Reform of the UK payments industry hits the statute book

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Introduction

The UK's Financial Services (Banking Reform) Act 2013, which introduces a utility-style regulator for the payments sector, finally received Royal Assent on 18 December 2013. The new regime presents some major challenges for the established payments industry, but offers the prospect of easier access for smaller players and new entrants to payment systems and could herald a new level of intervention in the way that payment systems operate.

"Designation" not "licensing"

The Government's original plans, set out in its March 2013 consultation, envisaged a regime for licensing direct members and direct participants of retail payment schemes. Respondents' concerns caused the Government to rethink: the new statutory regime instead covers payment systems which are designated by HM Treasury. This may occur where the Treasury believes that deficiencies in the design of the system or disruption in its operation would be likely to have a serious impact on its users. Designation has merits from a regulatory perspective, including:

- Focus: the first systems to be designated are likely to be the main inter-bank schemes and international card schemes. The new regulator will be able to focus its resources and attention on those systems which are largest and impact most upon the UK economy, with scope to designate more as its staffing and expertise levels increase;
- Flexibility: HM Treasury will be able to allow new payment systems to develop and bring them within the regulatory fold as and when they become systemically important.

Critically, the effect of designation is wide-ranging: the payment scheme operator, all providers of infrastructure to that system and all system participants (such as members, card issuers and merchant acquirers) will be brought under the regulatory umbrella. Effectively, regulation will cover the entire "payment journey" from end to end.

On the surface, this approach looks less far-reaching than the licensing proposal in the March 2013 consultation. However, much will clearly depend on how HM Treasury exercises its powers to designate particular payment schemes. These schemes and their users and competitors will be watching this aspect closely and may need to consider how far the Treasury's decisions are open to challenge.

A new regulator

A new Payment Systems Regulator (the "**PSR**") will be established in 2014 as a separate organisation sitting under the Financial Conduct Authority. The PSR will have its own resourcing and strategy and will have concurrent competition powers. Funding for the PSR may be by way of levies on designated payment systems.

The PSR's objectives will be to promote competition, innovation and the interests of end-users. The PSR will have some powerful tools with which to achieve these objectives, including:

- powers to require the establishment of system rules or changes to those rules, and to give directions to operators and other participants - the directions may cover whatever issues the PSR determines to be appropriate;
- specific powers include requiring amendments to service level agreements, access pricing and other fees. Payment system operators will need to assess how to accommodate the potential implications of these powers in their business models and terms of service;
- powers to issue directions to impose financial penalties for breach. Designated payment providers will be looking closely at what is required to stay within their remit;
- powers to require players to dispose of their interests in payment systems, subject to Treasury consent; and
- as part of the objective of simplifying access to payment systems, the PSR can require an established player to allow third party access to its system. New entrants and smaller banks should have an easier route to obtain access to essential payment systems as a consequence.

Participants in the payments industry will find this a world away from the previous regime presided over by the Payments Council.

Death knell for the Payments Council?

With hindsight, the Payments Council might be regretting its decision to abolish cheques by 2018. The uproar following that decision initially caused the Payments Council to back down, then led to a damming report by the Treasury Select Committee in 2011 which criticised the Payments Council and recommended that payments systems should be brought within the formal system for financial regulation. The Government's March 2013 consultation reiterated that many of the problems within the existing system arose from its domination by a small number of large banks and criticised the Payments Council for being unable to reflect the needs of all stakeholders due to its domination by the large banks, and its inability to deliver projects effectively because it operates by consensus. No formal role is envisaged for the Payments Council within the new regulatory regime.

So is that it for the Payments Council? We suspect not. The body was established in 2007 but is an industry membership organisation (not a body established by statute) and, in addition to its role as self-regulator of payment systems, it undertakes a number of industry co-ordinating and representative functions. If its members see that it has a continuing role once the PSR has been established, then it will be for them to decide the Payment Council's future. Given the sweeping powers of the PSR, it may be that the Payments Council will take on a greater lobbying role in future, similar to that of the British Bankers' Association in the wider banking sector.

New regime for administration of payment and settlement systems

In a much less heralded change, the Government has also introduced a special administration regime applying to operators of systemically important inter-bank payment systems and securities settlement systems in the event of their insolvency or threatened insolvency. This financial market infrastructure ("**FMI**") administration applies to both the scheme companies (e.g. Bacs and CHAPS in the payments field, and CREST for securities settlement) and service providers (e.g. Vocalink) to whom the actual processing of payment and technical infrastructure may be outsourced.

In an ordinary administration, the focus is to maximise returns to creditors while winding up the company. An administrator in an FMI administration is instead charged with continuing the delivery of the payment or settlement services; the interests of creditors will be subordinate to those of the economy as a whole. In further recognition of the national importance of such payment and settlement systems:

- an FMI administrator will be nominated by the Bank of England, which will have power to issue directions to the FMI administrator;
- the FMI administrator will have the power to transfer all or part of the business to another company on an expedited basis - and the Bank of England will have a role in approving (and, if appropriate, modifying) such transfers – in order to ensure critical settlement services are maintained; and
- third parties who supply certain goods and services to the operators of such payment systems and securities settlement systems are restricted from terminating early in the event of an FMI administration.

While likely to be beneficial to the efficient operation of the UK economy as a whole, third parties contracting with operators of such payment systems and securities settlement systems will bear the credit risk of their failure. This is something that such contractors, particularly smaller players, will need to consider when bidding for contracts.

Implementation

By "piggy-backing" on a Bill which was already being considered by Parliament, the Government was able to expedite the introduction of the new regime for payment systems regulation. HM Treasury anticipates that the new regulator will be formed as soon as late 2014 and fully operational in spring 2015. It will be a significant challenge to recruit the required number of people holding the necessary range of skills and expertise, and to roll out utility-style regulation in such a fast evolving sector, within such a short time frame.

Some final thoughts

The new regime adopted many of the features proposed by the Government in its original March 2013 consultation; as such, it was not a surprise to the industry. However, it is interesting to note the rhetoric accompanying the Government's press releases on the subject, which focussed on the Government's determination "to empower smaller firms to challenge the big banks to deliver real benefits for each and every user of financial services" and to diminish the incumbent banks' ownership of the system and domination of the payments industry at every level. We shall see whether the new regulator chooses to exercise its considerable powers in quite such an heroic fashion.

As the payments industry digests the implications of this new legislation, established players will be focussing on how to engage with a new form of oversight (with significant powers over their system operations and commercial activities). New entrants and smaller participants will be looking at how the new regime could enhance their payment offerings and deliver a more competitive service.

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