HM Treasury

Designation of payment systems:

response to the consultation

March 2015

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1 Introduction

1.1 The Financial Services (Banking Reform) Act 2013 ("the 2013 Act") received Royal Assent on 18 December 2013. It created a new competition-focused, economic regulator for retail payment systems in the UK: the Payment Systems Regulator (PSR). In April 2014, the PSR came formally into being as it was incorporated as a subsidiary of the Financial Conduct Authority (FCA). It will be fully operational from 1 April 2015. The 2013 Act provides that the Payment Systems Regulator will oversee all payment systems used in the UK that are brought into its scope by being designated by HM Treasury.

Background

1.2 In March 2013 the government published a consultation document, *Opening up UK payments*, setting out its proposals to bring payment systems under formal economic regulation. This followed a report published in July 2011 by the Treasury Select Committee, expressing serious concerns about the governance of payment systems, and recommending that the Payments Council be brought into regulation.

1.3 The government has considerable concerns about UK payment systems. The combination of strong network effects, and the ownership of many of the key payment systems by overlapping groups of the big incumbent banks, is seen as potentially giving rise to problems in three areas:

(a) Competition: the structure of the industry may give the incumbent big banks the opportunity to erect barriers to entry, so that challengers and smaller players find it more difficult to access payment systems on fair and transparent terms. These issues may occur both at the level of direct and indirect access to the payment systems.

(b) Innovation: the network nature of payment systems (i.e. all major banks need to be connected for the system as a whole to be effective) means that innovations in the shared space do not give a competitive advantage to banks individually. The banks also have the ability to slow the pace of development of new innovations if, for example, they are not as well-placed to take advantage of them. There is therefore a concern that new innovations might not be developed where they are in the wider social interest, but not in the narrower interests of individual banks.

(c) Service-user responsiveness: the network nature of payment systems means that, if a payment system fails to respond to service-user needs, this does not necessarily give a competitive disadvantage to any individual bank. This may lead to payment systems not being responsive to service-user needs and wishes.

1.4 In October 2014, the government published a consultation document setting out the criteria for the designation of payment systems, as well as those payment systems that the Treasury considers to meet the criteria and which should therefore be brought into the scope of regulation. The Treasury sought views from interested parties in relation to these proposals.

1.5 The government received 20 responses to this consultation, which were generally supportive of the Treasury's proposals for designation. Respondents included operators of payment systems, payment service providers, and payment user groups. The Treasury has taken respondents' views into account and has made a decision on which payment systems will be designated at this stage. This document summarises the responses received, and sets out the payment systems that will be designated at this stage.

2 The legislative framework: the Financial Services (Banking Reform) Act 2013

Overview

2.1 The 2013 Act defines a "payment system" and enables the Treasury to designate payment systems and thereby bring them into the scope of regulation by the PSR. The Treasury may designate a payment system only if satisfied that deficiencies in the design of the system, or disruption in its operation, would be likely to have serious consequences for service users, and the legislation provides four criteria to which the Treasury must have regard. However, the legislation does not prevent the Treasury from taking additional matters into consideration. In considering whether to designate a payment system, the Treasury may rely on information provided by the PSR, the Financial Conduct Authority, the Prudential Regulation Authority and the Bank of England.

2.2 Once a payment system is designated, this brings the system's participants (operators, infrastructure providers and payment service providers that provide payment services using the system) within the scope of the PSR's powers.

2.3 This designation framework allows the Treasury to focus the PSR's attention where it is required, without the need to designate less relevant payment systems at the outset. It then provides the flexibility to bring emerging payment systems into scope. Likewise, a system that declines in importance may no longer need to be regulated and this framework allows the Treasury to de-designate a system when appropriate.

Meaning of "payment system"

2.4 The 2013 Act defines a payment system as:

> "a system which is operated by one or more persons in the course of business for the purpose of enabling persons to make transfers of funds, and includes a system which is designed to facilitate the transfer of funds using another payment system."

2.5 This definition provides that third-party systems, which overlay or "piggyback" on core payment system rails are treated as payment systems in their own right and therefore may be designated for regulation.

2.6 The 2013 Act then specifies that the following are not considered as payment systems, and therefore cannot be brought into the scope of regulation:

- arrangements for the physical movement of cash
- a system which does not provide for funds to be transferred by payers, or to recipients, in the UK
- a securities settlement system operated by a person approved under regulations under section 785 of the Companies Act 2006
- a system operated by a recognised clearing house

- a system whose primary purpose is not enabling persons to transfer funds

Designation criteria

2.7 The 2013 Act provides that the Treasury may designate a payment system only if it is satisfied that:

> "any deficiencies in the design of the system, or any disruption of its operation, would be likely to have serious consequences for those who use, or are likely to use, the services provided by the system."

2.8 Therefore, the Treasury must be satisfied that the importance of the system is such that there is potential for serious consequences for service-users. For example, such consequences could be caused by failures in any aspect of the operation, development or provision of the system.

2.9 The legislation provides that a payment system may be designated if such consequences would be likely to occur if there were deficiencies or disruption; designation does not of itself mean there are specific failures identified in the system and does not automatically trigger any action by the PSR against the payment system. It allows the Treasury to designate systems in advance of any need arising for the PSR to take regulatory action in relation to them.

2.10 The 2013 Act then requires that, in considering whether to designate a payment system, the Treasury have regard to the four criteria below. Rather than a mechanical test, these four criteria provide for a multi-dimensional assessment of importance. For example, it is quite possible that a payment system has comparatively low transaction volumes or values, but that it is an important system for specific service-users. Therefore, no one criterion of itself necessarily qualifies a system for regulation.

(a) The number and value of the transactions that the system presently processes or is likely to process in the future

2.11 The Treasury must consider the overall volume and value of transactions. There is no absolute threshold that automatically triggers a payment system for designation. As with each of the criteria, this is one of several factors that the Treasury will take into consideration in building a picture of the overall importance of the system.

(b) The nature of the transactions that the system presently processes or is likely to process in the future

2.12 The Treasury must consider the type of service it provides to service-users. For example, the Treasury may consider what it is used for, who its service-users are, and any other characteristics of the transactions processed by it. Where relevant, the Treasury will note the proportion of payments that are retail versus wholesale.

(c) Whether those transactions or their equivalent could be handled by other payment systems

2.13 The Treasury must establish whether the types of transaction provided by the system could be provided by another payment system instead. In considering the degree of choice available to service-users, the Treasury will consider the availability of substitutes, how accessible and practical these are to use, and how this applies both for service-users and for payment service providers.

2.14 The existence of close substitutes can be a useful indicator of choice and competition, and helps assess where the balance of power in the market lies between firms and customers. However, this is not an automatic proxy for market power on its own. For example, there could be healthy competition and customer power even if a firm faces only one or two rivals. Or, the status of a new payment system as a substitute for another, well-established system could be a factor in a decision on whether it is now significant enough to designate.

(d) The relationship between the system and other payment systems

2.15 The Treasury must assess the significance of a payment system stemming from its relationship to other payment systems. The Treasury will consider whether the payment system in question supports or depends upon another system.

Future changes in designation

2.16 The legislation gives the Treasury powers to amend or revoke designation orders. Before amending or revoking a designation order, the Treasury must consult the PSR, and, if the payment system is a recognised inter-bank system, the Bank of England. The Treasury must notify the operator of the payment system and consider any representations made. The Treasury must consider any request by the operator of a regulated payment system for the amendment or revocation of its designation order.

2.17 As set out above, it is possible that payment systems not designated by the Treasury at this stage will in time become appropriate for designation. Likewise, payment systems currently designated may decline in importance and require de-designation. Therefore, the Treasury intends to carry out horizon-scanning on an annual basis with the PSR and Bank, to consider whether there are any systems that are now appropriate for designation, or any currently designated systems should now be de-designated.

2.18 This is consistent with the horizon-scanning role maintained with respect to the recognition of inter-bank payment systems under the Banking Act 2009. The Bank of England and Treasury meet on an annual basis to consider whether there are systems that may satisfy the criteria for recognition, or any recognised systems that no longer satisfy these criteria.

3 Designated payment systems

3.1 In its 2014 consultation document 'Designation of payment systems for regulation by the Payment Systems Regulator', which set out the scope of the PSR, the Treasury proposed to designate the following systems initially:

- Bacs
- CHAPS
- Faster Payments
- LINK
- Cheque & Credit
- Northern Ireland Clearing
- Visa
- MasterCard

3.2 The Treasury has considered the representations made by the payment systems listed in paragraph 3.1 above, as well as evidence gathered by the PSR and the Bank of England, and has considered the views of other respondents to the consultation.

Bacs

3.3 As set out in the consultation document, the Treasury considers that Bacs should be designated. Respondents agreed with this assessment. One respondent noted that Bacs is also dependent on CHAPS and the Real Time Gross Settlement (RTGS) system for the settlement of its transactions.

CHAPS

3.4 As set out in the consultation document, the Treasury considers that CHAPS should be designated. Respondents largely agreed with this assessment. One respondent argued that the Bank of England's ownership and operation of the RTGS system could mean CHAPS may not be able to effect actions imposed on it by the PSR, and therefore should not be designated. The Treasury notes, however, that the Bank of England and PSR will have a Memorandum of Understanding in place to mitigate exactly this kind of risk.

Faster Payments

3.5 As set out in the consultation document, the Treasury considers that the Faster Payments Scheme should be designated. Respondents agreed with this assessment.

LINK

3.6 As set out in the consultation document, the Treasury considers that the LINK Scheme should be designated. Respondents agreed with this assessment.

Cheque & Credit

3.7 As set out in the consultation document, the Treasury considers that the Cheque & Credit Clearing Company should be designated. Respondents agreed with this assessment.

Northern Ireland Cheque Clearing

3.8 As set out in the consultation document, the Treasury considers that the Belfast Bankers' Clearing Company Limited should be designated. Respondents largely agreed with this assessment, although one respondent did not. This respondent stated that Northern Ireland Cheque Clearing should not be included on the basis there are alternative payment methods to cheques, and the Northern Ireland scheme will soon merge with the Cheque & Credit Clearing Company when cheque imaging is introduced. However, the Treasury notes that cheques continue to be an important payment method for many consumers and businesses, and that it has the flexibility to de-designate payment systems should they no longer remain appropriate for designation in the future.

Visa

3.9 As set out in the consultation document, the Treasury considers that Visa Europe meets the criteria for designation. Respondents agreed with this assessment.

MasterCard

3.10 As set out in the consultation document, the Treasury considers that MasterCard meets the criteria for designation. Respondents largely agreed with this assessment, noting MasterCard's prevalence in the credit card market, use in e-commerce and use by overlay services such as PayPal. There was some suggestion that MasterCard is not a sufficiently significant player in the payments market to warrant designation. The Treasury notes, however, that MasterCard is the largest player in the credit card market, and considers, therefore, that end users could face difficulties in the event of disruption to MasterCard's operations in, for example, accessing another suitable credit card.

3.11 The Treasury has therefore decided to designate all of the systems mentioned above.

4 Other payment systems

4.1 Chapter 3 set out the payment systems that the Treasury has decided to designate at this stage. In its 2014 consultation document, the Treasury set out that it was aware of arguments for bringing a number of other payment systems into regulation, but that it did not consider that there was sufficient evidence to justify designating these systems at this point. These systems included American Express, Diners Club and PayPal.

American Express

4.2 Largely, respondents either agreed with, or did not comment on, the Treasury's provisional decision that American Express is not appropriate for designation at this stage. Respondents commented on the low number of transactions processed by American Express, the limited number of cards in force and the limited merchant acceptance of American Express cards. Some respondents said that they did not see a case for designation at this stage, but that the Treasury should reconsider if American Express became a "must-take" card.

4.3 A number of other respondents disagreed with the Treasury's assessment that American Express is not appropriate for designation, noting in particular the significance of these payment systems for specific service-users.

4.4 Having regard to these responses, the Treasury conducted a second round of evidence-gathering, working with the PSR. The Treasury concluded from this evidence that American Express does not process a sufficiently high number of credit card transactions and is not a sufficiently significant player in the credit card market; and has a limited rate of acceptance among merchants.

4.5 The Treasury has decided not to designate American Express at this stage. The Treasury will be able to reassess the situation at its next horizon-scanning meeting, and then at subsequent meetings.

Diners Club

4.6 Respondents either agreed with or did not comment on the Treasury's assessment that Diners Club is not appropriate for designation.

PayPal

4.7 Largely, respondents either agreed with or did not comment on the Treasury's provisional decision that PayPal is not appropriate for designation. Respondents commented particularly on the low number of transactions processed by PayPal, and its substitutability in the event of disruption to its operations (in order to set up an account with PayPal, a consumer needs to provide details of a valid credit or debit card). Respondents also noted that PayPal could grow over the next few years, at which point the Treasury should reassess its designation decision.

4.8 By contrast, some respondents said that PayPal is a significant payment option for specific end users, and suggested that certain merchants may only accept PayPal, which would mean end users could not substitute PayPal for other means of payment.

4.9 In response to these comments, the Treasury undertook a second round of evidence gathering working with the PSR. Data gathered through this process showed that PayPal's transaction volumes remain low as a proportion of the card-funded online payments market and as a proportion of the wider payments market at this stage. Information gathered also indicates that there could be a very small number of merchants that only accept PayPal, but in these circumstances a "guest" payment option, which allows a customer to pay with another payment method such as credit or debit card instead of a PayPal account, is still available. As a general rule, the Treasury understands that PayPal is not at present a "must-take" payment option for merchants, and card payments are still the preferred option for customers when making an online payment. As such, the Treasury has decided not to designate PayPal at this stage. The Treasury will be able to reassess the situation at its next horizon-scanning meeting, and then at subsequent meetings.

Other

4.10 Respondents agreed with the Treasury that there are a number of other payment systems that are currently too small to warrant consideration for designation or are not operational in the UK – for example, Paym, Zapp, M-Pesa or Google Wallet.

4.11 Another respondent stated their view that cash should be in scope. However, the Treasury notes that the definition of "payment system" in the 2013 Act explicitly excludes cash as a payment system.

4.12 It was also proposed that inter-bank agency agreements in themselves should be designated. Again, inter-bank agency agreements are not included in the definition of "payment system". The Treasury agrees, however, that it is vital that the PSR has oversight of agency agreements, which is why the PSR will have a range of powers over participants in a designated payment system, including strong powers concerning access to a designated payment system.

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