INCREASING COMPETITION IN PAYMENT SERVICES

How to increase competition and innovation in payment services by widening access to accounts at the Bank of England

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1. HOW TO INCREASE COMPETITION AND INNOVATION IN PAYMENT SERVICES BY WIDENING ACCESS TO BANK OF ENGLAND SETTLEMENT ACCOUNTS

1.1 Overview

UK banks earn over £8 billion each year from providing personal current accounts (PCAs) and a further £2 billion each year from business current accounts (BCAs)[1]. But the government's Competition & Markets Authority has declared that that the sector "lacks effective competition and does not meet the needs of personal consumers or small and medium sized enterprises"[2].

The current account sector should be ripe for competition. Payments and current accounts are fundamentally a technology business, and so we should expect to see the same levels of competition as exists in the mobile phone or broadband industry (for example).

However, there are huge and unnecessary barriers to entry to this market, which means that the UK's large incumbent banks are protected from competition from potentially more nimble and innovative technology firms. This works to the detriment to consumers, but to the advantage of the incumbent banks.

We believe that **responsibility for removing these barriers to entry lies ultimately with the Bank of England.** The Bank of England currently refuses to provide accounts ('settlement accounts') to entities that are not regulated as banks ('authorised credit institutions'). This means that only banks, building societies and a small number of other financial firms have the ability to store electronic money at the Bank of England; all other firms must make do with accounts at the larger banks. The Bank of England therefore denies new entrants direct access to its services in a way that benefits the incumbent banks (as explained in more detail below).

The Bank of England could open the payments industry to competition from technology firms with no risk to financial stability, if the recommendations in this paper were followed.

1 https://www.gov.uk/government/news/personal-current-accounts-and-small-business-banking-not-working-well-for-customers

2 Ibid.

1.2 Structure of this briefing

We start by explaining why the best chance of improving competition in the PCA/BCA space is to open the industry up to competition from firms that only provide payments services (payments-only providers). These firms are most likely to come from the tech industry, rather than from the financial services sector.

We explain how payments-only providers are currently required to fit into the regulation for “Payment Institutions” (PIs) or “Electronic Money Issuers” (EMIs) although this regulation preserves some significant barriers to entry that make it impossible for such firms to have a credible chance of competing with the incumbent banks. We list the barriers to entry that result from the legislation, and make recommendations as to how the Bank of England could remove these barriers to entry.

A wider-ranging submission on these issues was made to the Competition and Markets Authority in August 2014.

2. THE POTENTIAL FOR COMPETITION IN PAYMENT SERVICES

2.1 The greatest potential for competition around PCAs and BCAs comes from the tech industry

Payment services are ultimately a technology service. They require a database (ledger) that stores the balance of customer accounts, a protocol for allowing payments to be validated, and a network that allows different payment systems, payment terminals and banks to communicate with each other.

Consequently, it seems obvious that tech firms – whether ‘Shoreditch startups’ or firms like Google or Apple – would want to enter this space and launch innovative payment services that could compete with the incumbent banks.

However, this doesn’t happen, due to design features of the UK payments system, which act as a huge barrier to entry and which protect the incumbent banks from innovative competitors. We’ll analyse these barriers to entry shortly.

2.2 Competition can be increased by enabling the entry of firms that *only* provide payment services

Traditional banks provide two distinct services: a) payments (through current accounts), and b) savings products and loans. But there is no necessity for these services to be provided by one single entity. Competitors could just as well provide either payments services or savings and loans services. For example, peer-to-peer lender Zopa only provides savings and loans, but no payment services.

With regards to payments services and PCA/BCAs, the greatest potential for increasing competition comes from **encouraging the rise of firms that *only* provide payments services.** There is greater potential to increase competition here than there is by encouraging consumers to switch between the similar products offered by the same 4-5 large banks.

In an ideal world and in the absence of barriers to entry, a payments-only provider would:

1. **Provide payment services**

   - Provide personal or business current accounts to customers
   - Allow customers to make payments via:
   - BACS and Faster Payments
   - Debit card
   - Allow customers to make cash withdrawals via Link ATMs
   - Potentially also provide a range of mobile payment services, in which there is huge potential for innovation.

2. **Take no risk with customers' funds**

   - Payments-only providers would not make any loans, and therefore would not take any risk that could threaten the solvency of the provider. This means there is no risk to customers' funds.
   - To safeguard customers' funds, these funds should be stored risk-free at the Bank of England. (In practice, this means there would be £1 in the provider's Bank of England settlement account for every £1 of customer funds held by the provider).
   - In consequence, funds stored at a payments-only provider would be as safe as if they were stored directly at the Bank of England.

3. **Face much simpler regulation**

   - Because payments-only providers would not take risks with customers' funds, the regulatory regime they face should be an order of magnitude simpler than those facing the large incumbent banks.

2.3 Currently, a payments-only provider would need to structured as a 'Payments Institution' or 'Electronic Money Issuer'

Currently the most appropriate structure for a payments-only provider is as a "Payments Institution" (PI) under the Payment Services Regulations (2009), or as an "Electronic Money Issuer" (EMI) under the Electronic Money Regulations (2011). However, the PI/EMI structures maintain significant barriers to entry (discussed later).

Payment institutions and electronic money issuers can:

- Accept funds from other bank accounts on behalf of customers
- Provide the customer with an electronic balance
- Allow the customer to make payments to third parties (although in practice the barriers to entry below make this near to impossible unless the third party also has an account with the same EMI)

An PI or EMI **must:**

- Repay the customer balance 'at par' (i.e. £1 for every £1 deposited, like a current account)
- 'Safeguard' customer funds, by either:
  - Storing them at a bank (an "authorised credit institution"), or
  - Investing them in very high quality 'safe' assets i.e. government bonds.

2.4 But the Payment Services Regulations and Electronic Money Regulations preserve significant barriers to entry

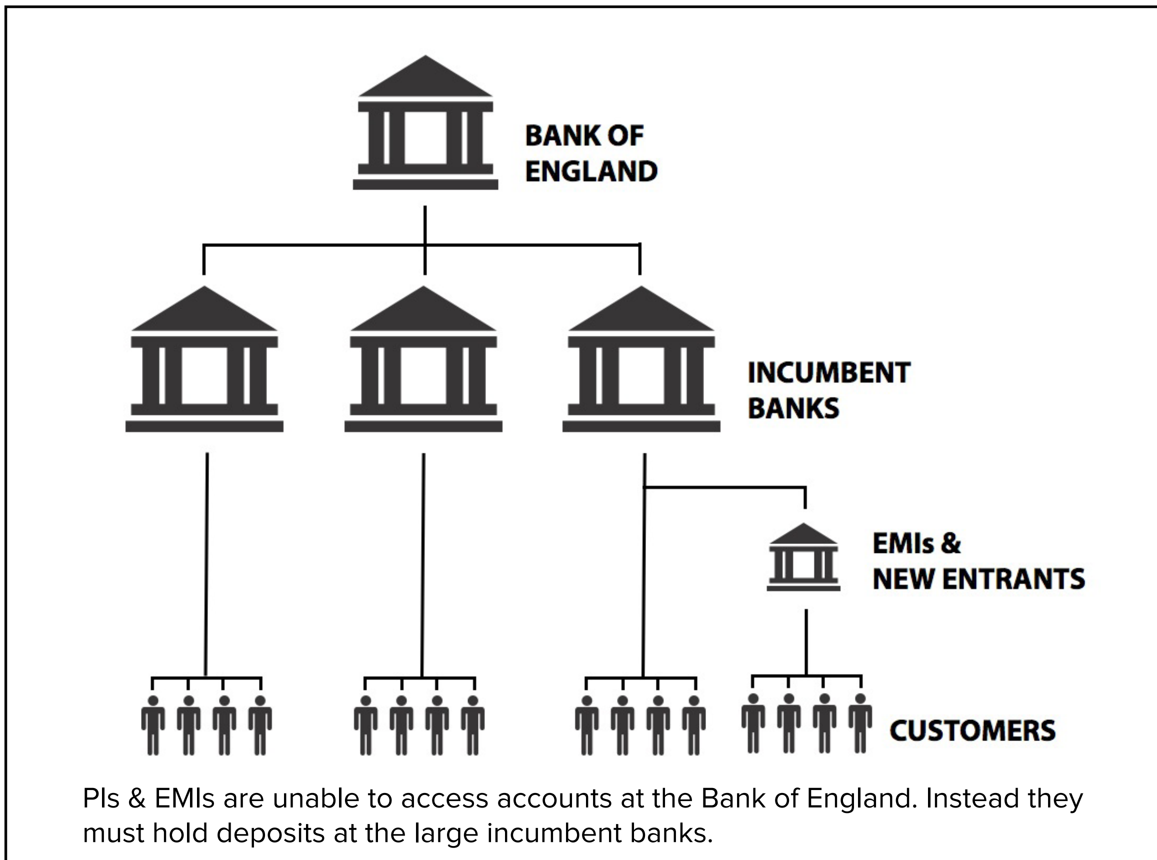
These regulations preserve significant barriers to entry that make it difficult or impossible for new entrants (such as tech firms) to compete with the incumbent banks on a level playing field. These barriers are listed below.

Barrier 1: The Bank of England does not provide settlement accounts to PIs & EMIs

The Bank of England provides certain 'settlement accounts' to banks and building societies. Ultimately, the entire UK payment system settles across these Bank of England accounts. As the Bank of England describes:

> "Reserves [i.e. settlement] accounts are effectively sterling current accounts for commercial banks - they are among the safest assets a bank can hold and are the ultimate means of payment between banks. Whenever payments are made between the accounts of customers at different commercial banks, they are ultimately settled by transferring central bank money (reserves) between the reserves accounts of those banks."

But accounts at the Bank of England are only available to central government, banks and building societies (specifically, firms that are "authorised credit institutions") plus a small number of other financial firms. PIs and EMIs do not qualify for settlement accounts at the Bank of England, even though they hold money and make payments on behalf of customers. This makes it impossible for the PI or EMI to store its funds at the Bank of England, risk-free. Instead, it must 'store' customer funds at an 'authorised credit institution' i.e. at



PIs & EMIs are unable to access accounts at the Bank of England. Instead they must hold deposits at the large incumbent banks.

one of the incumbent banks. In practice, this means that it simply has deposits (IOUs from one of the incumbent banks) to match the funds that it has received from its own customers. (See diagram on next page.)

Consequently, the incumbent banks are able to set the fees that provide the cost-base for EMIs. In other words, they can set the costs faced by any new entrants, who are their potential competitors. Our discussions with industry experts suggest that the fees can be many times higher than the actual cost to the bank.

Barrier 2: EMIs are not covered by the Financial Services Compensation Scheme

If a customer stores their funds in a current account at Royal Bank of Scotland, they will be covered by the government-backed Financial Services Compensation Scheme (FSCS)[3], which guarantees that if the bank fails, a customer will be reimbursed up to £85,000 of the balance of their account.

However, the FSCS scheme does not apply to PIs or EMIs. That means a customer who stores their funds at an PI or EMI is completely exposed to the risk of that firm failing.

In short:

- If a customer stores money at a PI or EMI, the government provides no guarantee that the money will not be lost.
- However, if a customer stores funds at a bank which already has failed in recent history, the government promises to repay those funds if that bank fails again.

3 There are huge problems with the FSCS scheme, as it ultimately amounts to the state underwriting the risks taken by banks. Ideally the extent of coverage of FSCS should be reduced rather than increased. However, that is outside the scope of this submission. A detailed critique of the negative impacts of deposit insurance is given in Modernising Money (2013) by Andrew Jackson and Ben Dyson.

Because PI/EMI customer funds would be segregated from the PI/EMI's own operational funds, it is unlikely that the failure of an PI/EMI's own operations would actually lead to significant losses to customers.

In practice, however, the actual risk is irrelevant compared to the perceived risk in the eyes of the public. The exclusion of PIs and EMIs from FSCS will have a negative impact on competition because any personal finance journalist or financial advisor will feel obliged to point out that storing money in an PI or EMI is 'riskier' than storing funds at a bank, due to the lack of FSCS.

This seems a hugely unfair exclusion, given the costs the incumbent banks have imposed on the taxpayer already, and the contingent risks they still impose, compared to the minimal risk from PIs and EMIs.

Barrier 3: PIs and EMIs are excluded from the wider payment networks

A settlement account at the Bank of England is a pre-requisite to becoming a participant/ member of the following payment networks:

- CHAPS
- BACS
- Faster Payments
- Cheque & Credit Clearing

Because the Bank of England refuses to provide settlement accounts to PIs and EMIs, these firms are automatically excluded from membership of any of the payment networks.

This is a prohibitive barrier to competition, as it limits the offering that these firms can provide to customers. EMIs in particular are only able to provide the following transactions:

1. From a customer's existing bank account to their account at the EMI
2. From their account at the EMI to another user's account at the same EMI
3. From their account at the EMI back to their own personal account at an incumbent bank

But it is impossible for a customer to use the services of an EMI to make a payment to a customer of another EMI or bank. This means that EMIs are only useful to the extent that the customer wants to make payments to other customers of the same EMI. **EMIs are not granted access to the wider payments system. They cannot compete with the incumbent banks therefore, because they cannot offer the same service.**

In effect, the only opportunity for EMIs to compete against the incumbent banks is by building a 'closed loop' payment system, in which customers must all have accounts at the same EMI to make payments to each other. However, this causes even further barriers to entry because every new EMI is competing for the same pool of 'early adopters' who would be willing to use an EMI as an alternative to a big bank. This competition makes it even less likely that any EMI would build up a sufficient user base to become commercially viable.

By excluding PIs and EMIs from the wider payment network, it guarantees that these firms can never mount an effective challenge to the dominance of PCA/BCA services by the incumbent banks.

3. HOW TO REMOVE THE BARRIERS TO ENTRY

Our core recommendation is that **the Bank of England should be required to provide settlement accounts to all providers of payments services.** Currently these settlement accounts are available only to 'authorised credit institutions' i.e. banks and building societies.

- If the Bank of England were required to offer settlement accounts to all payment service providers:
- PIs & EMIs would no longer have to store customer funds with a larger bank, and therefore the incumbent banks would not be able to set the fees faced by their new entrant competitors.
- Customers' funds would be stored at the Bank of England risk free, rather than stored at one of the incumbent banks. There would therefore be no disadvantage in the fact that the Financial Services Compensation Scheme does not cover EMIs, since customers' funds would be completely free of risk anyway (i.e. as safe as having an account at the Bank of England).
- PIs and EMIs with settlement accounts would no longer be denied membership of other payment settlement networks (e.g. BACS, Faster Payments, etc.)
    - Therefore customers of PIs & EMIs would be able to make payments to non-customers who bank with other banks (or with other PIs/EMIs). This means PIs and EMIs would be able to provide PCAs and BCAs that are comparable to those provided by the incumbent banks, and to compete on a much more level playing field.

By allowing PIs and EMIs to hold settlement accounts at the Bank of England, many of the barriers to entry that protect the large incumbent banks would be removed. PIs & EMIs would be able to offer an account that is as safe (or safer) as one of the government-guaranteed current accounts provided by the incumbent banks. Their customers would be able to make payments to any other bank account that is connected to the payment systems, and so PIs and EMIs would be part of the wider system rather than having a business model that relies on their customers transferring money only to other customers.

This is a simple and effective way that the Bank of England would be able to enable much more competition in the payments and current account sector.

Allowing a greater number of payment service providers also reduces risk to the financial system and real economy as a whole. The large incumbent banks had to be bailed out largely because they alone provide the payments system on which the real economy depends. The failure of RBS, for example, would have left millions of RBS current account customers without any way to make payments, potentially causing panic and further chaos in the financial system and real economy. Opening up competition and spreading current account services between a larger number of payment service providers will reduce the risk to the payments system (and to the real economy) of any single provider failing. In other words, rather than more providers creating more financial system risk (because there are more firms to monitor and regulate), a greater number of payment providers leads to greater financial system resilience.

4. WIDENING ACCESS TO SETTLEMENT ACCOUNTS TO ALL FINANCIAL FIRMS

By refusing to allow anyone other than banks and building societies (the 'authorised credit institutions') to hold settlement accounts with it, the Bank of England ensures that members of the public, businesses and other financial sector firms must use accounts at the incumbent banks if they want to make payments. The entire 'private sector' (businesses, households and other financial corporations) must use the deposits (IOUs) of banks because the Bank of England does not provide a form of electronic cash that is available to the public to use.

If this situation is preserved and the Bank of England continues to refuse access to settlement accounts for anyone other than regulated banks, it protects the banks from changes in technology.

All other financial firms are forced to store their funds as deposits at the larger banks. This provides a guaranteed demand for the function of large banks. But the financial industry is changing, and banks may become obsolete over the next couple of decades. In the absence of the barriers to entry mentioned above, we would expect to see large banks' role in payment services being encroached on by payment services from tech firms and mobile phone companies. We would also expect to see their role in providing savings and loans being encroached on by peer-to-peer firms (such as Zopa), peer-to-business lending (such as Funding Circle) and crowd funding platforms. It is hard to justify denying all of these firms the ability to store electronic funds at the Bank of England.

In the longer term, there are further advantages to making the current account payment services of larger banks operate in the same way as proposed for PIs and EMIs above. This idea is discussed in more detail of Chapter 6 of Modernising Money by Andrew Jackson and Ben Dyson.

5. LIKELY OBJECTIONS FROM THE BANK OF ENGLAND

There are a few potential reasons the Bank of England may give for refusing to widen access to settlement systems. We have suggested two, with counter-arguments, below.

1. **"Settlement accounts provide banks with access to borrowing facilities and other Bank of England schemes. Therefore widening access to settlement accounts would expose the Bank of England to financial risk."**

In the current scheme, access to settlement accounts also gives the bank or building society certain other advantages, such as access to borrowing facilities and liquidity support. The Bank of England is unlikely to allow new entrants access to such schemes, and **there is no reason for them to do so. Payment-only providers such as PIs and EMIs**

do not need access to these facilities. All they need is a way to store funds at the Bank of England, and pay these funds to banks and building societies through the payment schemes' settlement processes. Specifically:

- PIs and EMIs would not need liquidity support. They are 100% liquid by virtue of the fact that they only make payments using funds previously supplied by customers on whose behalf the payments are made. They can only make a payment instruction if they have first received funds, therefore for every £1 of an PI/EMI customer's account balance, the firm would hold £1 at the Bank of England. This is in contrast with the incumbent banks, who make payments on behalf of borrowers from whom no funds have been received and whose stock of settlement reserves (funds at the central bank) is considerably less than the payments that their current account holders may call upon them to make.
- PIs and EMIs do not need to acquire funds at the central bank (central bank reserves) through Open Market Operations or any other Bank of England scheme. They acquire funds only when customers of other banks transfer their funds to the PI/EMI or make payments to customers of the PI/EMI.
- PIs & EMIs do not need access to any other Bank of England schemes. Again, they simply need an account into which they can receive deposits from other banks' settlement accounts, on behalf of those banks' customers who are making payments to customers of the PI/EMI or who are transferring funds to their own accounts at the PI/EMI.

The Bank of England should therefore provide a single 'restricted' settlement account for each PI and EMI. The account would accept deposits and make payments through the existing payment schemes (BACS, Faster Payments, etc.) but would not entitle the EMI to any other Bank of England schemes.

2. **"The IT implications of providing extra settlement accounts at the Bank of England justify requiring small banks and EMIs to operate through larger 'agency' banks."**

Concerns about the IT difficulties of providing settlement accounts should be challenged.

Firstly, the technical task of connecting the systems of new settlement account holders to the Bank of England's RTGS system is handled by VocaLink, which manages the infrastructure supporting Bacs, Faster Payments and the ATM network. The burden on the Bank of England of adding new accounts for PIs and EMIs should be no greater than that faced by any of the incumbent banks when creating the same number of new accounts.

Secondly, the extra accounts that would be needed for PIs and EMIs would have very low payment volumes relative to the 5 largest incumbents (initally at least). And transactions that are made between the settlement accounts of the PIs or EMIs are transactions that would otherwise have been made through the incumbent banks, so the overall increased load on the Bank of England's IT infrastructure should be zero.

Naturally the Bank of England's payment systems are critically important, as they underpin the national payments system. But the IT systems should be designed to support an innovative national payments system that serves customers. Right now, allowing barriers to entry to persist in order to avoid changing the Bank of England's IT systems means that the industry is held back.

We therefore believe there are no strong reasons for refusing settlement accounts to EMIs. If there is resistance from the Bank of England, this may be due to organisational inertia, combined with the fact that it does not currently have a mandate to facilitate competition.

APPENDIX 1: HOW BANKS CREATE NEW MONEY

Banks create new money, in the form of the numbers (deposits) that appear in bank accounts, through the accounting process used when they make loans. In the words of the Bank of England:

> "When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created." (Bank of England Quarterly Bulletin, 2014 Q1)

Conversely, when people use those deposits to repay loans, the process is reversed and money effectively disappears from the economy. As the Bank of England describes:

> "Just as taking out a loan creates new money, the repayment of bank loans destroys money. … Banks making loans and consumers repaying them are the most significant ways in which bank deposits are created and destroyed in the modern economy." (Bank of England Quarterly Bulletin, 2014 Q1)

More than 97% of the money used by people and businesses in the UK exists as deposits at commercial or 'high-street' banks. Less than 3% (i.e. bank notes and coins) is created by the state or the Bank of England. A similar situation exists in most countries around the world.

(The full Bank of England paper explaining the process of money creation is available here.)

The modern payments systems – CHAPS, BACS, Faster Payments – allow the deposits created by banks to be used to make payments. This means those deposits function as money. If a bank issues further loans, it creates additional new money. A consequence of this process is that the banks' revenue-earning lending operations themselves create the deposits that form the basis for their payments settlement services.

In contrast, payments-only providers in the form recommended above would not create new money; they would simply transfer existing (Bank of England-issued) money from A to B. Independent payments-only service providers have to persuade customers to actively transfer money from their bank deposits in order to use their services, and charge them for doing so in order to cover their costs.

It is the fact that bank liabilities serve as money guaranteed by the government which ensures that banks hold an effective monopoly on payments services. Yet it is this very monopoly which threatens to bring down the payments system when banks get into trouble, and this is what makes them too important to fail. Opening up the payments system to non-bank competitors with a different business model will mitigate this systemic threat posed by the nature of banking, but to do that will require the dismantling of the barriers to competition discussed above.

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