

## WHY COMPETITION IS IMPORTANT

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**2.1** Competition is the key to giving consumers effective choice and innovative services at a fair price. It is only if competition works at all levels in the market will prices be low and innovation be high. The importance of competition in delivering benefits to consumers is recognised in all sectors of the economy. It has also been recognised by the Government in dealing with regulated industries. In the energy sector, the Utilities Act recently established the new Gas and Electricity Markets Authority, with a new principal objective to protect the interests of gas and electricity consumers, wherever appropriate by promoting effective competition.

**2.2** However, the Government recognises that competition will only benefit consumers where those consumers have easy access to the information they need to make informed choices about the competitive services on offer. There is little point in opening up access to payment systems and introducing greater choice in the provision of retail services if consumers find it too difficult to exercise that choice. It is crucial to ensure that consumers can be informed consumers.

## COMPETITION IS NOT WORKING

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**2.3** The Cruickshank report produced clear evidence that competition was not working in the provision of underlying wholesale payment services and that this had damaging knock on effects to the provision of retail banking services. For example, in looking at credit card payments, the report suggested that fees paid by a retailer's bank to a cardholder's bank – so called 'interchange' fees – were substantially higher than could be justified by legitimate cost recovery. It suggested there were a number of detrimental effects arising from inflated interchange rates including:

- high costs for retailers which in turn leads to higher costs for consumers;
- weakened incentives for banks to cut costs through greater efficiency; and
- competition between payment mechanisms being distorted in favour of products with artificially high interchange fees (when those interchange fees are used to fund loyalty schemes).

**2.4** Consumers often face few direct charges for payment services (although there are indirect charges such as low interest rates on current account balances). However, small businesses generally pay direct charges for every single payment transaction and with many banks these businesses will earn no interest at all on current account balances. The level of these charges can be significant. The Cruickshank report found that the UK was among the more expensive of the countries it surveyed when it came to small business current accounts. Indeed in looking at excess profitability the report concluded that excess profits in the supply of services to small businesses were unlikely to arise from the supply of loans and were instead likely to arise from the supply of money transmission services (or possibly from other services such as savings).

**2.5** The Government is determined to tackle these competition problems. It has examined a number of different options including:

- the scope for self-regulation;
- action under existing competition law; and
- the introduction of new powers.

## SELF-REGULATION

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**2.6** Whilst some payment schemes have made notable efforts to address the competition concerns highlighted in the Cruickshank report following its publication, others have made little or no progress at all. This does not suggest that the industry, as a whole, is prepared to put its own house in order through self-regulation.

**2.7** Indeed, self-regulation has a somewhat mixed history in the financial services sector. In terms of banking, the Cruickshank report raised serious concerns about whether current self-regulatory approaches, such as the Banking Code, were delivering real benefits to consumers. It welcomed the creation of the new statutory Financial Ombudsman Service and suggested that information disclosure should be improved but without regulating the provision of banking services. The Government announced in its response to the Cruickshank report that there would be a fundamental review of whether the codes, such as the Banking Code, are delivering sufficiently strong benefits to consumers. The Banking Services Consumer Codes Review Group is chaired by DeAnne Julius and has been asked to report by April next year. Its terms of reference are to examine:

- whether the voluntary codes are delivering sufficiently strong benefits to consumers;
- what scope there is to introduce greater independence and consumer representation in the drawing up of codes;
- what role there is for the Ombudsman in influencing or determining standards for consumers;
- whether greater information disclosure can be achieved without the need for further regulation.

**2.8** Whilst a self-regulatory approach may be capable of working in relation to promoting greater information disclosure, it is difficult to see how such an approach could be made to work in regulating payment systems. The financial incentives on firms supplying payment services are such that a self-regulatory approach to issues of access and pricing is unlikely to deliver sufficiently satisfactory outcomes for consumers.

## COMPETITION LAW AND REGULATION

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**2.9** There is no doubt that the existing provisions of general competition law should be capable of tackling a number of the competition concerns identified in the Cruickshank report. Indeed, competition authorities in the UK, Europe, the US and Australia are all currently reviewing competition issues associated with credit card schemes. However, payment systems share many of the characteristics of other networked industries such as electricity or telecommunications, where specific sectoral regulation is seen as being in the public interest.

**2.10** 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.

**2.11** The Cruickshank report pointed out that 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.

**2.12** The 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.

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

**2.14** The costs and benefits of the different approaches to tackling the competition problems associated with payment systems are explored in greater detail in the Partial Regulatory Impact Assessment set out in Annex 2.

## **WHAT FORM OF REGULATION: WILL CONSUMERS BENEFIT?**

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**2.15** In seeking to regulate, the Government's objective is to create a framework to foster competition which is sufficiently robust to tackle the competition concerns and deliver benefits to consumers, but not so onerous that it stifles innovation or discourages companies from entering the market to provide payment services.

**2.16** The most effective regime must be one which tackles the root causes of the competition problems rather than merely tackling the symptoms. The Government therefore agrees with the Cruickshank report's recommendations that remedies should be focussed on the underlying payment networks and wholesale payment services rather than on the provision of retail services. It accepts that sector-specific competition powers are necessary to:

- require firms to provide access on fair, reasonable and non-discriminatory terms;
- require firms to ensure wholesale charges are derived through a published methodology based on legitimate costs anticipating future cost reductions;
- place an obligation on firms to co-operate in the development of payment systems;
- place restrictions on the governance and control of payment systems where there is a material effect on competition; and

- enable the regulator to directly determine terms and conditions for access to payment systems (including price) where parties have failed to reach agreement or where agreed terms are not fair, reasonable and non-discriminatory.

**2.17** Whilst the central objective of the new regime is to tackle competition at the wholesale level for the benefit of consumers, the Government agrees with the Cruickshank report that consumers need to be fully informed about the prices they are charged for payment services. It therefore accepts that specific powers are also necessary to:

- require price transparency in the provision of retail services.

**2.18** In line with the Cruickshank report, the Government is not proposing that the new regime should extend to the regulation or price capping of retail prices such as ATM charges (see Chapter Five for a discussion of this). The Government believes that a combination of tough powers to tackle the competition concerns together with price transparency should bring about effective competition and ensure a fair deal for all consumers.