Payment Systems and Services Sector Report

1. This is a report for the House of Commons Committee on Exiting the European Union following the motion passed at the Opposition Day debate on 1 November, which called on the Government to provide the Committee with impact assessments arising from the sectoral analysis it has conducted with regards to the list of 58 sectors referred to in the answer of 26 June 2017 to Question 239.

2. As the Government has already made clear, it is not the case that 58 sectoral impact assessments exist. The Government's sectoral analysis is a wide mix of qualitative and quantitative analysis contained in a range of documents developed at different times since the referendum. This report brings together information about the sector in a way that is accessible and informative. These reports aggregate some sectors in order to either avoid repetition of information or because of the strong interlinkages between some of these sectors.

3. This report covers: a description of the sector, the current EU regulatory regime, existing frameworks for how trade is facilitated between countries in this sector, and sector views. It does not contain commercially-, market- or negotiation-sensitive information.

Description of the sector

4. Payment systems and services provide the means by which funds are transferred electronically between payers and payees – as such they are a vital element of the domestic and international economic system.

5. Payment systems are the plumbing of the financial system. Each one consists of a set of rules and procedures that govern the transfer of funds between the financial institutions that participate in that payment system.

6. Payment Service Providers (PSPs) are firms which carry out a payment service, such as allowing two parties to make a payment transaction, or providing a user with aggregated information about their accounts. PSPs can include banks (credit institutions), e-money institutions, payment institutions, and payment initiation service providers.

7. For the purposes of this paper, we have split the payments sector into five functions:

8. **Money transfer and remittance activities** – the transfer of funds from one individual or firm to another, either domestically or internationally, including the issuance of payment instruments to facilitate this. This function includes the payment services performed by banks and building societies, as well as the transfer and

remittance services provided by payment financial technology, or FinTech, firms and more traditional money service businesses.

9. **Merchant acquiring** – the activity of processing payment transactions on behalf of a retailer so that they can accept particular payment types (typically credit or debit cards) online and/or at physical points of sale (e.g. using chip and pin terminals).

10. **Card schemes** – payment networks linked to payment cards, such as debit or credit cards. Card schemes are network services that have strong network effects (i.e. the more buyers and sellers who use a particular card scheme, the more benefit will flow to a new buyer or seller signing up to use it). Two global card scheme firms have their European headquarters in the UK.

11. **Corporate payments / cash management** – commercial services provided by banks to business clients, such as making payments (including across borders, to EU and non-EU countries) or managing liquidity.

12. **Inter-bank payments** – the transfer of money between financial institutions through clearing and settlement systems. These systems underpin the activities above by allowing financial institutions to transfer information on financial transactions and make payments to each other within the UK and across borders:

    a. UK clearing systems for different types of sterling payments include CHAPS, Bacs, Faster Payments and Cheque and Credit.

    b. Euro-denominated payment systems for central and commercial banks include TARGET 2, and the Single Euro Payments Area (SEPA) systems (e.g. STEP2), which support efficient cross-border payments in euros within SEPA, and facilitate cross border payment services such as direct debits and credit transfers.

    c. The international payments systems (non-EU cross-border payments) are not built on agreements between states (or their institutions, such as central banks), they rely on:

        i. international wire transfers;

        ii. where firms cannot correct through wire transfers, correspondent banking relationships (a commercial arrangement where a firm transmits payments on behalf of another), and;

        iii. the international card schemes

13. Payment services, particularly money transfer and remittance activities, merchant acquiring and corporate payments, are typically integrated into the other services offered by the financial sector, particularly the provision of bank accounts to consumers and corporates and cash management/treasury services for corporates.

14. An estimate of the number of customer-facing firms authorised to operate in the UK can be gathered from Financial Conduct Authority (FCA) data[1]:

- Credit institutions (UK banks and building societies) – 341
- E-money institutions – 119
- Authorised payment institutions – 371
- Registered (small) payment institutions – 721

15. Non-bank firms providing stand-alone money transfer and remittance activities and merchant acquiring activity are regulated as e-money or payment institutions.

16. Cross-EU activity is an important part of the business model for firms providing money transfer and remittance activities. Both banks and non-bank firms provide cross-border payments into and from the EU for retail customers, relying on access to Eurozone payment systems. Some money transfer businesses have a large agency network based across the EU to support their business.

17. Cross-EU payments also underpin banks' corporate payments / cash management activities, as they provide services into the EU for corporate clients based in the UK and worldwide. This is based on the use of Eurozone payment systems and potentially also a branch or subsidiary in other Member States.

18. Payments is recognised as one of the largest sub-segments of FinTech in the UK, which as a whole generated £6.6 billion in revenue in 2015.[2]

19. The card schemes headquartered in the UK are separate corporate entities to the banks, but are closely linked to banking activity as they rely on banks to issue cards and for bank customers to then use the card network. UK based card schemes operate across the EU. However, they do not rely on EU legislation (e.g. an authorisation regime) to do this, except to the extent that they also provide payment services to end customers.

20. Payment services firms are found across the UK, with firm headquarters both in and outside of London. As a financial services subsector, payments systems and services regulation is a reserved issue.

The current EU regulatory regime

21. Payment services are subject to an over-arching regime of EU regulation which sets out the right of payers/payees and the obligations on firms providing these services, for both domestic and cross-border activities.

---

[1] 'Implementations of the revised Payment Services Directive (PSD2): draft Approach Document and draft Handbook changes' (page 71), Financial Conduct Authority, April 2017

[2] 'UK FinTech on the cutting edge: An evaluation of the FinTech sector', EY (commissioned by HM Treasury)

22. The key pieces of EU legislation affecting payment services include:
    - **The second Payment Services Directive (PSDII)** – sets out obligations for firms providing payment services (such as minimum processing times) and rights for firms and consumers making payments.
    - **The second E-money Directive (EMDII)** – sets out rights and obligations for firms and consumers for the provision and issuance of e-money.
    - **SEPA Regulation and Cross-border Payments Regulation** – created the Single Euro Payments Area: common rules for payments in Euros.
    - **Interchange Fee Regulation** – caps interchange fees paid by a consumer's bank to a merchant's (acquiring) bank/processing firm for most retail debit and credit card transactions.
    - **The fourth Anti-Money Laundering Directive (AMLDIV)** – sets out obligations for firms to carry out due diligence measures in relation to their customers
23. The majority of UK payment services are governed by PSDII, including money transfer and remittance activities, merchant acquiring and corporate payments. Credit institutions (banks and building societies) authorised under the fourth Capital Requirements Directive (CRDIV) and e-money institutions, authorised under EMDII, may provide payment services under their existing authorisations, but must comply with PSDII's conduct requirements.
24. Firms that are not authorised under CRDIV and EMDII must be authorised under PSDII as a payment institution, unless they are small enough to qualify for an exemption. There is a passport for authorised payment institutions; but there is no equivalence regime for third country firms.
25. The SEPA Regulation, which sets out the rules for credit transfers and direct debits in Euros between payment service providers based within its geographical scope, also governs many euro-denominated payments. The SEPA Regulation effectively allows banks that meet the rules to send low-cost euro payments to other SEPA participants, through European payments systems (such as EBA [Euro Banking Association] Clearing's STEP2). SEPA is governed by the European Payments Council (EPC), which, while an independent trade body, works closely with the European Commission and the European Central Bank (ECB).
26. Card schemes' activities are not regulated under PSDII and are not subject to an authorisation regime, so passporting is not of direct relevance to them. However, the activities of any firms issuing payment instruments (e.g. the bank issuing credit or debit cards) or merchant acquirers acquiring transactions within that card scheme are regulated under PSDII.
27. Inter-bank payment systems (activity 5 above) underpinning the majority of payment services are not subject to an over-arching regulatory regime; there are not, for example, pan-European 'authorisation' requirements. However, the Settlement Finality Directive (SFD) does allow for the smooth functioning of these systems by

limiting issues that would arise if a participant in a designated SFD system, such as a payment system, were to become insolvent.

28. Consumer and competition law is particularly relevant to this sector. Competition cases and decisions by the European Commission and the Court of Justice of the EU have had a particular influence on the formation of the Interchange Fee Regulation, which sets a cap on the level of interchange fees (paid to the card issuer as a cut of each transaction) and which was designed to address market failures in this sub-sector.

Existing frameworks for how trade is facilitated between countries in this sector

29. The arrangements described in this section are examples of existing arrangements between countries. They should not be taken to represent the options being considered by the Government for the future economic relationship between the UK and the EU. The Government has been clear that it is seeking pragmatic and innovative solutions to issues related to the future deep and special partnership that we want with the EU.

30. With respect to international trade, the World Trade Organization's General Agreement on Trade in Services (WTO-GATS) establishes a baseline for trade in services including in relation to all financial services, including payments. This has been developed through EU FTAs with, in particular, South Korea and Canada.

31. Non-EEA countries are currently able to access EU payment systems. SEPA has specific access criteria against which third countries can be judged. If deemed functionally equivalent by the European Payments Council (EPC), an industry led body that governs SEPA, and the European Commission has raised no objection, then third countries can participate in the SEPA schemes. Currently, Switzerland, the Crown Dependencies (Guernsey, Jersey and the Isle of Man) and others participate in SEPA as third countries.

32. More widely in financial services, there are well-developed principles at the international level that seek to support cross-border activity and avoid duplicative regulation and fragmentation. These are set out in more detail in the Wholesale Capital Markets report.

Sector views

[This information was provided by the Government to the Committee, but the Committee has decided not to publish this section]