

## INTRODUCTION

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**3.1** The Cruickshank report recommended that:

The Government should establish a licensing regime to regulate competition in payments markets. This regime should have the following features:

- (a) Participation in payment systems should be a licensed activity. All participants in payment systems would be subject to a class licence, written by the Treasury;
- (b) A legal person should be granted effective powers to monitor compliance with the class licence and to impose sanctions. The sanctions should be in line with those contained in the Utilities Bill, currently before Parliament;
- (c) There should be a process of appeal.

**3.2** The Government accepts that a new sector-specific regime is needed to tackle the competition problems associated with payment systems. It is committed to the introduction of primary legislation as soon as parliamentary time allows.

**3.3** However, the Government does not believe that a licensing regime is the best way to develop a free and open market in the provision of payment services. Licensing regimes are normally based on the premise that an undertaking is prohibited from carrying out an activity unless it is licensed to do so. However, many providers of payment services already have to secure authorisations under banking legislation to provide financial services. It would be disproportionate and inappropriate to require them to be licensed for activities which they may already be authorised to provide.

**3.4** The Government therefore proposes, instead, to introduce a regime whereby any firm which provides payment services must comply with a set of competition-orientated rules. The Government proposes that a regulator will be granted powers to monitor compliance with those rules and to impose sanctions, including financial penalties, where those rules are breached.

**3.5** This framework will enable the Government to foster competition and establish a new regime which is sufficiently robust to tackle the competition concerns, but not so onerous that it stifles innovation or discourages companies from entering the market to provide payment services.

## OVERALL FRAMEWORK

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**3.6** In introducing a new framework, the Government is seeking to build upon the strengths of the current system for sector-specific economic regulation and for financial services regulation in the UK. Therefore, whilst the Government will establish the statutory framework for regulation, the regulator will act at arms length from Ministers. There will be a full appeals process against the decisions of the regulator. Other bodies such as the Bank of England and the FSA will continue to have responsibility for the non-competition issues relating to payment systems.

## THE NEW REGULATOR

**3.7** The Cruickshank report suggested that there were four candidates for the new regulator: the OFT, the FSA, the Bank of England, or a new payments regulator. It examined the merits of each:

**3.203** Each of these options has its attractions. Regulation by the OFT would ensure consistency with the application of competition policy elsewhere in the economy. The FSA is experienced in assessing the risks posed by particular firms and their competence in managing those risks. The FSA should be well placed to evaluate any trade off between competition and risk. And it already has some experience of regulating similar financial services through its oversight of stock exchanges and clearing houses. But the FSA would need a sufficiently robust duty to secure a competitive outcome. Locating these powers in the central bank is the approach taken in Australia. The Bank of England has developed expertise in payment systems issues. The Bank's objectives would need to reflect the explicit aim of promoting competition. Finally a new payments regulator would have a clear focus on competition in payment systems but would need to co-operate carefully with other government bodies involved.

**3.8** The report proposed a free-standing payments regulator on the basis that this would best guarantee the sustained dynamic focus on competition in payments systems that is required to deliver results in this area.

**3.9** The Government believes there would be considerable merits in establishing a new standalone regulator. However, there are a number of disadvantages to such an approach. These include the burdens associated with the creation of a new authority to sit alongside those which already have a direct interest in payment systems. In response to consultation on the Cruickshank recommendations to regulate payment systems, much of the industry questioned the need for a new regulator especially when the Office of Fair Trading already had a role in examining competition issues associated with payment systems. A small standalone regulator could also face difficulties in recruiting staff. A number of those in the industry have suggested that such a standalone regulator might be inclined to intervene in the market too readily in order to justify its existence. The Government recognises these concerns and has examined the costs and benefits of the different approaches in the Partial Regulatory Impact Assessment set out in Annex 2. In light of this, it proposes that **the OFT should be the new regulator for payment systems**.

**3.10** The OFT already has considerable expertise in dealing with competition issues in the financial services sector. As primarily a general competition authority it will be well placed to avoid too intrusive regulation but at the same time, given its other functions, it will also be able to ensure that consumers' interests are protected. Given its remit to deal with issues in all sectors of the economy it will also be able to ensure payment issues are picked up where they overlap with other sectors, such as in the development of e-commerce.

**3.11** The Cruickshank report recommended that the regulator should not be a single individual but that there should be a payment systems commission. Such an approach fits in well with the Department of Trade and Industry's plans to convert the OFT into an Authority with a Board responsible for taking decisions rather than there being just the Director General of Fair Trading with executive powers.

**3.12** The Government is keen to ensure that there is a sustained dynamic focus on competition in payments systems. The OFT is already examining the competition issues associated with a number of payment systems, such as the LINK ATM network and the MasterCard credit card scheme in the UK. However, in giving the OFT new powers it is important that these powers are exercised within a separate framework focussed on promoting effective competition in payment services and delivering benefits to consumers. It therefore proposes a number of measures to ensure sufficient resources are devoted to payment system issues:

- specific duties for OFT in relation to payment system issues;
- specific and separate reporting and decision-making procedures for payment system issues within OFT;
- the appointment of a senior official (in due course, a Board member) with day-to-day responsibility for payment system issues;
- separate identified funding and budget for payment system activities; and
- separate annual report on payment system issues.

The OFT would also be accountable through the select committee system of the Houses of Parliament for its activities in this area.

**3.13** In introducing a new framework it is important to understand how the OFT's role in relation to payment systems will fit alongside its role as a general competition authority and how it will interface with other authorities. The Government's objective is to create sharply focussed regulation that is the minimum necessary to achieve its objectives. This is explored in greater detail in the next chapter, but essentially the OFT's role in relation to payment systems will be confined to promoting effective competition in underlying payment networks and in improving price transparency for retail payment services. In balancing its specific powers in this area and its general powers under existing competition law it is expected that the OFT will use its general powers unless it considers use of its specific powers is more appropriate in dealing with the matter at hand. It will be important to ensure that those subject to the rules are not exposed to double jeopardy and that both sets of powers cannot be used simultaneously against the same alleged abuse.

**3.14** The rest of this chapter sets out how competition issues will be integrated with those of consumer protection and financial stability and how the proposed UK regime will fit in with the overall European framework for financial services.

## CONSUMER PROTECTION

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**3.15** The Government expects that the existing range of consumer protection mechanisms will continue to apply under the new framework:

- the Financial Ombudsman Service;
- general consumer protection law;
- self-regulatory mechanisms such as the Banking Code; and
- the FSA's role in promoting consumer awareness.

**3.16** The Government does not propose to alter the arrangements for dealing with consumers' complaints about payments services. Such services tend to be an integral part of a retail banking service and as such will fall within the scope of the new statutory Financial Ombudsman Service. Access to the Ombudsman Service is open to all personal consumers and those small businesses with an annual turnover of less than £1 million. Firms which fall outside this, and others, can seek redress through other avenues including legal proceedings.

**3.17** Consumers of payment services may also be able to seek redress through general consumer protection law such as that dealing with unfair consumer contracts. As now, they would be able to complain to the Consumer Division of the Office of Fair Trading about such contracts. And it is also expected that the Financial Services Authority will be given powers under this legislation later next year.

**3.18** Self-regulation also seeks to protect consumer interests through the Banking Code. As referred to in Chapter Two above, the Government has established the Banking Services Consumer Codes Review Group to undertake a fundamental review on whether such voluntary codes are delivering sufficiently strong benefits to consumers.

**3.19** The FSA has a wide range of responsibilities in relation to authorised institutions including those banks and building societies which are members of UK payment schemes. These include issues of consumer protection and consumer awareness but do not extend to the introduction of specific rules relating to the provision of retail payment services. The Cruickshank report recommended that the Government should announce an intention not to designate the supply of personal banking services as regulated activities under the provisions of the Financial Services and Markets Act. In its response to the report, the Government agreed that the case for regulating banking products, other than mortgage lending, was weak and that there were no intentions of extending the regulatory scope of the Act.

**3.20** The OFT's role in consumer protection in dealing with payment systems will be focussed on improving price transparency (see Chapter Five) and in dealing with complaints to the extent that they raise competition issues which are within its remit. Individuals and small businesses are unlikely to be in a position to determine whether their complaints involve competition issues and so should be directed at the OFT or whether they involve consumer protection issues and so fall within the remit of the Financial Ombudsman Service. They will therefore be encouraged to approach the Ombudsman in the first instance. The Ombudsman Service would expect consumers to have utilised a firm's consumer complaints procedure before accepting the complaint itself. Procedures will be put in place to facilitate the transfer of complaints to the OFT where it appears there has been a breach of the rules or wider competition issues arise. Larger firms, particularly those already in the payments sector, are more likely to be in a position to make complaints directly to the OFT where they believe their interests have been harmed. The OFT will be free to accept these representations.

**3.21** In order to ensure a co-ordinated approach is taken to consumer protection issues, the Government would expect the OFT to draw up a Memorandum of Understanding with the FSA and the Ombudsman setting out their respective responsibilities in this area.

## **FINANCIAL STABILITY AND THE OVERSIGHT OF PAYMENT SYSTEMS**

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**3.22** The Bank of England is responsible for the oversight of payment systems from a financial stability perspective<sup>1</sup>. It is envisaged that this role will continue unchanged under the new regime. The Bank's responsibilities in this area are set out in the Memorandum of Understanding between the Treasury, the Bank and the FSA<sup>2</sup>:

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<sup>1</sup> Bank of England *Oversight of payment systems* November 2000.

<sup>2</sup> *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority* 1997.

The Bank will be responsible for the overall stability of the financial system as a whole which will involve . . .

- (ii) financial system infrastructure, in particular payments systems at home and abroad. As the bankers' bank, the Bank will stand at the heart of the system. It will fall to the Bank to advise the Chancellor, and answer for its advice, on any major problem inherent in the payments systems. The Bank will also be closely involved in developing and improving the infrastructure, and strengthening the system to help reduce systemic risk;
- (iii) broad overview of the system as a whole . . . Through its involvement in the payments systems it may be the first to spot potential problems. The Bank will be able to advise on the implications for financial stability of developments in the domestic and international markets and payments systems . . .

**3.23** The Bank of England also has formal powers under regulations implementing the EC Settlement Finality directive. These regulations allow the Bank to designate payment systems which apply for protection of their rules against the operation of insolvency law. Both CHAPS Euro and CHAPS Sterling were formally designated in May 2000.

**3.24** The FSA has an interest in payment systems through its authorisation and prudential supervision of deposit taking institutions such as the banks and building societies who are members of UK payment schemes. These regulatory powers relate to authorised institutions and therefore do not necessarily encompass all providers of payment services.

**3.25** Under the Memorandum of Understanding, the FSA also has a role in relation to financial stability and clearing and settlement systems:

The FSA's powers and responsibilities will be set out in statute. It will be responsible for . . .

- (ii) the supervision of financial markets and of clearing and settlement systems;
- (iii) the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities . . .

**3.26** In order to safeguard financial stability and to promote the smooth operation of payment systems, the Government proposes to require the OFT to consult both the Bank of England and the FSA on such issues and to take their advice into account. These proposals are set out in the following chapter.

## INTERNATIONAL DIMENSIONS

**3.27** Within the European Union, there is a common supervisory regime for banks and building societies (known as 'credit institutions') which helps to promote a single market for financial services. Under the Consolidated Banking Directive the regulation of credit institutions is subject to mutual recognition whereby an institution which is authorised in its home state to provide certain services is free to provide those services in any other Member State without further authorisation<sup>3</sup>. It is under an obligation to notify its home state authority, which in turn notifies the host state authority, of its intention to provide services in that country. The Directive lists money transmission services as one of the services which is subject to mutual recognition. The host state may impose additional regulatory requirements if those requirements are justified in the interests of the 'general good'.

<sup>3</sup> Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions OJL L 26 26 May 2000.

**3.28** The Government's proposals for introducing competition-based regulation of payment services in the UK are compatible with the concept of mutual recognition. Its approach will not erect barriers to the provision of payment services in the UK. The Government believes that it is in the interests of the 'general good' to subject those firms which provide services in the UK to rules designed to ensure effective competition, unless it can be demonstrated in a particular case that rules applicable in the home state provide equivalent safeguards in relation to payment services provided in the UK.

**3.29** It will also be important for the OFT to recognise the global nature of certain payment systems. It will need to ensure that it takes account of international initiatives in relation to payment systems including, in that context, liaison with overseas authorities as appropriate.