Financial Services Future Regulatory Framework Review

Response to the call for evidence on regulatory coordination by Link Scheme Holdings Ltd

Introduction

1. In his 2019 Spring Statement the Chancellor announced that the Treasury would be conducting a review of the financial services regulatory framework. On 19th July the Treasury issued the first publication as part of this review, a call for evidence on the processes for managing the combined impact of regulatory change on financial services firms and their customers, including coordination between regulatory authorities. The call the evidence runs from 19th July to 18th October 2019.
2. Link Scheme Holdings Ltd (Link) is responsible for managing the country's largest cash dispenser (ATM) network. All the major card issuers and ATM operators belong to Link. Link is regulated by the Payment Systems Regulator (PSR) as a payment system and by the Bank of England as a systemically important financial infrastructure. However, Link has also assumed responsibility for ensuring that communities throughout the UK have free access to cash, a public policy issue that predominantly rests with HM Treasury and other government departments. Link therefore has a significant interest both on the impact of regulatory change and on coordination not only between regulatory authorities but also between regulatory authorities and those responsible for wider public policy.

Executive summary

3. Link's key observations are as follows:
   - 3.1 The financial services market is changing rapidly, primarily in response to technological developments.
   - 3.2 The policy and regulatory framework is bound to lag behind changes in the marketplace, which can cause problems for financial institutions and for the markets in which they operate.
   - 3.3 Regulators tend to operate in silos, reflecting their mandates, which can mean that their policies and practices may not fully reflect the interests either of other regulators or more importantly of wider public policy concerns.
   - 3.4 Memoranda of understanding, overlapping boards and joint committees can all mitigate this problem although it needs managing proactively and with clear overarching objectives. The Bank of England's overarching requirement on the need for operational reliance is an example of this being done well. An effective feature of the Bank's approach is the strong coordination of different participants as well as different regulators. This approach should be developed.
   - 3.5 More direct input from government on clear high-level policy is required to help regulators align. The Treasury's recent helpful guidance on the need to manage cash access is an example of this being done well.
   - 3.6 The PSR has a very narrow focus and in retrospect its responsibilities should have been assigned either to the Bank of England or to the Financial Conduct Authority (FCA) rather

than to a standalone regulator. Link welcomes moves to integrate more closely the work of the PSR with the FCA and the Bank.

The changing financial marketplace

4. The financial services marketplace is changing at probably an unprecedented rate. In the retail banking sector, in which Link operates, 40 years ago people typically obtained cash from bank branches and made payments by cheque. With the advent of the cash dispenser, people visited banks less often as ATMs were more convenient. Over time, credit and debit cards and direct debits have increasingly replaced cheques, and more recently internet banking has accelerated this trend. Debit cards have also increasingly replaced cash. This trend has in the last three years been substantially accelerated by the use of contactless cards combined with low-cost technology that enables very small businesses and even individuals to accept card payments. Non-traditional institutions, such as Apple and Google, have also entered the payment market, and a number of challenger banks have been established, operating entirely electronically.
5. These trends have inevitably meant a significant reduction in the number of bank branches and more recently in the number of ATMs. However, public policy typically seeks to protect what exists. There is therefore the paradox of public policy overtly encouraging new banks (all of which have no branches) while at the same time expecting long-established banks to maintain physical access to cash through branches and ATMs.

The policy and regulatory framework

6. It is inevitable that public policy and the regulatory framework lag behind changes in the marketplace. Policymakers and regulators do their best to adapt to the changing marketplace but cannot be 100% successful. For example, regulators struggle with "policing the perimeter" as the perimeter becomes much more porous, a point acknowledged in July 2019 by the Chairman and the Chief Executive of the FCA in evidence to the Treasury Select Committee and endorsed by the Committee. Regulators tend to be blamed not only when things go wrong within their remit but also when people lose money through investing in products or with institutions which are outside the remit of the regulator. There is also a growing expectation that the public should be protected from any malpractice on the part of financial institutions, and also that their access to financial services will be enhanced if not preserved, often at no cost.

Silos between regulators

7. Regulators tend to operate in fairly tightly defined silos. This is not necessarily a criticism but rather reflects the legislation under which they are established, which clearly sets out their objectives and roles. However, it is inevitable that regulators will tend to err on the side of ensuring that their specific objectives are met, even if this is at the expense of wider public policy objectives:
    7.1 For example, there is a general public policy objective of assisting people to purchase their own homes. However, the Prudential Regulation Authority (PRA) imposes strict prudential requirements on mortgage lending. This prevents some people who could otherwise afford to buy a home from doing so. Public policy is therefore frustrated, and the regulator does not have to bear the cost of people not being able to buy homes, which might include occupying subsidised rented accommodation or simply occupying

higher cost rented accommodation. The regulator is able to claim success in that mortgage lending losses are minimal and that mortgage lenders are ultra-safe, but little consideration is given to the impact on the housing market.

7.2 Another example illustrates the sometimes illogical regulatory boundaries between markets. An investor wishing to invest in equities but to spread risks would be well advised to invest in a collective investment scheme that broadly tracks a share index. However, the regulatory requirements around such investing are substantial and costly, and in many cases sufficient to deter people, who may therefore invest in a single equity with virtually no regulatory protection, but exposing the individual to much greater risk. Meanwhile, on the streets, "chuggers" aggressively seek to persuade people to sign standing orders paying significant amounts to charities. This activity is subject to no more than a voluntary code of practice.

8. Link believes that the rather fragmented nature of payments regulation means that managing these silos is especially important for authorities if they are to avoid unfortune consequences. The mandated tender exercise for Link's infrastructure, run by the PSR, gives good examples of some of the issues, and also some of the approaches that can resolve them.

9. The PSR has fairly narrow statutory objectives relating to the payment systems that it regulates. They are as follows:

9.1 Ensure that payment systems are run and developed in a way that takes account of and promotes the interests of those that use, or are likely to use, the systems.

9.2 Promote effective competition in the market for payment systems and markets for services provided by payment systems in the interests of those who use, or are likely to use, them.

9.3 Promote the development of, and innovation in, payment systems in the interests of those who use, or are likely to use, them.

It will be noted that the objectives make no direct reference to enhancing outcomes for consumers.

10. In pursuit of these objectives, the PSR required LINK to conduct a mandated procurement exercise for its infrastructure provider. Arguably, it was from its perspective, reasonable for it do so given its objective of promoting competition in the market for payment systems. However:

10.1 Payment systems also need to maintain low systemic risk. The initial mandate did not appear to consider systemic risk adequately.

10.2 In the case of LINK, which operates in a competitive environment alongside the international card schemes, there is also a requirement to remain attractive to participants. The initial mandate did not appear to consider this adequately.

10.3 There was no obvious benefit to consumers whatever the outcome of the tender.

10.4 Finally, Link is operating in a rapidly declining market for cash. A competitive tender for infrastructure is arguably unhelpful in these circumstances. Rather, a move to a more utility approach is likely to be more appropriate. The recent well received Access to Cash Review sets this thinking out.

11. Hence, the narrow mandate of the PSR and the lack of a clear join-up across broader objectives led to an approach that in Link's view was suboptimal, at least initially.

12. During the process, this situation improved, largely due to the increased focus by regulators including the PSR on managing overall outcomes such as systemic risk and access to cash. This is

an example of how this sort of problem should be addressed in the future. The result of the tender process in the end had been an improved contract both commercially and from a systemic risk perspective. However, the overall costs of the approach have been higher than needed, and the uncoordinated thinking at the early stages meant that other pressing matters in the cash payments system (such as maintaining free access in the case of rapidly declining volumes) lacked sufficient attention from regulators and participants. Link's view is that stronger coordination between regulators, guided by a handful of clear policy requirements from government (such as lowering systemic risk and maintaining broad free cash access) is the right way to conduct these matters.

Mitigating the effects of an imperfect regulatory structure

13. Regulators and policymakers are well aware of the issues briefly outlined in this paper. They seek to address them by a mixture of formal memoranda of understanding between institutions, overlapping membership of the boards of regulators, and the establishment of formal joint committees. However, these can do no more than mitigate. It is common ground that when the financial crisis occurred in 2008 the existing arrangements and coordination between the single financial regulator, the Financial Services Authority, the Bank of England and the Treasury were inadequate. The tight dividing lines meant that the institution with the greatest responsibility for financial stability, the Bank of England, did not have the necessary tools or appetite, given its role predominantly as a central bank, to take the appropriate action. This position has been usefully improved and within the current regulatory structure there are statutory obligations on the PRA, the FCA and the PSR to cooperate and to have memoranda of understanding. The chief executives of the PRA and the FCA sit on each other's boards.
14. However, with the best will in the world these arrangements are only mitigants and are heavily reliant on the people operating them. The disagreements between the Treasury, the FCA and the Bank of England during the financial crisis have been well-documented in a number of studies, including the memoirs of the then Chancellor Alistair Darling. While regulatory authorities are generally excellent in preserving confidentiality, political bodies are less so and from time to time there are press reports of significant disagreements on regulatory or wider public policy issues.
15. The issue of access to cash provides a useful case study of how public policy tends to lag behind market developments, often leading to a sticking plaster approach.
16. Several government departments have an interest in access to cash:
    - 16.1 The Department for Work and Pensions (DWP) shares with the Treasury responsibility for financial inclusion and has a particular interest in enabling pensioners and benefit recipients to access cash. The DWP is represented on Link's Consumer Council.
    - 16.2 HMRC has expressed interest in the roles of different payment methods, including cash, on tax collection effectiveness and fraud and error.
    - 16.3 ATMs need planning permission if they front directly on to the street. Obtaining planning permission can be costly and time-consuming. Overall responsibility for planning in England rests with the Ministry of Housing, Communities and Local Government, but individual local councils have a considerable amount of discretion and there are significant differences in approach between councils. Also, if the building is listed then Listed Building Consent is needed.

16.4 The closure of bank branches and ATMs is part of a wider trend of the running down of the traditional high street. The Ministry of Housing, Communities and Local Government has policy responsibility for this area in England.

16.5 Rural areas have their own problems. The Department for Environment, Farming and Rural Affairs is the responsible department.

16.6 The Scottish Government and the Welsh Assembly are both interested in the issue and have devolved responsibility for some policy areas.

16.7 The Post Office is an important source of cash and banking facilities generally and is becoming more so as bank branches and ATMs close. It is also represented on Link's Consumer Council. The sponsoring department for the Post Office is the Department for Business, Enterprise and Industrial Strategy.

17. The use of cash has now been declining for nearly 10 years. "Access to cash" is no longer just about bank branches and ATMs, but rather includes Post Offices and retailers' tills (this option is currently limited in part because of PSD2 regulation). The regulatory framework is ill-suited to addressing this issue. The primary regulator of Link, the PSR, is pursuing its objectives of competition in the provision of financial infrastructure, the FCA is constrained in changing regulation to allow cash to be obtained from retailers' tills, while Link and the banks are trying to get on with actually addressing the problem.

18. Link, as the company actually responsible for managing the network of ATMs, has been actively addressing this issue for several years, partly through running a financial inclusion programme to provide access to cash in areas which could not justify a cash dispenser, and more recently by restructuring the fees that card operators pay to ATM operators to support the continuation of low-volume machines and reduce the incentive for the excessive clustering of machines in busy urban centres. As part of this work, in 2018 Link commissioned an independent Access to Cash Review, chaired by Natalie Ceeney CBE. This gained substantial traction amongst all stakeholders, including HM government and the Bank of England as well as the direct participants in the market. Arguably, this was something that the government should have initiated.

19. The conclusions and recommendations of the Review have been broadly accepted by all stakeholders. Subsequently, the government has established a co-ordinating body. In June 2019 it was announced that: *"HM Treasury (HMT) has established and will chair a Joint Authorities Cash Strategy (JACS) Group, bringing together the Payment Systems Regulator (PSR), the Financial Conduct Authority (FCA) and the Bank of England (BoE). This is within the context of the Government's policy to safeguard access to cash for those who need it, whilst supporting digital payments."*

20. The announcement was clear recognition that left to their own devices the regulators would be unlikely to have a series of policies which would together meet the government's objective, hence the need for the political organisation, the Treasury, to be seen to be taking the lead. Link sees it as an important step forward in how regulators coordinate and is as far as we aware the only example so far of such a group being set up.

The cost of regulation

21. Regulators charge fees but the bulk of the cost of regulation is through regulatory requirements, either to conduct business in a certain way, or to give assurance to regulators or to provide information. Regulators worldwide and not just in Britain have increasingly been requiring regulated institutions to change their governance, commission external reports on aspects of

their business, beef up internal or external audit requirements, etc. Some of this might be reasonable and what institutions should be doing anyway but some of it is not what institutions would choose to do themselves and may be a little value to them. However, it does give protection to the regulator by limiting the chance of anything going wrong (as opposed to business being lost). The cost of all these measures is always born by the institutions not by the regulator, and it is not transparent.

22. It is also an inbuilt trait of regulators to seek more information, an act which is virtually costless to the regulator, but can lead to huge costs on the part of regulated institutions. Financial institutions have no problem in providing data which the regulator requires to do its job but often regulated institutions know that the data is little or no use to the regulator and very costly to themselves to provide. Nevertheless, they have to continue providing the data or they will be in breach of their regulatory requirements. Government departments are required to conduct impact assessments of policies and regulations, but regulators are partly exempt from this. The regulator exercising its power to require institutions to provide data may provide no justification for this other than simply a few lines with no costs involved. The cost to the regulated institutions can run into millions, especially where IT changes are involved. While attempting to impose regulation on regulators in this respect is probably a step too far, regulators need to be far more aware of the cost they are capable imposing on others in relation to the benefits and these should be explicitly considered when data requests are made.

The regulatory structure

23. Paragraph 25 of the call for their evidence states that there are five regulators responsible for the regulation and supervision of financial services firms:

    23.1 The FCA is the conduct regulator of 58,000 financial services firms and the prudential regulator of 18,000 of those firms.

    23.2 The PRA is responsible for the prudential regulation and supervision of around 1,500 institutions, including the major banks and insurance companies.

    23.3 The Bank of England is responsible for the financial market infrastructure.

    23.4 The PSR is the economic regulator of the £81 trillion payment systems industry.

    23.5 The Competition and Markets Authority (CMA) is the UK's primary competition and consumer authority.

24. However, this categorisation is somewhat misleading. The CMA is not a financial regulator although it exercises concurrent jurisdiction with the FCA and PSR to apply competition law in the financial services sector. The PRA is closely integrated with the Bank of England and with similar financial stability objectives. The PSR, whilst housed within the FCA, has very different objectives (it is an economic regulator rather than a conduct regulator) and has just 81 staff. Paragraph 2.1 of the call for evidence states that "The government believes that the regulatory institutions that are in place are the right ones". However, informal discussion with policy makers, including those heavily involved in establishing the structure, and given the analysis in this paper, rather suggests that creating a separate PSR as an economic regulator was a mistake. Its narrow focus and small staff mean that it is not well-equipped to play a role in wider public policy issues, which are the responsibility of the Treasury, and financial stability issues, which are the responsibility of the Bank of England and the PRA. In retrospect, its responsibilities should have been assigned either to the Bank of England or to the FCA rather than to a standalone regulator.

25. However, the case of the changing a regulatory structure needs to be a very powerful one and the government has already said that it has no plans to change the structure. Nevertheless, Link believes there is merit in seeking to integrate and align as far as possible the work of the PSR into the FCA.

Conclusions

26. Link's conclusions, and specifically seeking to address the questions on the call of evidence, are:

    26.1 There should be even more coordination between the Treasury and the regulators with respect to regulatory interventions. However, regulators and policy makers well understand that. Link has noticed a significant improvement in the position over the past year, particularly in respect of the approach to access to cash.

    26.2 Cross-cutting approaches – both between regulators and in how regulators deal with groups of firms – are helpful. The Joint Authorities Cash Strategy (JACS) Group and the Bank's approach to operational resilience are examples that are effective and that can be developed.

    26.3 Regulators should give more attention to the cost that is imposed on regulated institution institutions, not predominantly through formal regulatory changes, which may well be subject to an impact assessment, but rather through data requests with the data requested being of little use to policymakers or to the institutions from which it is requested.

    26.4 The PSR needs to be more integrated and aligned within the FCA. The overall focus on consumers should be stronger.