Unlocking the potential of Open Banking

Why the Payment Systems Regulator, as part of the Joint Regulatory Oversight Committee, is planning regulatory intervention

Variable Recurring Payments Phase 1

2 May 2024

Background

In 2014, a review into the provision of consumer and SME banking services by the UK's competition regulator, the Competition and Markets Authority ("CMA"), concluded that ***it was likely that competition was being prevented, restricted and/or distorted.*** The result of this was that consumers and SMEs were likely suffering (and paying) as a consequence of anti-competitive bank behaviour and practices.

Following this review, formal CMA market investigations confirmed that there was indeed a lack of competition, and that the banking sector needed fixing if it was to serve consumers and SMEs. The result of this market investigation was a CMA Order in 2017, which was hoped to remedy the distorted banking services market.

Concurrently, new legislation, the 2nd Payment Services Directive ("PSD2") came into force in the UK in 2018. PSD2 provided for new types of FCA authorised and regulated companies:

i) Payment Initiation Service Providers ("PISPs") who would provide Payment Initiation Services ("PIS"), and

ii) Account Information Service Providers ("AISPs") who would provide Account Information Services ("AIS").

Utilising the legislative enablers in PSD2, the CMA Order required:

(i) the 9 largest banks in the UK and Northern Ireleand (termed the "CMA9[1]") to build, provide and maintain standard and secure APIs. These APIs would allow FCA regulated PISPs and AISPs to provide innovative services enabled by PSD2 to consumers and businesses; and

(ii) an independent central not-for-profit body (now called OBL, Open Banking Limited), be set up, governed by and answerable to the CMA, to safely and securely manage the standards and usage of the APIs described in point (i).

[1] The CMA 9 banks comprise: Barclays plc, Lloyds Banking Group plc, Santander, Danske, HSBC, Royal Bank of Scotland, Bank of Ireland, Nationwide and Allied Irish Bank

From a payments perspective, the CMA Order API requirements covered the initation (with explicit customer consent) of Open Banking single payments, and Open Banking repeated payments, so-called Variable Recurring Payments ("VRP"). However, banks argued that allowing consumers to pay *all* their bills via lower cost secure Open Banking VRP went beyond the original harm the CMA had authority to rectify. Consequently, the CMA Order was restricted to allow the following:

i) single ad hoc payments, and

ii) VRP where both sending and receiving account are in the same name. For example: from my current account to my savings account, from my current account to my loan account, from my current account to my credit card account, so-called "me to me" payments, or "sweeping".

As a result of the CMA Order mandating and standardising PSD2 Open Banking implementation, the UK is a global leader in Open Banking.

Timeline and documents

Why did the UK government and the CMA endorse Open Banking?

Many market studies have shown the usage of cheques and cash dramatically reducing. The corollary of this is that card payments are significantly and consistently rising, a trend accelerated by COVID. Provision of card payments is enabled by the duopoly of Visa and Mastercard. As the UK becomes ever more cashless, the dominance of Visa and Mastercard, and their card issuers – the banks, become ever more powerful and dominant. The UK is unique in that it does not have an effective competing payment method to cards.

Open Banking solutions disintermediate the banks and card schemes, and transfer the value that would have gone to banks and card schemes to consumers and businesses. The value transfer manifests as the benefits listed below going instead to those who contribute to the UK's GDP, namely, businesses and the ultimate paying consumer. Competition for banking services to banks and card schemes is, therefore, beneficial for businesses and ultimately consumers.

There is then, a clear case for Open Banking, both at consumer and business level, and for UK PLC.

What are the benefits of Open Banking?

The benefits of Open Banking for consumers and SMEs, and businesses generally, are as follows:

Consumers:

i) Instant money transfer – enabling accurate financial managmenet and improved cash flow,
ii) More time to cancel – dynamic, flexible and controllable,
iii) Enhanced security – reducing fraud and mistaken payments,
iv) Indirect cost saving – saving money,
v) Smooth payment journey – convenient and efficient;

Businesses:

i) Instant money transfer – boosting liquidity,
ii) Lower cost – saving costs,
iii) Greater access than DD – better service provision,
iv) Automatic reconciliation – better services and indirect cost savings,
v) Enhanced security – reducing fraud and mistaken payments, and
vi) Easy to integrate – convenient, efficient and low cost.

Why is further PSR regulatory intervention needed?

There are two structural reasons why further, but minimal, regulatory intervention is necessary for Open Banking to be an effective competitor to cards, and bring about the benefits to the UK outlined above:

(i) the banks' conflict of interest in competing with card payments, and
(ii) the monopoly position of each bank with regard to access to its own customers' accounts.

Banks' conflict of interest

Receiving card payments is expensive for businesses: high direct fees, plus indirect costs of reconciliation and multi-working day clearing cycles, all of which, ultimately, the consumer bears.

The card costs a business has to cover include revenue for the paying consumer's bank: every time a card payment is made, the card holder's <u>bank</u> receives revenue, along with Visa and Mastercard.

Simply enabling a new payment *method* does not increase the *number* of payments consumers and businesses make (ie the pie is not getting any bigger). The more Open Banking is used to make payments, the fewer card payments there will be, and the less card revenue the banks will reap….there are more entities competing and eating the same size pie, so incumbents' slices will necessasrily slim down; the definition of competition resulting in lower costs for consumers.

It is not, and cannot be, in the banks' or card schemes' intersts for Open Banking to succeed, therefore. The banks, from whom cooperation is necessary for Open Banking, have an unresolvable conflict of interest: Open Banking cannibalises their card revenue. This can only be managed with regulatory intervention, which came in the form of the CMA Order for single and sweeping payments to date. Unless the PSR mandates banks to allow their already mandated and built secure VRP APIs to be used for an expanded set of VRP use cases, they are not and cannot be incentivised commercially to do so. All the while Open Banking is not enabled to compete fully with cards, businesses and consumers suffer by continuing to pay, consumers indirectly, high card fees and bank revenue.

Bank Monopoly

To provide their service, Payment Initiation Service Providers (PISPs), having fulfilled the legal requirement of gaining the payer's explicit consent, need access to a payer's bank account to securely set up a payment/VRP mandate for the payer to authorise (or not). There is only one bank a PISP can go to for customer account access, and that is the bank of that customer. Each bank is therefore the gatekeeper to, and monopoly provider of, access to their own customers' accounts. As a bank has a conflict of interst in Open Banking being successful (argument above), it is an untenable position for a bank to also be the single gatekeeper to providing PISPs' with they access they need to provide their service. The bank monopoly gatekeeper position is another reason why regulatory interevention is essential.

As a result of these two structural points, whilst the regulatory intervention in the form of the CMA Order enabled Open Banking single and sweeping payments, the PSR proposed intervention is what is required to expand VRP beyond sweeping.

Why is expansion of Open Banking VRP needed?

For Open Banking to fulfil its potential and be a true competitor to cards, resulting in the benefits to consumers and UK PLC outlined above, it needs a critical mass of adoption. PISPs have had some success so far. However, uptake has been limited as businesses are slower to embrace Open Banking without the ability to collect *all* payment types using a newly procured capability. The repeated payments people need to make are often between accounts which are not in the same name (eg regular bill payments), and do not therefore meet the definition of 'sweeping'. The banks are not *required* by regulation to allow PISPs to initate these payments, and consequently the banks do *not* allow PISPs to initiate these payments. Consumers and businesses are left with limited digital options to make and receive repeated payments beyond sweeping: either slow and expensive card, or slow and restricted direct debit.

In 2023 alone, the 4 biggest UK banks made £44bn profit, whilst many consumers were struggling. This clearly demonstrates that there is a desperate need for bank and card scheme competition; that the status quo is costing consumers and businesses. The CMA Order, as far as it extends to singe and sweeping payments, has not effectively resolved this distorted market, and consumers and businesses are paying for it.

The PSR has proposed to expand already live VRP to a specific set of Phase 1 sectors. These sectors already have in place, and in operation, consumer protection frameworks and regulators for Consumer recourse. As a means of creating competition for bank and card schemes, to transfer some of the £44bn profit from banks and card schemes to consumers and businesses, the PSR's VRP proposal is a necessary step.

The need for a secure, low cost and easy to use and control payment method that competes with cards to drive benefits for businesses and consumers, has never been more needed.