taskforce estimated to be in the range of £48m-65m[3]. Given the pace of change in the payments industry, it may be reasonable to estimate the level of change required in the industry as roughly equivalent to introducing the Faster Payments Scheme once every five years.

BENEFITS

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.

Key Benefits

Effective regulation in the payments industry will:

(i) **Encourage competition in the banking sector**, in particular, by ensuring participants or potential participants in payment systems are able to access them on reasonable commercial terms; and where they gain indirect access, receive an adequate level of service/access from their provider. This will help challenger banks to compete in the banking sector.

(ii) **Encourage innovation in payments systems**, by opening up access and competition, and by giving the regulator express powers and responsibilities to instruct the industry on developments and innovations required in payment systems. This will have benefits for industry and for end-users in terms of cost and quality of service.

(iii) **Support better delivery of services that meet consumer needs**, in particular, by adding competitive pressures, so that payment systems must deliver services as demanded by consumers or risk losing business to competitors. This can may be achieved either directly, via

[3] http://www.oft.gov.uk/shared_oft/reports/financial_products/oft901.pdf

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the capacities of the central system, or indirectly, via the opening up of payment systems to innovative bank and non-bank players offering value-added services for consumers.

(iv) **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) Encourage Competition in the banking sector

As stated in the June 2012 Banking Reform 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 of 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.

From '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

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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.[4]

Within banking, additional competition in the UK banking market is likely to bring significant benefits to consumers and business customers, both through lower charges both for current account services (which are more common in business accounts), and better rates for banking products more generally.

(ii) Encourage innovation in payments systems

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. As set out in the section on costs, above, it may be reasonable to predict that the level of innovation the regulator will drive in the industry will be roughly equivalent to introducing a new Faster Payments System every five years.

One key area where we may expect the benefits of increased innovation in payment systems to be manifested is via supporting 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[5].

(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

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31414/12-644-competition-regime-for-growth-final-impact-assessment.pdf
[5] Boston Consulting Group

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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. This is an extremely conservative estimate, however; the Prime Minister's EU Business Taskforce estimated that regulation of fees could save UK businesses up to £1bn, which they could either retain or pass through to consumers.

One-in-Two-Out Regulatory costs

The Treasury is of the opinion that this policy is pro-competition measure. A regulator is necessary to deliver reforms to strengthen competition, due to the network nature of the industry, in line with the recommendations of the OFT's latest report on this subject. As such falls outside the scope of the One-In-Two-Out calculation of new regulatory burdens.

To go into more detail, the Better Regulation Framework Manual sets out four criteria by which to judge whether a policy is pro-competition for the purposes of qualifying for this exemption. This policy meets each of these criteria, as set out below:

1. The measure is expected to promote competition via the following mechanisms:

    - **Indirectly increasing the number or range of sustainable suppliers.** Actions the regulator will be able to take will indirectly help boost the number of suppliers in the UK banking market, and the market for non-bank payment service providers. The regulator will have the power to mandate direct access to payments infrastructure, which is currently denied to new, challenger payment service providers. This will remove barriers to new start-ups entering the market and providing competing services, increasing the number of products available. It will also remove barriers for new, challenger banks that wish to, for example, offer current accounts, challenging the current market concentration found by the OFT.

    - **Strengthening the ability of suppliers to compete.** Through its power to mandate access to payments infrastructure, and to modify the terms of agreements for indirect access, the regulator would be levelling the playing field on which new payment service providers can compete. New banks, for instance, would no longer be reliant on incumbent banks to be able to complete transactions.

    - **Increasing suppliers' incentives to compete vigorously.** Through mandating access to payments infrastructure, new, innovative providers will be able to enter the market, offering a bigger challenge to existing providers. For example, as the OFT notes in its *UK Payment Systems* report, payment businesses like Go Cardless could use increased access to the recognised payment systems to generate competition with payments more normally made by payment cards. This would incentivise card schemes to review their offer to ensure it remains competitive.

2. The net impact of introducing a payments regulator is expected to be a significant increase in competition. In addition to its regulatory powers of direction and censure, the regulator will have concurrent competition powers, which means it will have both Competition Act 1998 powers to enforce the prohibitions on anti-competitive agreements and abuse of dominant position; and Market Investigation Reference powers to refer the market, or a subsection of it, to the CMA for a full Market Investigation. It will also have powers to require the current owners of the payment systems to divest

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themselves of those systems, if it judges such action to be necessary. The use of these powers in pursuit of the regulator's objectives are likely to increase competition, by increasing the number of competitors and the level of competitive intensity across both payment systems and payment service providers. We cannot foresee any circumstances in which the regulator would take action that would be detrimental to competition. Therefore, it is reasonable to expect the net impact of this policy to be pro-competitive.

3. Promoting competition is the primary expected impact of the payments regulator. The entire rationale of the policy is to address the failures of competition in the payment systems market, which have negative knock-on effects on the level of competition in the market for the provision of payment services, and banking services more widely. As noted earlier in this document, we expect the benefits of an increase in competition to flow over into other spheres, such as increasing innovation and improving services offered to end users.

4. It would be reasonable to expect a significant net social benefit from the policy, even where all the impacts may not be monetised. The payments system is at the heart of the financial sector; every time someone uses a cash machine or makes a purchase on their card, they are using it. 17.5bn non-cash payment transactions took place in the UK last year, and this is set to rise. Ensuring the payments industry works competitively and efficiently will have a huge positive impact on those that use payments systems in the UK. While it is not possible to quantify this, the indicative evidence set out in the costs and benefits points to the regulator's set-up and running costs creating a net cost to business of £2.94m a year, set against potential net efficiency benefits to wider society stemming from the impact of decisions the regulator may take that are several orders of magnitude more significant than this.

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.

Impact on small firms and micro-businesses

This policy will not come into force until the second half of 2014, and so is out of scope of the Micro-Business Moratorium.

There are two populations of small firms and micro-business for which this policy may create impacts:

1. Operators of payment systems
2. Business users of payment systems

This section considers the expected impact on each of these categories in turn.

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1. Operators of payment systems

The major card schemes are well above the threshold for being small firms or micro-businesses.

For the major inter-bank schemes, the scheme companies in themselves would qualify as small or micro businesses. However, in reality these scheme companies are owned and controlled by their direct members (i.e. large financial institutions). Therefore, while we the establishment of the regulator may be expected to place demands on them, these would not be disproportionate, as these firms have the resources – human, technological and financial – of their member-owners to fall back on.

For clarity, the main five UK inter-bank payment scheme companies are wholly owned and run by the following members:

BACS has 16 members: Allied Irish Bank, Bank of England, Barclays, Citibank, Clydesdale Bank, Coutts & Co, Danske Bank, HBOS, HSBC, Lloyds, Nationwide, NatWest, Santander, The Co-op Bank, RBS, and Virgin Money.

CHAPS has 19 members: Bank of America, Bank of England, HBOS, Barclays, Citibank, CLS Bank, Clydesdale bank, Co-op bank, Danske Bank, Deutsche Bank, HSBC, JP Morgan, Lloyds Bank, NatWest, RBS, Santander, Standard Chartered, State Street Bank, and UBS.

Cheque and Credit has 10 members: BoE, Bank of Scotland, Barclays, Clydesdale Bank, Co-op Bank, HSBC, Lloyds, NatWest, Nationwide, RBS, and Santander.

The Faster Payments Scheme has 10 members: Barclays, Citibank, Co-operative Bank, Clydesdale and Yorkshire Banks (National Australia Group), HSBC Lloyds Bank, Nationwide, Danske Bank, Royal Bank of Scotland Group (including NatWest and Ulster Bank), and Santander.

LINK has 36 members, who again are all major UK financial institutions.

There are other payment systems falling within the category of small firm or micro-business, which are not affiliated to major financial institutions (so-called “no party schemes”). However, the Treasury does not anticipate that it will designate such schemes, so the regulator will not be able to take action that imposes costs on them. Generally, the Treasury would not expect any firm to gain sufficient market power to require being designated without either (a) ceasing to satisfy the qualification criteria for being a small firm/micro-business or (b) being closely affiliated with one or more major financial institutions.

2. Business users of payment systems

We expect that the proposals will have a positive, indirect impact on small or micro-businesses that have transactions processed through payment systems, to the extent that the proposals have the social benefit of driving up payment standards and reducing fees via increased competition and innovation. As set out previously effective regulation could help to ensure that any efficiency gains is passed on to the end-users of payments systems – i.e. ordinary businesses. We do not foresee any additional costs falling on this group as a result of the policy.

Competition

This proposal is focused on 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

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be expected to take a more systematic approach to supervising the industry than the OFT, for example through more regular market studies and reports.