



## BRIEFING PAPER

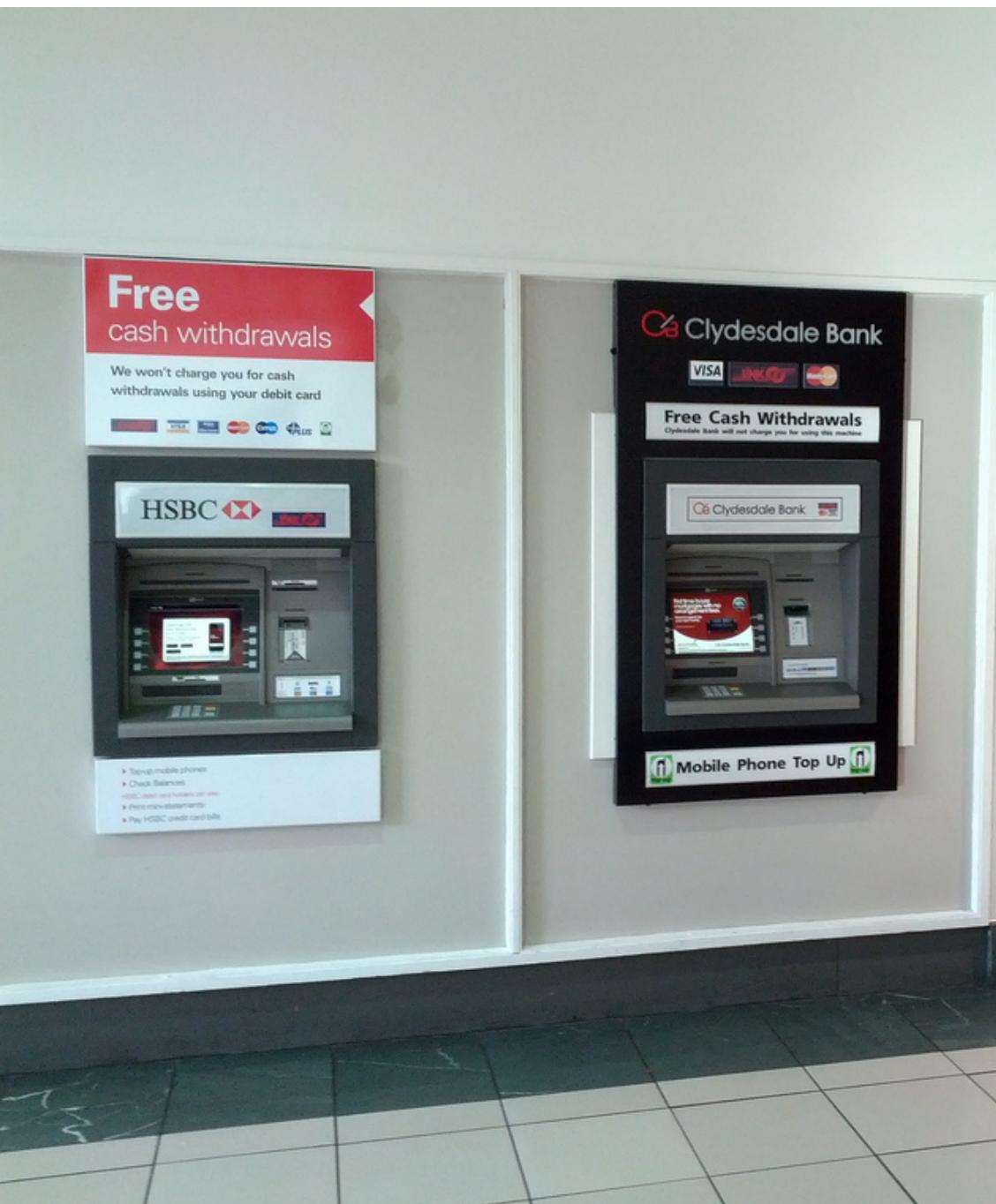
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# Payment Services Regulator

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## Summary

This note sets out some basic information about the Payment Systems Regulator which is one of the new regulatory bodies set up in the wake of the financial crisis of 2008. Although, by and large, payment systems remained stable throughout the crisis, the potential consequences of a breakdown in the 'plumbing' of the system, on top of all the other problems at the time, alerted authorities worldwide to a possible weakness in their regulatory powers.

Part 5 of the *Financial Services (Banking Reform) Act 2013* established a new regulator – the Payment Systems Regulator or PSR. The immediate task for the Financial Conduct Authority, the body responsible for the PSR, was to draw up the framework of rules and guidance for the new body to employ from April 2015.

In March 2015 the PSR announced that it had completed its work on how the sector would be run and published its first policy framework and Annual Budget and Plan. More information, updated regularly, on the PSR can be found on the regulator's webpage.

# 1. Payment services in the UK

Although, by and large, retail payment systems remained stable throughout the financial crisis which began in 2008, the potential consequences of a breakdown in the 'plumbing' of the system, on top of all the other problems at the time, alerted authorities worldwide to a possible gap in their regulatory powers.

The payment systems in the UK depend upon a number of interrelated bodies and functions all operating together. A summary of these can be found in a Financial Conduct Authority (FCA) paper described below:

1. The Bank of England facilitates settlement for the major UK payment systems.
2. Infrastructure providers (e.g. VocaLink, RTGS) control and operate the infrastructure over which the transfer of funds is executed for the purposes of operating the payment system.
3. Payment system operators are the schemes and networks (e.g. Bacs, Faster Payments (FPS), CHAPS, Link, the Cheque and Credit Clearing Company (C&CCC), and three and four party card schemes). For card schemes, the payment system operator and infrastructure provider may be same entity.
4. Direct members are payment service providers that have direct access to payment system operators, and can provide access to indirect participants. The major banks in the UK are direct members of most of the UK payment systems.
5. Indirect participants are payment service providers that access the payment system through agency agreements (i.e. via sponsorship) with a direct member. This may include, for example, smaller banks and new entrants.
6. Service-users are those who use, or are likely to use, services provided by payment systems to transmit funds. For example, businesses, consumers and government departments.
7. Other payment providers include non-banks and other service providers that use the payment systems to provide payment services to service-users. This could include overlay services, such as a mobile phone payment service that enables payments to be made with mobile phones over the Faster Payments Service.
8. Third-party service providers provide services across the value chain to facilitate the processing, acceptance, management and/or transmission of payments (e.g. technology providers, telecommunication providers, payment gateways/platforms, point of sale terminal providers, fraud management services).
9. Trade bodies, consumer groups and regulators represent the external stakeholders active within the payment industry (e.g. the Prudential Regulatory Authority, The European Commission, and the Payments Council).<sup>1</sup>

Information about the payments system in the UK can be found on the website of its representative body [Payments UK](#).

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<sup>1</sup> FCA, Payment Systems Regulations: Call for inputs; March 2015, p8

## 2. Establishing the Regulator

### 2.1 Legislation

The upshot in the UK of concerns about the system was Part 5 of the [Financial Services \(Banking Reform\) Act 2013](#) that established a new regulator – the Payment Systems Regulator or PSR. Section 49 of the Act sets out the general duties of the PSR:

- (1) In discharging its general functions relating to payment systems the Payment Systems Regulator must, so far as is reasonably possible, act in a way which advances one or more of its payment systems objectives. .
- (2) The payment systems objectives of the Payment Systems Regulator are — .
  - (a) the competition objective (see section 50),
  - (b) the innovation objective (see section 51), and
  - (c) the service-user objective (see section 52).
- (3) In discharging its general functions relating to payment systems the Payment Systems Regulator must have regard to — .
  - (a) the importance of maintaining the stability of, and confidence in, the UK financial system,
  - (b) the importance of payment systems in relation to the performance of functions by the Bank of England in its capacity as a monetary authority, and
  - (c) the regulatory principles in section 53.
- (4) The general functions of the Payment Systems Regulator relating to payment systems are— .
  - (a) its function of giving general directions under section 54 (considered as a whole),
  - (b) its functions in relation to the giving of general guidance under section 96 (considered as a whole), and
  - (c) its function of determining the general policy and principles by reference to which it performs particular functions.

The **competition objective** is a long list of considerations which the PSR must take into account including, the needs of different users; the ease of systems' use; the ease with which users can change their service provider; and the ease with which new infrastructure providers can enter the market.<sup>2</sup>

The **innovation objective** is simply to encourage new developments in both service delivery and infrastructure development.<sup>3</sup>

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<sup>2</sup> Section 50

<sup>3</sup> Section 51

The **service user objective** is “to ensure that payment systems are operated and developed in a way that takes account of, and promotes, the interests of those who use, or are likely to use, services provided by payment systems”.<sup>4</sup>

Prior to the Act there were a series of reviews into UK payment systems.

In March 2013, HM Treasury published a consultation [Opening up UK payments](#) on implementing regulation of UK payment systems. The consultation proposed the introduction of a competition-focused, utility-style regulation of payment systems.

In response to HM Treasury’s consultation, the Office of Fair Trading (OFT) gathered evidence on competition and innovation in payment systems in the UK. In July 2013, the OFT published a report UK Payment systems – [How regulation of UK payments systems could enhance competition and innovation](#).

The PSR is a subsidiary of the FCA. In May 2014 the FCA announced the appointment of Hannah Nixon, who was previously a senior partner at Ofgem, as its first Managing Director. It became fully operational in April 2015.

## 2.2 Practical implementation

The early work in establishing the PSR was done by the FCA, as the body responsible for the PSR. The main task was to draw up the framework of rules and guidance.

In March 2014 the FCA published [Payment Systems Regulation: Call for Inputs](#). The purpose of this is:

We welcome input that will assist the PSR to understand the current concerns of the UK payments industry, develop its regulatory approach and design, and identify early priorities for action. The PSR will consider all the evidence and information from respondents to inform and scope a number of policy workstreams. These will lead to formal consultations on the regulatory framework and content later this year. The PSR will provide the FCA with information relevant to its functions under a statutory gateway to be set out in secondary legislation under section 91 of the Banking Reform Act.<sup>5</sup>

The culmination of the FCA consultation came in March 2015 when the PSR published its framework document. Announcing this a press release stated that:

Today’s publication confirms the three ‘pillars’ of the new PSR’s work:

1. A new and inclusive strategy setting process that really involves users of these systems for the first time. This will be done by setting up a Payments Strategy Forum to develop a long term vision for how payment systems

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<sup>4</sup> Section 52

<sup>5</sup> FCA, [Payment Systems Regulations: Call for inputs](#); March 2015, p9

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- should develop and identify priority areas for the industry to work together where appropriate to deliver this vision;
2. Increasing transparency around how decisions are made, and who is making them. We will shine a light on the control and governance of payment systems, challenge payment system operators to explain how they have listened to people and organisations that use payment systems, and check that operators are really taking payment systems in a direction that meets people's needs; and
  3. Improving the way people and businesses gain access to a payment system - whether directly or indirectly – to be clearer and fairer and in a way that fosters innovative and competitive solutions for customers using payment systems.

As well as confirming its final policy, the PSR has published draft terms of reference for two market reviews and announced a card payment systems programme of work. The two market reviews will look at ownership and competitiveness of infrastructure provision; and the supply of indirect access to payment systems. This work will help the PSR gather important evidence to help it make robust decisions that make a real difference to those who use payment systems.<sup>6</sup>

The formal Policy Statement: [\*A new regulatory framework for payment systems in the UK\*](#), and other material, can be found on the PSR website [here](#).

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<sup>6</sup> PSR Press release 25 March 2015.

## 3. Regulatory activity

The Payment Systems Regulator website can be found [here](#).

The Regulator published her first Annual Report in July 2015. It can be found [here](#). It includes 'objectives and priority activities':

- Market review into the supply of indirect access to payment systems
- Market review into the ownership and competitiveness of infrastructure provision
- Code of conduct for indirect access to UK payment systems
- Card payment systems programme of work
- Regulatory directions on access
- Finalise guidance on how we will exercise our concurrent competition powers, and how we will carry out our regulatory market reviews
- Setting up decision making committees (Competition Decisions Committee and Enforcement Decisions Committee)
- Promote innovation: Payments Strategy Forum
- Promote the interest of service-users; conduct investigations; establishment of PSR Panel; regulatory directions on governance<sup>7</sup>

The latest Report and Plan (2016/17) can be found [here](#).

### 3.1 Current work

As well as establishing the broad framework of regulation the PSR has initiated two market reviews. Both are aimed squarely at one of the big stumbling blocks (it is alleged) to a more competitive banking system.

The two reviews are:

- [ownership and competitiveness of infrastructure provision](#)
- [the supply of indirect access](#)

#### Ownership and competitiveness of infrastructure provision

As a result of history and 'natural' economic advantage, the main banks have developed the payments infrastructure system – the 'plumbing' – amongst themselves. The body running this, Vocalink, is owned by the banks. It is argued that the current set up does not encourage competition or innovation in the payments system.

Whether these accusations had merit was one of the first work-streams of the PSR.

The PSR published the [interim findings of its review](#) in February 2016. Its interim findings included:

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<sup>7</sup> Payment Systems Regulator; [Annual Report and Accounts 2014/15](#)

- There is scope to improve competition in the provision of infrastructure services through competitive procurement processes.
- The common ownership and control of payment systems at both operator and infrastructure provider level have an impact on competition and the speed of innovation in the industry.
- LINK and VocaLink are currently not legally separate entities and the contractual agreement for core services is between VocaLink and 38 PSPs in LINK, which makes it difficult to change provider.
- The UK payment systems' unique messaging standards are acting as a barrier to entry for new infrastructure providers into the UK market.<sup>8</sup>

The full report was published in September 2016. It concluded "We have found that there is no effective competition for the provision of UK payments infrastructure for the three interbank payment systems".

The final report included a [factsheet](#) which summarises the findings and proposed remedies contained within it. The remedies are shown below:

- **Competitive procurement exercises are undertaken for the provision of infrastructure services.** This will enable other infrastructure providers to offer these services, which will create the potential for more efficient and innovative services.
- **Divestment by the four largest VocaLink shareholder PSPs of their interest in VocaLink.** This will address the operators' lack of incentive to consider alternative infrastructure providers, as the operators and the infrastructure provider are currently owned and controlled by the same PSPs. MasterCard has recently announced its acquisition of VocaLink, subject to regulatory approval and other customary closing conditions. It will be for the relevant merger authority to consider the effects of this merger under merger control law. However, we note that the transaction would change VocaLink's ownership arrangements in a way which could address the issues we've identified as restricting competition.
- **A common international messaging standard for Bacs and FPS.** This will help facilitate a wider choice of infrastructure providers.

### The supply of indirect access.

Any institution which wants to use the payments system has to pay for it. It is argued (by the non-members) that the costs are high and the service is not as good as for members, e.g. it might be slower and prevent real time settlements. This was the focus of a second review by the PSR.

The main outcome so far of this work has been an industry code of conduct overseen by Payments UK the UK's trade body for groups involved in payment transactions. The new code (a revised version was published in September 2016) can be found [here](#).

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<sup>8</sup> Payment Systems Regulator; [MR15/2.2](#); 25 February 2016

## Phishing

Of more popular interest is the fact that the PSR is engaged in the problem of bank fraud – in particular when individuals are tricked into making payments online through their banks. This followed a ‘super-complaint’ by the consumer group Which?. The PSR response, published December 2016 can be found [here](#).

The scale of the problem is becoming enormous and the impact on ordinary people . The PSR note in their response:

Information on the scale of APP scams is currently limited and presents an inconclusive and uncertain picture. Estimates from the various data sources we were able to consider suggest an annual volume of APP scams in at least the tens of thousands, and possibly hundreds of thousands. In contrast, Financial Fraud Action UK (FFA UK) reported 1.5 million cases of debit and credit card fraud in 2015.<sup>9</sup>

The effort to reduce this sort of fraud is proceeding on several levels and is something which the payments industry, the banks and the regulators are working hard to find a solution that does not impede the smooth flow of billions of genuine transactions and the expectations of immediate settlement via a range of internet based applications. The PSR see improvements possible in the following areas:

The ways in which payment service providers (PSPs), which includes banks, currently work together in responding to reports of APP scams needs to improve.

There is some evidence to suggest that some PSPs could do more to identify potentially fraudulent incoming payments and to prevent accounts falling under the influence of scammers.

The data available on the scale and types of APP scams is of poor quality. Some of the initial evidence we have identified about the scale suggests that it may be significant and the general view held is that the prevalence of APP scams is likely to increase.<sup>10</sup>

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<sup>9</sup> PSR; [Which? push payments super-complaint: PSR response](#)

<sup>10</sup> PSR; [Which? push payments super-complaint: PSR response](#)

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