A2 PARTIAL REGULATORY IMPACT ASSESSMENT

ISSUE AND OBJECTIVE

Issue

A2.1 The Government intends to introduce legislation to establish a competition regulator for payment systems as proposed in the Cruickshank report on Competition in UK Banking. It proposes to introduce a set of rules, to which those providing payment services will be required to adhere, designed to open up access to payment systems and oversee access charges. This assessment sets out provisional estimates of the likely costs and benefits, and invites comments on the accuracy of these estimates.

A2.2 The Cruickshank report followed an independent review into competition in UK banking commissioned by the Chancellor, and was published in March 2000. It found that a more competitive framework for payments systems and retail banking was needed. It estimated that UK banks were making excess profits of between £3 billion and £5 billion per annum.

A2.3 One of the major findings of the Review concerned the anti-competitive nature of the money transmission systems. The UK payment system consists of series of unregulated networks, mostly controlled by a few large banks. The report found that the market power that these banks possess generated considerable anti-competitive effects (see Chapter 3 and Annexes D1 to D4 of the Cruickshank report).

A2.4 The report noted that the economics of payment systems – in particular, the competitive advantage that network effects confer on schemes that have established critical mass – tended to work against the development of new payment systems in competition with existing bank-run schemes. This meant that potential new entrants had to utilise established schemes – on terms set by those with whom they were attempting to compete.

A2.5 The report found that existing powers to promote competition were not able to deal effectively with the concerns raised. This was primarily due to the network structure of the money transmission system. It presented a strong case for government intervention to deal with the competition concerns raised in the report.

Objective

A2.6 The Government's objective in legislating is to address the competition concerns regarding the money transmission system raised in the Cruickshank report. Specifically, the objective is to promote price transparency, good governance, non discriminatory access, efficient wholesale pricing and fair trading in payment services.

RISK ASSESSMENT

A2.7 The anti-competitive nature of money transmission systems is detrimental to all consumers of banking services. The same major banks who control money transmission systems also dominate the markets for services to SMEs and to personal customers. This results in concentrated downstream markets, artificial barriers to entry, distorted wholesale prices, and higher costs to retailers (and thus consumers). It also precipitates low levels of flexibility and innovation that stifle the adaptation of payment systems to e-commerce.

A2.8 The lack of competition is most obviously manifest in the levels of interchange fees that retailers are charged for accepting payment by plastic card. Interchange fees for credit and debit cards are substantially higher than can be justified by legitimate cost recovery. The Cruickshank report estimated the total value of interchange fees in the UK to be over £750 million – 85% of which came from credit and charge cards. Invigorated competition could cut this by between a third and a half. There was also strong evidence that small retailers were discriminated against in the charge levied by merchant acquirers. The report found that some small retailers paid over 500% of the average merchant service charge. In relation to debit cards, interchange fees were around £100 million – a reduction of just 10% would amount to direct costs savings of £10 million. Furthermore, the report also stated that opening up access to these schemes would allow payment cards to be accepted by a wider range of businesses and underpin the provision of e-commerce services. The potential leveraging benefits here were very significant.

A2.9 The deficit of competition in the money transmission system is also detrimental to SMEs. The small number of banks that dominate the money transmission system also have significant market power in the provision of current account services to SMEs. The SME market would appear to be the most profitable market for the banking industry (measured by rate of return on equity). Small business banking accounts for around £1 billion of excess profits, which the Cruickshank report suggested was from provision of money transmission services rather than lending. Consequently, a reduction of, say 25%, in those profits through enhanced competition would amount to benefits of £250 million.

A2.10 Aside from indirectly paying for the high costs faced by businesses, personal consumers of retail banking are also directly affected by the deficiency of competition in the money transmission system. The current account, which depends crucially on money transmission systems, is at the heart of a consumer's banking relationship, and is the locus for the cross-selling of other banking products. Improving competition in money transmission systems should also therefore drive competition in all banking markets.

OPTIONS

A2.11 The Government is determined to tackle the competition problems that the Cruickshank report outlined. It has examined a number of different options including:

- the scope for self-regulation;
- action using existing powers;
- the creation of a new body endowed with new sector-specific powers; and
- endowing an existing body with new sector-specific powers.

Option 1

A2.12 The first option is to rely on self-regulation by those involved in the payments industry to address the competition concerns raised in the Cruickshank report. However, the report rejected a self-regulatory approach. It was highly critical of self-regulatory codes in the banking sector. It found that they were not delivering sufficient benefits to consumers and in some cases were used to frustrate competition rather than to promote it. The structure of money transmission systems means that a voluntary code is unlikely to remedy the competition problems identified by the report. The financial incentives, particularly for those with significant market power in the money transmission market, mean it is unrealistic to expect a self-regulatory process to drive a significant improvement in competition given the effect it would have on profitability. Therefore, the Government does not have confidence, given the financial incentives on firms, that a self-regulatory approach could be made to work in this area.

Option 2

A2.13 The second option is to rely on existing powers, such as those created by the Competition Act 1998 or the Financial Services and Markets Act 2000. The report concluded that neither the OFT nor the FSA could establish an appropriate framework under their existing powers.

A2.14 While existing competition law should be capable of tackling a number of the competition concerns identified in the Cruickshank report, it is unable to deal with them all. Payment systems demonstrate so-called 'network effects' whereby each user benefits from the addition of further users. So, for example, debit card holders gain value as more retail outlets join their particular scheme, as do retailers in relation to growing numbers of customers holding cards belonging to the scheme.

A2.15 Network effects have profound implications for competition, efficiency and innovation in markets where they arise. Establishing critical mass is the first hurdle, as the benefits to customers and businesses of a network arise only gradually with increasing use. Once a network is well established, it can be extremely difficult to create a new network in direct competition. The established network holds two key advantages. First, customers faced with a choice will usually prefer to use the larger network, other things being equal. Second, many end users will already own or use equipment connected to the existing network. Customers carry particular cards in their wallets, for example, and firms have invested in systems that enable them to accept particular forms of payment. To compete, a new network supplier must either replicate this equipment or gain access to this existing installed base of infrastructure.

A2.16 The Cruickshank report concluded that competition between networks – in this case payment schemes – will not by itself drive efficiency and innovation, as usually happens in normal markets. Where network effects are strong, the number of competing networks is likely to be small and the entry barriers facing new networks will be high. Inefficiency can persist in network industries without stimulating new entry. Such problems can be exacerbated when different schemes are commonly owned by the same financial institutions and so there are few incentives for the different schemes to compete with each other.

A2.17 The economic characteristics of payment systems therefore mean that markets are characterised by there only being a limited number of players with few incentives for competition. This together with the strategic importance of payment systems to the wider economy, particularly the development of e-commerce, means that, as the Cruickshank report noted, none of the alternatives to regulation could guarantee the sustained dynamic focus on competition in payment systems that is required to deliver results in this area.

A2.18 Whilst OFT's competition focus could allow it to exercise a role in promoting competition in money transmission (see below), this is not the case for the FSA. The Financial Services and Markets Act is concerned with the prudential supervision of financial services, consumer protection and public awareness and eliminating financial crime. It is not a competition authority. The FSA's role in dealing with competition issues was extensively debated during the Act's passage through Parliament. Ministers made it clear that they did not think it appropriate for the FSA to have a primary competition focus. The payments services industry, as a networked industry, is more akin in many respects to the regulated utility sectors than it is to the provision of retail financial services. The resources and skills based need to tackle the two issues are very different.

Option 3

A2.19 The third option is for the Government to introduce new, sector-specific competition powers in relation to payments systems. This was the approach that the Cruickshank report favoured. It had significant doubts about the adequacy of self-regulation or existing powers to tackle the competition and public interest issues it identified. It argued that reacting to complaints as they arise, or to individual agreements, may not reach the heart of the competition problems in money transmission, which are inherent to the economic character of the system. Similarly, specific changes to existing services would not get to the root causes of the competition problems in the dynamic market of money transmission.

A2.20 The Cruickshank report recommended establishing a licensing regime for payment systems. Under this approach, a legal person would be given the power to issue licences for participating in payment systems. Licence conditions would spell out principles aimed at safeguarding effective competition, and violating these principles would put a firm or scheme in breach of its licence. Establishing ex ante principles up front would allow new entrants to make investments secure in the knowledge that they will not, for example, be denied access unreasonably.

A2.21 The Government has accepted that the competition problems identified in the Cruickshank report cannot be adequately tackled under existing legislation and that a new competition regime is needed. However, it does not believe that a licensing regime which would be based on a prohibition to provide payment services unless licensed to do so is compatible with a free and open market in the provision of payment services. The Government therefore proposes, instead, to introduce a regime where firms providing payment services will be required to adhere to a set of sector-specific rules.

A2.22 This rules based approach will enable the Government to create a framework to foster competition 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.

A2.23 The Cruickshank report also examined the possibilities for the location of a new regulatory regime. It suggested four candidates: the OFT, the FSA, the Bank of England, or a new payments regulator. Having examined the merits of each, it suggested that a new payments regulator would be the best option with a view to guaranteeing the sustained dynamic focus on competition in payments systems that is required to deliver results in this area.

A2.24 The Government believes there would be considerable merits in establishing a new standalone regulator. It could have a dynamic sustained focus on payment issues, and act as a one-stop-shop for competition issues in payment systems. However, the advantages of such an approach need to be considered against possible disadvantages. 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 number of those in the industry also suggested that a standalone regulator may be inclined to intervene in the market too readily in order to justify its own existence.

Option 4

A2.25 The fourth option is for the Government to endow an existing body with new sector-specific competition powers. There are three obvious candidates; the Bank of England, the Financial Services Authority, and the Office of Fair Trading.

A2.26 While the Bank of England is currently responsible for the oversight of payment systems from a financial stability perspective, it does not have the competition focus that would be required to operate a new regime for payment systems. Similarly, while the FSA has an interest in payment systems through its authorisation and supervision of the deposit taking institutions such as banks and building societies who form some of the major participants in payment systems, its focus is on prudential supervision and not competition.

A2.27 Thus, the most feasible existing body which could be endowed with new sector-specific powers is the OFT. The OFT already has considerable expertise in dealing with competition issues in the financial services sector. As the general competition authority it would be well placed to avoid too intrusive regulation but at the same time, given its other functions, it would also be able to ensure that consumers' interests are protected. Given its remit to deal with issues in all of sectors of the economy it would also be able to ensure payment issues are picked up where they overlap with other sectors, such as in the development of e-commerce. Endowing the OFT with new, sector-specific powers would also ensure consistency with the application of competition policy elsewhere in the economy, and avoid additional proliferation in the number of regulatory bodies.

A2.28 In light of this, the Government is proposing that the OFT should be the new regulator for payment systems.

BENEFITS

Option 1

A2.29 A self-regulatory approach is unlikely to deliver sufficient benefits to consumers. Given the current structure of money transmission systems and the financial incentives on firms, it is unrealistic to expect a self-regulatory process to drive a significant improvement in competition.

Option 2

A2.30 The Cruickshank report concluded that an appropriate framework for dealing with the competition concerns it raised could not be established under either the OFT's, the FSA's, or the Bank of England's existing powers.

Option 3

The introduction of new sector-specific powers

A2.31 The introduction of new, sector-specific powers would most effectively deal with the competition concerns identified in the report. Rules would be put in place to ensure price transparency, good governance, non discriminatory access, efficient wholesale pricing and fair trading. Such a competition regime should also promote innovation which would encourage the adaptation of payment systems to e-commerce. Furthermore, the body endowed with these new, sector-specific powers would have a primary objective of promoting effective competition for the benefit of consumers.

A2.32 The benefits of the increase in competition in money transmission that the introduction of new sector-specific powers would drive are difficult to accurately quantify. The Cruickshank report noted how the many varied factors involved in the overall cost of a transaction make it difficult to quantify. This in turn makes it difficult to quantify the exact level of excess profits currently derived from the lack of effective competition in money transmission. However, it is possible to estimate some of the benefits of increased competition that new sector-specific powers would introduce.

A2.33 The benefits of increased competition would be seen, for example, in a reduction in the levels of fees that retailers are charged for accepting payment by plastic card. Interchange fees for credit and debit cards are currently substantially higher than can be justified by legitimate cost recovery. As noted above, invigorated competition could cut the existing level of interchange fees, which the Cruickshank review estimated to be over £750 million, by between a third and a half. This estimate is supported by a recent study of interchange fees in debit and credit card schemes in Australia[1], conducted by the Reserve Bank of Australia and the Australian Competition and Consumer Commission. It found that interchange fees in Australia are significantly above cost, estimating they provide a margin of revenue over average cost for credit card issuers of around 39%. Increased competition would also benefit small retailers, some of whom currently pay over 500% of the average merchant service charge. The study of interchange fees in Australia estimated that the fees charged by credit card acquirers provide a margin of revenue over cost of around 67%. Aside from a reduction in fees, there is also a potential wider benefit in opening up access to the payments cards networks, as it would allow them to be accepted by a wider range of businesses and would help to underpin the provision of e-commerce services.

A2.34 The increase in competition driven by the introduction of new powers would also benefit SMEs. The review found that the small number of banks that dominate the money transmission system also have significant market power in the provision of current account services to SMEs. Unlike personal consumers, SMEs do not have ‘free’ current accounts, as they typically pay monthly or annual charges for holding a current account and are charged for individual transactions. Most do not receive any interest when their current account balances are in credit. This provides an indication of the current value of SME custom to the banks. The Cruickshank review estimated that in 1998 between £13 and £20 billion was held in SME current accounts at the big four banks. Assuming that in a fully competitive market the banks would pay a 5% return on this deposit base, SME current accounts are worth between £650 million and £1 billion a year to the banks in foregone interest alone. This is, of course, on top of the profits that are made from money transmission charges.

A2.35 The Cruickshank report found the SME market to be the most profitable market (measured by rate of return on equity) for the banking industry. It suggested that small business banking would account for around £1 billion of these excess profits. The report argued that the source of these excess profits was more likely to be in the provision of money transmission services rather than in lending.

A2.36 The increase in competition driven by the introduction of new sector-specific powers would also benefit personal consumers of retail banking. Money transmission services are an integral component of current accounts, which are at the heart of a consumer’s banking relationship. The introduction of new powers would also indirectly benefit personal consumers, as retailers would no longer face charges inflated by a lack of competition for accepting various payment methods.

[1] *Debit and Credit Card Schemes in Australia; A Study of Interchange Fees and Access* Reserve Bank of Australia and Australian Competition and Consumer Commission, October 2000.

A2.37 The Cruickshank report estimated that UK banks were making an excess profit of between £3 billion and £5 billion a year. It is difficult to ascertain accurately how much of this excess is derived from the lack of competition in money transmission. However, the figures in paragraphs A2.33 and A2.34 would suggest an estimate of the effect of effective competition in money transmission could amount to an overall benefit to consumers and businesses of between £750 million and £1.25 billion a year. The Government would welcome views.

Endowing a new body with the new sector-specific powers

A2.38 The new sector-specific powers that a new body would be endowed with would have the benefits outlined above. The specific benefit of giving these powers to a new body, as opposed to an existing body, is that it would have a sustained dynamic focus of purpose on payment system issues.

Option 4

The introduction of new sector-specific powers

A2.39 The general benefits of introducing new, sector-specific powers have been outlined above. These would not be significantly affected by giving an existing body the new powers.

Endowing an existing body with the new sector-specific powers

A2.40 As noted above the general benefits of introducing new sector-specific powers would not be significantly affected by giving them to the OFT. In addition, there are several specific benefits of giving these powers to the OFT. Firstly, it already has significant expertise in dealing with competition issues in the financial services sector. Secondly, its remit to deal with competition issues in all sectors of the economy would allow it to ensure that payment issues are picked up across the piece. Finally, endowing the OFT with new, sector-specific powers in relation to money transmission would avoid additional proliferation in the number of regulatory bodies.

A2.41 As noted above, the main benefit of a new body is that it would possess a sustained dynamic focus of purpose on payments issues. However, in giving the OFT the new, sector-specific powers, the Government would introduce a number of measures to ensure sufficient resources are devoted to payment system issues. These would include specific duties for OFT in relation to the exercise of its new, sector-specific powers, specific and separate reporting and decision-making procedures for payment system issues within OFT, the appointment of a senior official with day-to-day responsibility for the regulatory framework and a separate annual report on payment system issues. In order to ensure that the OFT receives adequate resources to exercise its new, sector-specific powers it would be assigned separate identified funding and budget for payment system activities. These measures would ensure that the OFT could have a sustained dynamic focus of purpose on payments issues.

COMPLIANCE COSTS FOR BUSINESS, CHARITIES, AND VOLUNTARY ORGANISATIONS

Business sectors affected

A2.42 The banking sector would be directly affected by any Government activity concerning payment systems. There are approximately 445,000 employed in the commercial banking sector in the UK, of whom 355,000 are employed in retail banking. Whilst there are over 400 banks in the UK most of these do not have a major involvement in the provision of payment services to end users. The main payment schemes in the UK – BACS, CHAPS, Cheque and Credit Clearing (CCCL), LINK, Switch, Visa debit & credit and MasterCard – generally have a direct membership of around 20 banks. However, not all of these member banks would be found to have market power and so not all would be affected by all of the proposed sector-specific rules.

A2.43 Effective competition in money transmission should indirectly benefit all businesses, charities and voluntary organisations who have relationships with the banking industry.

COMPLIANCE COSTS

Option 1

A2.44 It is difficult to accurately quantify the costs of self-regulation by the payments industry. The exact cost would, of course, depend on the nature of the regulations and their process of enforcement. However, it is possible to estimate the costs of a self-regulatory regime using existing regimes as a point of comparison.

A2.45 The Banking Code is a voluntary code covering current accounts, loans and savings to which all high street banks and building societies subscribe. It is policed by the Banking Code Standards Board. It is funded by fees levied on its 142 subscribers, with the total subscription in the 12 months to 31 March 2000 being £937,191. Its budget for 2000-2001 is £1.25 million plus VAT. In addition to these direct costs, it will also cost its members to monitor their behaviour to ensure that they comply with the Code. It is difficult, for obvious reasons, to quantify this cost.

A2.46 The Mortgage Code is a voluntary code that sets out standards of mortgage lending practice. The Mortgage Code Compliance Board is responsible for monitoring the compliance of mortgage lenders and brokers within the Mortgage Code. The MCCB is also funded by fees levied on the Code's subscribers (142 lenders and around 13,065 intermediary firms). Its income for the year ending 30 April 2000 was £4,059,719. Again, in addition to these direct costs, it will also cost its members to monitor their behaviour to ensure that they comply with the Code. It is similarly difficult to quantify this cost.

A2.47 Using the existing codes examined above as a guide, the direct costs to the payments industry of establishing and policing a self-regulatory code would be at least £1 million a year.

Option 2

A2.48 It is difficult to estimate the cost of action to improve competition in money transmission using existing powers. The increased direct costs to the organisations which would be tasked with taking action are obviously difficult to gauge. It is similarly difficult to estimate how much action using existing powers would cost the payments industry. It is unlikely in either case that the costs would be large.

Option 3

A2.49 In costing the creation of a new body endowed with sector-specific powers, it is possible to draw comparisons with existing sector specific regulators. The Postal Services Commission employs around 30 staff and has a projected budget for 2000 – 2001 of £3.7 million. OFTEL employs around 190 staff and its annual expenditure for 1999 was £11.5 million. On the basis of a payment services regulator employing between 30 to 50 staff, with the pay flexibility needed to recruit such staff in the financial services sector, then an annual cost of around £5 million would be likely. Sharing expertise with existing bodies and enlisting professional and other help may help reduce costs. It is not envisaged that there would be significant extra first year costs or capital expenditure in addition to the annual cost estimated above. The regulator would be funded by central government, not by fees charged on those subject to the regime for payments systems.

A2.50 The costs to business of a new, sector-specific regime are difficult to quantify accurately. However, the introduction of a system of rules would mean that business would not face any application fees. The main costs to business would arise from costs associated with compliance. Businesses already need to put compliance procedures in place for dealing with general competition law, and so any new procedures would be supplementary to these. In addition to such direct compliance costs businesses may need to seek expert legal or economic advice. As a rule of thumb, compliance costs could be estimated as four times the direct costs of the regulator. On this basis, it is expected that the total cost to business would be around £20 million a year for the foreseeable future.

Option 4

A2.51 Efficiency savings from economies of scale mean that the OFT could be expected to employ significantly fewer staff in its payment systems role than would be required by a newly created standalone regulator. The costs, therefore, of endowing the OFT with new, sector-specific powers in regard to payment issues would be lower than the costs of giving such powers to a newly created body.

A2.52 The OFT currently employs around 400 permanent staff and has an annual budget of £30 million. Taking into account extra costs associated with consultancy and research, the extra annual cost for the OFT in regulating payment systems would be likely to be between £2 million and £3 million. It is not envisaged that there would be significant extra first year costs or capital expenditure in addition to the annual cost estimated above. The additional cost of giving new sector-specific powers to the OFT would be funded by central government, not by fees charged on those subject to the regime for payment systems.

A2.53 It is difficult to quantify accurately the cost to business of giving new, sector-specific powers to the OFT. However, it is likely that the cost would be appreciably lower than that of an independent regulator, due to savings stemming from the diminished need for duplication in compliance work.

SMALL BUSINESS

A2.54 Small businesses will benefit considerably from a more competitive money transmission system in the form of lower charges and more innovative services.

A2.55 Currently, direct access to the money transmission system is generally restricted to established banks. Opening up access could provide opportunities for more direct use of the money transmission system by small business. It may present the possibility for small businesses to expand and to offer specialised services as intermediaries in the payment service market or to provide services in their own right. A number of potential new entrants have approached the Treasury about the market opportunities which a new sector-specific regime might open up.

A2.56 The proposals are unlikely to impose costs on small businesses and so it is not necessary to conduct a 'small business litmus test'. The Department of Trade and Industry's Small Business Service have confirmed they do not believe this measure will have an adverse impact on small businesses.

RESULTS OF CONSULTATION

A2.57 Initial consultation has taken place with the banking industry, representatives of the payment systems, and consumer groups. It prompted varying responses. A number of members of the industry were opposed to new sector-specific measures, some arguing that no competition problems existed, and others suggesting that there was scope for a limited review of some issues. Smaller players and potential new entrants were, on the whole, more likely to be in favour of introducing sector-specific measures, as were consumer groups.

SUMMARY

A2.58 The benefits of establishing new sector-specific powers to promote competition in payment systems would far outweigh the costs. It would ensure price transparency, good governance, non discriminatory access, efficient wholesale pricing and fair trading – all for the ultimate benefit of consumers. Endowing the Office of Fair Trading with new, sector-specific powers would ensure that these benefits are effectively delivered at a lesser cost than establishing a new regulatory body.

COMMENTS

A2.59 The Government would welcome further information on the costs and benefits associated with its proposals to endow the Office of Fair Trading with new sector-specific powers in relation to payment systems. It is specifically looking for comments on:

- ***its estimates of the benefits of introducing new sector-specific powers (A2.31 – A2.37);***
- ***its estimates of the costs to business of introducing such powers (A2.50 & A2.53);***
- ***its estimates of the costs of establishing a new free-standing regulator (A2.49); and***
- ***its estimates of the costs of giving the OFT those powers (A2.52).***