

The Payments Revolution

- access to payment systems -

when opportunity knocks



15 May 2009

Long before the Payment Services Directive ("PSD") had even been contemplated, competition concerns had been identified in the field of UK payment systems. Previously, these concerns had been addressed through a series of voluntary initiatives and a number of investigations by the competition authorities. Going forward, under the Payment Services Regulations 2009 ("PSRs"), the Office of Fair Trading ("OFT") will have specific new powers to oversee the rules and conditions governing access by authorised and small payment institutions (including EEA authorised payment institutions) to payment systems. In this briefing paper, we examine the aim of the access requirements under the PSRs and consider how these requirements might operate in practice. We also address the likely impact of the OFT's new supervisory powers pursuant to the PSRs on payment systems operators and those who use (or wish to use) payment systems.

The recent past and where we are now

According to the Cruickshank Report prepared at the request of HM Treasury and published in 2000, "... the membership criteria of the main UK payment schemes distort competition by restricting full access to banks and other deposit taking institutions. This restriction cannot be justified by the risks involved and leads to reduced competition and innovation. Further restrictions imposed by individual schemes make the problem worse".

The Cruickshank Report also described the competition authorities' attitude to banks on the issue of access requirements for key UK payment schemes as "benevolent" and pressed for radical change. Since then, there have been a number of industry-wide, voluntary initiatives to address concerns identified in the Cruickshank Report, as well as other statutory and industry-wide supervision and review of UK payment systems (see **Box 1**). There have also been a number of specific interventions by the UK and EU competition authorities relating to UK payment systems (see **Box 2**).

What is the aim of the new access requirements in the PSRs?

Under the PSRs, the OFT will have new powers to scrutinise access to payment systems. According to the OFT, the key aim of these new powers is "to ensure that authorised payment institutions and small payment institutions are allowed access to payment systems in the UK on an even playing field".

What is a "payment system" for the purposes of the PSRs?

To determine the meaning of a "payment system" for the purposes of the PSRs, it is appropriate to consider the context in which the concept is used in the PSD. According to the PSD's recitals, the PSD is only concerned with such systems to the extent it is necessary to ensure fair access to "technical infrastructures", in which it is "essential" for payment service providers ("PSPs") to participate in order to provide their payment services. On this basis and, in our view, it is the public or quasi-public nature of the services provided by a payment system and their wider impact on the financial system or end-users, that makes it appropriate for the PSD to provide a restriction on the general contractual freedom of a payment systems operator to determine the basis and terms on

Key client points:

- *The OFT will have new powers to scrutinise access to payment systems.*
- *Rules or conditions governing access to payment systems will be prohibited unless they are objective, proportionate and non-discriminatory, and do not restrict access more than is necessary to ensure the safety and stability of the payment system.*
- *In addition, certain restrictive or discriminatory rules or conditions are prohibited outright.*
- *The OFT will have extensive powers of investigation and enforcement, including the power to impose a fine of such an amount as it considers appropriate.*

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which it chooses to admit new members in its system.

Where the services provided by a person lack this fundamental character of a "public function", we think it unlikely that it would be considered to be an operator of a "payment system" for the purposes of the PSRs.

Which particular payment systems will be scrutinised by the OFT?

The OFT has already indicated a number of payment systems which it considers to be within the scope of its powers under the PSRs, including LINK (the UK's ATM system) and the Visa and MasterCard credit and debit card systems.

The OFT is expected to issue further guidance on this issue at the end of May 2009 but, in the meantime, the scope of its powers in this area is most clearly delineated by the exceptions, i.e. the payment systems which fall outside its scrutiny, which are as follows:

- systems designated under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, such as CHAPS, BACS and the "embedded payment system" that operates in CREST (the UK's securities settlement system);
- payment systems composed exclusively of PSPs belonging to the same group, where one of the group entities has effective control over the other group members, for example, an internal system used between RBS, ABN AMRO and Natwest; and
- payment systems where a sole PSP (whether as a single entity or as a group) (a) acts (or is able to act) as PSP for both payer and payee, (b) is exclusively responsible for the management of the system and (c) licenses other PSPs to participate in the system, subject to their having no right to negotiate fees in respect of the payment system between or among themselves, for example, American Express or the money transmission system operated by Western Union. (This does not preclude the licensed PSPs from establishing their own pricing in relation to payers and payees.)

What access requirements are prohibited under the PSRs?

Any rules or conditions governing access to those payment systems which fall within the OFT's powers of scrutiny will be prohibited, unless they are **objective, proportionate and non-discriminatory, and do not prevent, restrict or inhibit access more than is necessary to ensure the safety and stability of the payment system.**

In addition, rules or conditions governing access to such payment systems which:

- restrict effective participation in other payment systems;
- discriminate (whether directly or indirectly) between different authorised payment institutions, or different small payment institutions, in relation to the rights, obligations or entitlements of participants in the payment system; or
- impose any restrictions on the basis that a person is not of a particular institutional status,

are prohibited outright.

To see what the practical implications of these prohibitions on restrictive access requirements might be, please refer to the section below, headed "*How might these access requirements apply in practice?*".

What can the OFT do?

There is no requirement to submit rules to the OFT for vetting and approval before they are introduced and so the OFT does not have the pre-approval role which the Financial Services Authority ("FSA") has in the context of the PSRs' authorisation and registration regime. Rather, it seems that the OFT will keep a watching brief and has the power to initiate investigations as and when it deems appropriate, for example, following a complaint. With this in mind, the OFT has already, in the context of the FSA's guidance on its approach to the PSRs, been encouraging potential complainants to come forward to alert them to existing rules governing access to payment systems which may breach the PSRs.

If the OFT suspects that a rule breaches the PSRs' access requirements, it can carry out an investigation, including requiring documents and information to be provided to it.

If the OFT finds that a rule breaches the PSRs' access requirements, it can impose a fine of such amount as it considers appropriate if it is satisfied that the infringement was committed intentionally or negligently. No maximum limit has been stipulated in the PSRs and no guidance has, as yet, been issued as to how it will be calculated. The OFT may also give directions which can:

- require the amendment of any rule or condition so that it no longer contravenes the law; and
- relate to the conduct of any person the OFT considers appropriate in implementing a rule or condition.

It will be possible to appeal directions made or fines imposed by the OFT to the Competition Appeal Tribunal, as is currently the case for certain decisions of the OFT under the general competition law regime.

How might these access requirements apply in practice?

The following are examples of how the PSRs' access requirements might apply in practice:

- The OFT might find an access rule that did not take into account the relevant differences between members of a payment system to be disproportionate. For instance, a rule that required all members of a payment system to pay the same fees, regardless of usage of the system, could be disproportionate. A payment system that made allowance for different levels of usage, perhaps by having a sliding scale of fees for membership, might be more proportionate. This wouldn't necessarily prevent a payment system from having a fixed element to its pricing.
- Rules requiring users of the system to use one particular supplier of services could be unnecessarily restrictive. Instead, a rule that says that suppliers of a service must meet certain criteria, based on their ability to supply a safe, secure service, is more likely to be acceptable.
- A rule which had the effect of denying access to payment institutions who aggressively marketed themselves at the expense of other members of the payment system could be considered unnecessarily restrictive if it did not contribute to the financial and operating stability and security of the payment system.

What do the PSRs add to existing EU/UK competition law?

Arguably, there is a significant overlap between the access requirements in the PSRs and existing competition law in terms of the rules which may be subject to challenge. However, the PSRs create an additional avenue of challenge for those seeking access to payment systems which is likely to be more cost-effective and quicker for complainants than a complaint under general EU and UK competition law (see **Box 3** for a summary of key general EU and UK competition law provisions). A particular advantage of a challenge under the PSRs is the relatively straightforward, rule-based test. By comparison, general competition law is likely, in most cases where the PSRs would also be a suitable basis for complaint, to require a more complex, effects-based analysis. Such considerations will not only help the scrutiny regime under the PSRs to find favour with complainants, but may also lead the OFT to prioritise complaints under the PSRs.

Competition law will, nonetheless, continue to have an important role to play as regards access to payment systems. For example, competition law will still be the primary avenue of complaint for companies facing obstacles that are not rule-based or where the relevant payment system does not fall within the OFT's powers of scrutiny under the PSRs. In addition, it may be advantageous to bring a claim regarding a pan-European issue under general competition law (see "*What about access to non-UK payment systems?*" below).

What about access to non-UK payment systems?

As the PSD must be implemented in all EEA member states by 1 November 2009, the effect of the PSD's access requirements will be felt beyond the UK and may represent a particular opportunity for new PSPs in those member states which have not previously focused on competition problems relating to the key payment systems operating in that member state.

In addition, companies may prefer to approach the European Commission (the "Commission") directly under EU competition law regarding a pan-European issue, given the Commission's EU-wide jurisdiction on such issues under competition law. In contrast, to address such an issue under the new payment services regime, it would be necessary to approach the various national regulators under the PSRs in the UK and the equivalent provisions implementing the PSD in each of the other relevant member states. In such a case, it may be that competition law provides the more cost-effective and quicker route for complainants.

Box 1

Previous industry-wide supervision / review of payment systems

(a) "PayCom"

The Cruickshank Report recommended that an independent regulator - PayCom - should be established to set up a mandatory licensing regime for money transmission systems. Instead, following the publication of the Cruickshank Report, HM Treasury offered industry participants an opportunity to address the concerns identified by the report on a voluntary basis and the Payment Systems Task Force (which was chaired by the OFT with other members including The Bank of England, HM Treasury, the British Bankers' Association and a range of other industry bodies) was established to do so. The Payment Systems Task Force was subsequently disbanded after industry participants agreed to establish the Payments Council, the remit of which is to work "*to ensure that UK payment systems and services meet the needs of users, payment service providers and the wider economy*". There have been a number of improvements to payment systems as a result of these voluntary structures, including the implementation of the Faster Payments Service, which now allows certain UK customers to make and receive certain payments within hours. However, some critics have argued that Cruickshank's PayCom solution would have resulted in more rapid progress in relation to the concerns he identified.

A recent report by the OFT, whilst recognising that some progress had been made, criticised certain elements of the Payments Council's work. In particular, the OFT recommended that a specific mechanism should be introduced to take into account the views of non-member users, such as businesses or consumers, in relation to the Faster Payments Service. The OFT also advocated a change to the Payment Council's rules "*to allow bodies other than payment service providers to join the Payments Council as full members*".

(b) The Bank of England (the "Bank")

The Bank is responsible for overseeing systemically important payment systems in the UK in the context of the overall robustness and resilience of the financial system and the extent to which such payment systems could threaten financial stability through disruption and contagion. Its role does not extend to consumer protection objectives, which lie with other bodies, including the OFT, the Payments Council and the FSA.

As part of its oversight function, the Bank assesses systemically important payment systems against a set of longstanding core principles. Core Principle IX prescribes that the system should have objective and publicly disclosed criteria for participation,

which permit fair and open access. This principle mirrors the overarching purpose of the access requirements under the PSRs.

Until recently, the Bank's payment systems oversight role had been on a purely non-statutory basis. However, earlier this year, the Banking Act 2009 (which is designed to strengthen the existing framework for financial stability and depositor protection by establishing a regime with improved mechanisms for dealing with failed banks) received Royal Assent and includes a statutory framework for the oversight of certain "recognised" inter-bank payment systems by the Bank. In its new role as statutory overseer of operators of recognised inter-bank payment systems (which are likely to consist of those payment systems designated under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999), the Bank can be expected to require operators of such systems to have rules for access which meet the objective, proportionate and non-discriminatory criteria to be applied to payment systems subject to scrutiny by the OFT under the PSRs.

(c) EU Financial Services Sector Inquiry

Between 2005 and 2007, the Commission conducted a competition law sector inquiry into financial services in the EU. One main strand of the inquiry related to payment cards and payment systems. The Commission's final report raised concerns regarding, amongst other issues, the level of default interchange fees in certain payment networks, particularly in relation to cross-border transactions, (see **Box 2**). The Commission also emphasised the importance of access to clearing and settlement for any bank intending to enter a new retail banking market and noted that the Directive, then at a very early stage, would be one relevant next step in minimising access restrictions to payment systems.

Box 2

Examples of specific intervention by the UK and EU competition authorities relating to UK payment systems

(a) ATMs

The OFT concluded in 2001 that the agreements for the operation of the LINK network, in particular the default interchange fee arrangements, met the criteria for individual exemption from the usual application of Chapter I (see **Box 3**). The OFT found that the benefits of the LINK system (such as the fact that it would be more expensive for all the members to negotiate individual interchange fee arrangements with each other) outweighed any restriction of competition arising from the use of the relevant default interchange fees.

This exemption granted by the OFT expired in October 2006. The OFT no longer has the ability to grant exemptions (see **Box 3**). However, the LINK arrangements have continued since the expiry of the exemption and the OFT has not publicly indicated that it now regards the arrangements as problematic.

(b) Credit / debit card default interchange fees

Unlike the default interchange fee in the LINK Rules, certain of the EEA cross-border and EU member state domestic default interchange fees applying in the MasterCard and Visa systems are meeting with considerable resistance from the Commission and the OFT.

The Commission decided in 2007 that MasterCard's EEA cross-border, and certain domestic, default interchange fees had the effect of restricting price competition between acquiring banks (i.e. the retailers' banks). Its view was that the fixing of the level of interchange fee restricted price competition on the merchant service charge charged by the acquiring banks to retailers (the "MSC"). The interchange fees comprised a large part of the MSC (about 70% in some member states) and effectively set a floor below which the MSC would not be reduced. The Commission considered that this had inflated the costs of payment card usage for both retailers and their customers and infringed Article 81 (see **Box 3** for a description of Article 81). Subsequent to this decision, MasterCard agreed to reduce its EEA cross-border default interchange fees to 0.3% for credit cards and 0.2% for debit cards and to reduce certain of its domestic member state default interchange fees (for example, in Belgium, Ireland and Italy). The Commission, in turn, announced its intention not to pursue MasterCard for its alleged failure to comply with the 2007 decision.

The Commission originally granted an exemption to Visa's EEA cross-border default interchange fees in 2002. However, this exemption expired in December 2007 and the Commission – apparently now applying the arguably more restrictive approach adopted in its 2007 MasterCard decision - has since issued a statement of objections to Visa, arguing that its current EEA cross-border, and certain EU member state domestic, default interchange fees similarly infringe Article 81.

The OFT has had similar concerns regarding the domestic default interchange fees applying to MasterCard and Visa domestic transactions in the UK. It initially found, in September 2005, that the domestic default interchange fee imposed by MasterCard in the UK (under the MasterCard structure in place prior to that time) was anti-competitive. It also issued a statement of objections to Visa in October 2005 regarding the default interchange fee applicable to UK transactions using Visa cards. On appeal, the Competition Appeal Tribunal set aside the OFT's decision in relation to MasterCard's domestic default interchange fee. The OFT then announced that it would no longer investigate the previous MasterCard default interchange fee arrangements and would instead concentrate on examining MasterCard's and Visa's current domestic UK arrangements. The outcome of these investigations is still pending.

(c) Other credit / debit card rules

The Commission also previously considered in 2001 certain other rules of the Visa system applicable in the EU, including the "territorial licensing", "no discrimination", "cross-border issuing", "cross-border acquiring", "no acquiring without issuing" and "honour all cards" rules. Certain of these rules were amended or withdrawn by Visa and, as regards the remainder, the Commission determined that none of the rules in question resulted in a breach of Article 81. However, in its 2009 statement of objections, the Commission set out its current view that rules such as the "honour all cards" rule increase the restrictive effects of the default interchange fees.

(d) *Visa / Morgan Stanley*

In April 2000, Morgan Stanley complained to the Commission that it had been refused membership of Visa because it was the owner of the Discover brand credit card network in the US. Visa was applying one of its bylaws which prevented membership by competitors. In 2007, the Commission imposed a €2 million fine on Visa. This decision is currently subject to an appeal to the Court of First Instance. In the interim, Visa has reached a settlement with Morgan Stanley and admitted it to its network.

The Commission reasoned that Morgan Stanley was not a competitor of Visa in the UK card networks market. There was no real possibility of its entering the EU market with its Discover card network. Therefore, Visa had applied the rule without objective justification. In addition, the refusal of Morgan Stanley's membership was discriminatory as Visa had previously accepted card network operators, such as Citigroup (the owner of the Diners Club network) and the shareholders of the JCB card, as members.

The Commission decided that the refusal amounted to a breach of Article 81 as it prevented Morgan Stanley from providing merchants with card acceptance capabilities in relation to Visa and other cards. It also restricted competition in the market as a whole as Morgan Stanley was a likely effective entrant into a highly concentrated market.

Box 3

Relevant general EU and UK competition law provisions

(a) Article 81

Article 81 is concerned with anti-competitive agreements between undertakings. Article 81(1) **prohibits agreements** which may affect trade between EU member states and which have as their object or effect the prevention, restriction or distortion of competition in the EU. The effect on trade must be appreciable. Under Article 81(3) an agreement caught by Article 81(1) may nonetheless **escape prohibition if it gives rise to benefits** that outweigh its anti-competitive effects.

Until 1 May 2004, an exemption could be gained either by means of notification of the agreement to the Commission for an **individual exemption** or by ensuring that the agreement complied with the terms of one of the published **block exemptions**. On 1 May 2004, the system of notifying agreements for individual exemption came to an end and self-assessment by the parties is now required. The system of published block exemptions, however, remains in force.

(b) Article 82

Article 82 prohibits an **abuse** by one or more undertakings of a **dominant position** within the EU or in a substantial part of it, having an effect on trade between member states.

Examples of potential abuses of a dominant position include:

- imposing unfair prices or other trading conditions;
- limiting production, markets or technical development;
- undue discrimination; and
- tying (i.e. making the supply of a product or service required by a customer conditional on the purchase of another product or service).

(c) UK competition law

Chapter I and Chapter II of the Competition Act 1998 are the provisions of UK law which correspond to Article 81 and Article 82 of the EC Treaty, respectively, albeit that Chapter I and Chapter II relate to agreements, trade or conduct which affects competition within the UK, rather than within the EU.

Disclaimer

Please note that the contents of this note provide an overview only. This note is guidance only and should not be relied upon as legal advice. Clients' circumstances will differ in each case. If you would like to receive specific advice on the new regime for payment services, please contact:

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