

The Payment Systems Regulator's Financial Penalty Scheme

Decision on the Financial Penalty Scheme for the use of
the retained amount from PSR regulatory penalty receipts



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1. The PSR's Financial Penalty Scheme

This is the Payment Systems Regulator's (PSR's) decision on how we will implement our Financial Penalty Scheme. Following an eight-week consultation period we have decided to adopt the approach we suggested in our November 2016 consultation paper (CP 16/5).

The scheme, published in its final form alongside this decision paper, describes our method for allocating the money we retain from penalty receipts. Following our consultation we have decided to use this money to reduce the amount we collect from payment service providers (PSPs).

Introduction

- 1.1** Following consultation¹, we have decided to use the money we are entitled to retain out of financial penalties paid to us to reduce the money we collect from payment service providers (PSPs) who pay regulatory fees in the following fees year. We will do this through our Financial Penalty Scheme (the scheme). The scheme covers certain of our powers, including under the Financial Services (Banking Reform) Act 2013 (FSBRA), the Interchange Fee Regulation (IFR), the Competition Act 1998 (CA98) and the Enterprise Act 2002 (EA02).
- 1.2** We may impose penalties for compliance failures on persons we regulate (organisations and individuals). We are required to pay certain penalty payments we receive to the Treasury, after deducting an amount to cover our relevant enforcement costs (the retained amount). The Treasury may give directions to us on how we do this.
- 1.3** We are required to prepare and operate a scheme (the Financial Penalty Scheme) for ensuring that we meet these obligations, and that we apply the retained amount for the benefit of participants in regulated payment systems. The same legislation also requires that persons who have become liable to pay a penalty during a financial year do not benefit from the scheme in the following year. The timing of the penalty payment itself determines when we return the retained amount. We will only return money to the industry in the year after we have received a financial penalty payment. For example, if for any reason a PSP first becomes liable to pay a penalty in year X, but the penalty is paid in year X+1, we will return the retained amount from the penalty in year X+2. The party that paid a penalty will not benefit from the retained amount in year X+2.
- 1.4** The Financial Penalty Scheme published alongside this policy statement explains our approach to using the retained amount. We consulted publicly on the scheme details between 17 November 2016 and 13 January 2017. In the consultation we proposed to return the retained amount to PSR fee-payers by reducing the money we collect from them in the following fee year. The fees are collected by the regulated payment system operators (PSOs) on our behalf. Our implementation approach ensures that no invoices will need to be adjusted.
- 1.5** We received a total of ten responses to our consultation. The majority supported our proposals.
- 1.6** Having considered the issues raised by respondents, we have decided to implement the Financial Penalty Scheme we proposed in November without any substantive changes. We have made some minor clarifying changes to the text. These reflect the clarifications set out in this decision and the fact that we will be reducing the moneys collected from fee payers rather than adjusting our overall budget or fees levels.

¹ CP16/5, *The Payment Systems Regulator's Financial Penalty Scheme* (November 2016): www.psr.org.uk/psr-publications/consultations/PSR-CP165-draft-financial-penalty-scheme

The scope of the Financial Penalty Scheme

Penalties covered by the Financial Penalty Scheme

The scheme currently applies to many circumstances in which we are able to impose penalties. It applies to any penalties we impose under:

- section 73 FSBRA (for a compliance failure)
- regulation 6 of the Payment Card Interchange Fee Regulations 2015 (PCIFRs)², which implement the IFR (for a compliance failure)
- regulation 105 of the Payment Services Regulations 2009 (PSRs09) (which implement the Payment Services Directive) (where rules or conditions governing access to, or participation in, a payment system contravene certain regulations)

However, the scheme does not apply to any penalties we impose through our concurrent competition powers under CA98 or EA02. The scheme also does not apply to our functions under the Payment Accounts Regulations 2015 (which implement the Payment Accounts Directive).

What counts as a compliance failure

Under FSBRA, a compliance failure is the failure of a participant in a regulated payment system to comply with:

- a direction (general or specific) given under section 54
- a requirement imposed (generally or specifically) under section 55
- a requirement to grant access to a payment system under section 56

Under the IFR, a compliance failure is the failure of a regulated person to comply with:

- an obligation or prohibition imposed by the IFR
- a direction given by the PSR under Regulation 4 of the PCIFRs

² See Guidance on the PSR's approach as a competent authority for the EU Interchange Fee Regulation, paragraph 7.43: www.psr.org.uk/sites/default/files/media/PDF/PSR-IFR-Guidance-Phase-2.pdf

Enforcement Costs covered by the Financial Penalty Scheme

The enforcement costs which are currently covered are:

- certain enforcement costs:
 - related to FSBRA and IFR compliance failures
 - under CA98
 - under EA02
 - related to the PSRs09
- the enforcement of an order to dispose of an interest under section 58 of FSBRA, and
- the investigation and prosecution of certain offences under FSBRA, CA98, EA02 and the PSRs09

For further details on the legal framework please refer to section 3 of our Financial Penalty Scheme.

This box sets out the scope of the Financial Penalty Scheme at the time of publication. The scope of the scheme is subject to change.

Responses to our consultation

- 1.7** We received responses from ten stakeholders. The respondents generally supported our approach. Broadly, they raised three concerns:
- The scheme might add an additional layer of complexity to our fees collection process, and increase administrative costs for the PSOs.
 - One stakeholder was concerned that in the exceptional circumstances where we may not publish details of a penalty, the way we intended to implement our preferred approach might allow PSOs to know which individual PSPs had paid a penalty.
 - The way we plan to return the retained amount to the industry may benefit some participants disproportionately. This concern is twofold: firstly, two stakeholders pointed out that the population of fee payers is different to (and smaller than) the population of persons that may become liable to pay a penalty; secondly, the population of participants is different under different operators.
- 1.8** In the remainder of this policy statement, we:
- summarise the main points raised by respondents
 - explain why we have chosen to implement our proposed scheme without significant changes
 - clarify a number of issues that were raised during the consultation

Summary of submissions and our response

- 1.9** Stakeholders were generally supportive of our proposed scheme. A considerable number of respondents acknowledged the difficulty and complexity of setting a Financial Penalty Scheme. Several stakeholders were content with our approach. One stakeholder highlighted that it felt we had chosen the most pragmatic approach. We categorise and summarise the respondents' views below.

Allocation methodology

- 1.10** One respondent said that it preferred a system that treats penalties and fees entirely separately. The respondent was under the impression that we could return a large enough sum to reimburse some participants for their entire fee. This would potentially mean an amount larger than our annual budget. Such a policy would have caused complications in invoicing as well as potentially causing perverse incentives for participants. We note that we will only return a sum covering our enforcement costs. These form a small part of our overall costs and not the full amount of any penalties. Therefore we do not expect a fee payer would be completely reimbursed for their fee through the scheme.
- 1.11** Another stakeholder noted that the population of persons that could be liable to pay a penalty is larger than the PSR fee-paying population that would be entitled to any rebate. It suggested we regularly review the overall population in payments to make sure that the right persons are covered by our powers and pay our fees.
- 1.12** One stakeholder questioned whether, if a PSP has paid a penalty for non-compliance related to one payment system, it is appropriate for the retained amount to be spread across fee payers of all relevant payment systems. This is because different operators have different direct participants.
- 1.13** The same stakeholder questioned whether, if a PSO has paid a penalty, it would be fairer to return money to fee payers in relation to that PSO's payment system – rather than our recommended option of splitting the retained amount among direct participants of all payment systems.

Complexity and regulatory burden

- 1.14** A small number of respondents were concerned by the complexity that the proposed approach might add to the fees collection process. One felt that the process of PSOs reducing the moneys collected by the retained amount and adjusting their invoices is a lengthy one which will not be clear to many participants.
- 1.15** One stakeholder requested that, when we impose a penalty, we provide PSOs with an itemised account of the adjustments they will need to make for each individual PSP. They also asked us to give PSOs enough time to process any necessary adjustments to invoices and communicate these adjustments to their members.
- 1.16** We also received a comment about the scheme's complexity through our consultation on PSR regulatory fees for 2017/18.³ One stakeholder believes that our proposed implementation of the scheme would add 'further significant administrative and regulatory complexity for extremely limited gain'. It suggested that the best way of returning the retained amount to the industry is by reducing our annual funding requirement (AFR).

Information sharing

- 1.17** One stakeholder was concerned about the way the information about a penalty would be shared with the regulated PSOs. By this it meant the way that the PSR would communicate the penalty to the relevant PSO (if at all). It suggested that communication should be restricted to the affected PSO. The stakeholder asked us to elaborate on the level of information that we would provide to PSOs handling the return of the retained amount.

³ www.psr.org.uk/sites/default/files/media/PDF/CP-1635-PSR-fees-2017-2018.pdf

Other comments

- 1.18** One stakeholder suggested that we should have a degree of oversight to ensure that:
- indirect access providers (IAPs) gaining from the scheme pass some of the benefits on to their indirect participants
 - IAPs who become liable to pay a penalty do not pass the cost on to their indirect participants
- 1.19** One stakeholder questioned the treatment of card system operators that also act as PSPs within their own systems. We proposed to treat these as PSPs within the scheme. The respondent considered that this approach would be unfair.

Alternative options

- 1.20** The majority of respondents agreed that the benefits of our preferred option (returning the money to the industry) outweigh the benefits of the alternative option we considered (using the retained amount for special projects).
- 1.21** One PSO was in favour of the special projects option. It suggested that we could consult to decide which project to subsidise, or that the money could be used for payments education initiatives.
- 1.22** The same respondent recommended a number of other possibilities including to:
- create a contingency and innovation fund with some of the retained amount
 - donate some of the retained amount to a payments or finance-related charity or project that supports financially excluded parts of society
 - consult the wider community when the retained amount becomes available, so we can consider options that are relevant to our requirements at the time
- 1.23** Another respondent recommended that we keep the Financial Penalty Scheme under review as the payments landscape is currently changing, and at some point we may need to adapt the scheme in response.

Clarification questions

- 1.24** One stakeholder asked for clarification on two issues:
- **How our proposed Financial Penalty Scheme will apply to banking groups:** More specifically, if a financial penalty is applied to one member of a banking group, would the other members of that group benefit from reductions in regulatory fees in the next year?
 - **How we will communicate the return of the retained amount to fee payers if the penalty itself has not been published:** In paragraph 2.5 of our Penalties Guidance⁴ we state that our normal practice will be to publish details of any financial penalty imposed as a result of a compliance failure. However, we do anticipate that in exceptional circumstances we may refrain from publishing details of a financial penalty. We explain our approach to information sharing further in paragraph 1.38.

⁴ www.psr.org.uk/psr-penalties-guidance

Our response

Allocation methodology

- 1.25** We acknowledge that the population that may become liable to pay a penalty is larger than the fee-paying population. However, we do not believe our approach to redistributing the retained amount is unfair. Only the persons that pay our fees would bear our enforcement costs if we had no Financial Penalty Scheme. Therefore we believe it is fair that they should be the ones to benefit from the retained amount.
- 1.26** We also acknowledge that different PSOs have different populations of participants. With the retained amount split equally among the PSOs, participants in systems with fewer members may benefit more than those in larger schemes. However, they also pay a higher proportion of our fees.
- 1.27** The way we propose to allocate the retained amount is based on the fees paid by participants in the following fee year. The general principle is that participants will receive an equivalent share of the retained amount to the fee they would pay, which we consider fair. We consider it would be impractical to split the retained amount any other way than equally across the PSOs. This aligns with our regulatory fees approach, where we have the principle of equal allocation of the AFR across PSOs.⁵
- 1.28** A number of respondents to our consultation were concerned that our proposed approach could create an extra regulatory burden due to the adjustments that would be needed to all the invoices. This concern was raised in the context of some confusion on the way we proposed to split the retained amount across payment systems. We describe our approach in more detail here.
- 1.29** As we stated in our consultation CP16/5, on the draft Financial Penalty Scheme, our proposal was to ensure that only the invoices of any PSP that became liable to pay a penalty would need to be adjusted. In paragraph 2.22 of CP16/5 we stated that to minimise the administrative burden, we would implement the Financial Penalty Scheme by reducing the amounts collected across all fee payers. We have adjusted our implementation approach in such a way that no invoices will need to be adjusted.
- 1.30** In order to achieve this, the retained amount will be split into pots (presently two pots reflecting the separate FSBRA and IFR fee allocation): the FSBRA retained amount and the IFR retained amount. These will be split in line with the split of our annual funding requirement (AFR). This is because we consider it fair that the retained amount that we would return to fee payers would be proportional to the fee they pay in relation to each regulatory area. We will keep this approach under review, but expect to continue to follow it if new regulation (such as the second Payment Services Directive) comes into effect and is captured by the scope of the scheme.
- 1.31** We will then follow the equal allocation approach to divide the FSBRA retained amount between FSBRA regulated payment systems. The amount of money each FSBRA regulated PSO will need to collect from fee payers in its system will be reduced by one seventh of the retained amount⁶, as there are currently seven FSBRA regulated payment systems. This will be deducted from the total sum that PSOs collect in line with their fee allocation. Following our usual fees methodology, PSOs will apportion the **reduced** amount to their members according to their respective transaction volumes (excluding any member that has become liable to pay a penalty, which will pay its allocation of the fees in full). In practice this has the same effect as if the FSBRA fee allocated to that system had been reduced, except in relation to any fee payer that was liable to pay a penalty. To clarify the position, we have included a worked example in Annex 1.

⁵ See, for example, paragraph 4.20 of CP16/11.

⁶ We regulate eight payment systems, namely Bacs, CHAPS, FPS, LINK, Cheque and Credit (C&C), Northern Ireland Cheque Clearing (NICC), Mastercard and Visa. For fees purposes we treat C&C and NICC as one payment system.

- 1.32** We recognise that this approach is different to our approach to returning our underspend, as discussed in our most recent fees consultation (CP16/35, November 2016).⁷ As the total sum of the retained amount as compared to the recent underspend may be very small, we do not consider that it would be practical to follow the approach that we have used for the much larger underspend rebate whereby operators are required to adjust all their invoices with itemised rebates (one for the retained amount in addition to any rebate for any underspend). This would increase regulatory burden. This has been confirmed by respondents to our consultation, who highlighted the need to reduce the administrative burden. We consider that given the small sums likely to be involved, this will have an insignificant impact on individual fee payers relative to the underspend rebate.
- 1.33** The IFR retained amount will be returned to IFR regulated card schemes. We will only reduce the fee allocated to fee payers in the first (highest) tier for IFR fees. This is because fee payers in relation to this tier pay the vast majority of our IFR fees. The allocation to card schemes in the second tier is set as a very small fixed rate contribution. We do not consider that it would be proportionate to adjust this on an annual basis in relation to any retained amount. For each of the IFR card payment systems in the first tier, the PSO would then follow the same process as described in paragraph 1.31 in relation to FSBRA regulated payment systems. This is detailed in Annex 1.
- 1.34** In response to the suggestion referenced in paragraph 1.13 that where a PSO has paid a penalty the retained amount should be returned only to the members of that PSO's system, we do not believe that this would be fair. Our enforcement costs are also paid by the participants in the other systems that pay our relevant fees, so they should be equally eligible to have those costs reimbursed through the scheme.

Complexity and regulatory burden

- 1.35** We appreciate that implementing the Financial Penalty Scheme will add another layer of complexity to the fees collection process. It is worth noting that the way we propose to implement it is designed to minimise this additional burden. Our approach ensures that no invoice will need to be adjusted, and so no regulatory burden or complexity is added to the fees process. Further, it is very similar to the way that the Financial Conduct Authority (FCA) implements its own financial penalty scheme.
- 1.36** We agree and will implement the suggestion to give PSOs enough time to process any necessary adjustments to invoices and communicate to their members. However, as no invoices will need to be adjusted, we do not need to provide PSOs with an itemised account of the adjustments required for each PSP that became liable to pay a penalty.
- 1.37** We do not believe that returning the retained amount to the industry through a reduction in our AFR would be appropriate. Our AFR is set in relation to our budget and reflects our costs for the year. We consider that the approach we are proposing has a similar effect, while ensuring that no person who became liable to pay a penalty in the previous year benefits in the next year, which is a legal requirement.

⁷ See PSR and FCA CP16/35, *PSR regulatory fees 2017/18* (November 2016), paragraphs 4.15 to 4.24: www.psr.org.uk/psr-publications/consultations/cp-1635-fees-2017-2018

Information sharing

- 1.38** Based on the concern raised around information sharing, we decided to adjust our implementation approach in the exceptional circumstances where we do not publish information on a penalty. In those circumstances, information about the details of a penalty will not be shared with PSOs. In such circumstances we would instead separately collect an additional fee from the relevant fee payer. This fee would negate the effect of any reduction the fee payer will have received in the amount collected by a relevant PSO. We note that this approach will only be adopted in exceptional circumstances, which we expect to be very rare. Our usual approach will be to publish the details of any penalties imposed in relation to compliance failures. Therefore, we would expect PSOs to already be aware of these.⁸
- 1.39** We will consider whether we need to make any changes to the fees rules to implement this approach and, if necessary, we expect to consult on any changes as part of the next fees cycle.

Other comments

- 1.40** Regarding the comment about us ensuring indirect PSPs receive the benefits of a rebate, or do not pay for a penalty that their IAP has incurred:

The prices set by direct participants are a result of their own pricing principles. It is for them to decide if they would like to pass benefits from the Financial Penalty Scheme on to their indirect participants.

- 1.41** Regarding the comment about our treatment of card schemes that also act as PSPs:

We would like to re-emphasise the legal and regulatory framework under which we developed the Financial Penalty Scheme. We must use the retained amount for the benefit of participants in regulated payment systems, and regulated persons under the IFR (by virtue of Regulation 15 of the PCIFRs). Under FSBRA, no person who became liable to pay a penalty in any financial year may benefit from our use of the retained amount in the following year. Therefore, irrespective of whether the card system operator has paid a penalty as a PSP within its own system or as an operator, the legislation is clear in not allowing us to return any of the money to this person.

Alternative options

- 1.42** We continue to consider that the potential benefits of the alternative option (funding special projects) are uncertain. This is due to the unknown timing and size of any penalties, and the expectation that the retained amounts will be too small to fund a substantive 'special' project. For these reasons, we do not consider the alternative option suggested by one stakeholder (payments education initiatives) to be practicable given the uncertainty around the size and timing of penalties and the probable small size of any retained costs. Any such approach would be very uncertain and unlikely to bring significant benefits. In fact, the administrative costs are likely to be higher than any benefits.
- 1.43** We already spend a portion of our budget on increasing awareness of our work and payments in general⁹, and such initiatives should not be dependent on whether we impose any penalties or not.

⁸ See the PSR Penalties Guidance paragraphs 2.3 and 2.5:
www.psr.org.uk/sites/default/files/media/PDF/Create%20File%20page/PSR%20Penalties%20Guidance%20docx.pdf

⁹ See our 2016/17 PSR Annual Plan for details of our annual budget:
www.psr.org.uk/sites/default/files/media/PDF/PSR-Annual-Plan-Budget-2016-17_0_0.pdf

1.44 We considered the additional options suggested by a respondent (see paragraph 1.22). However, we do not consider these to be practicable or appropriate. This is because:

- The total retained amount is unlikely to be large enough to create an innovation fund that funds meaningful initiatives.
- The process of choosing an appropriate charity to donate to is likely to be complex.
- Consultation processes are time and resource-intensive. It is quite likely that the cost would outweigh the benefit of using the money for the community's purposes.

1.45 As we stated in our consultation paper, we intend to review the Financial Penalty Scheme where appropriate, for example if relevant circumstances change.

Clarification questions

1.46 Our responses to the clarification questions are as follows:

- For the purposes of paying PSR regulatory fees, as well as for the Financial Penalty Scheme, members of banking groups are seen as separate legal entities. This means that each member of the corporate group would have to pay its own separate fee. Group members who had not become liable to pay a penalty would be eligible for a reduction in the amount due to the PSR the following year.
- Please refer to paragraph 1.38 for our response to the issue around information sharing.

Annex 1

Allocation of the retained amount among fee payers

For our example we assume that PSP1 is only a member of PSO1. PSP1 has become liable to pay a penalty for the current financial year. In this worked example we show how operators can calculate the net fee liability for their members for the following financial year.

Annual Funding requirement (AFR)	£700
Retained amount	£70
PSO1 portion of AFR	£100
PSO1 portion of retained amount	£10
Net amount payable by PSO1	£90
PSP1 fee before retained amount = PSO1 portion of AFR multiplied by share of payment system denominator	£10.47
Net amount to be allocated across members who were not liable to pay a penalty = net amount payable by PSO1 minus PSP1 fee before retained amount	£79.53

PSO1 members	Share of payment system denominator including PSP1	Share of payment system denominator excluding PSP1	Net allocated amount for members not liable to pay a penalty = net amount to be allocated across members multiplied by share of payment system denominator excluding PSP1
PSP 1	10.47%	0.00%	£10.47
PSP 2	14.62%	16%	£12.99
PSP 3	12.13%	14%	£10.77
PSP 4	3.32%	4%	£2.95
PSP 5	12.29%	14%	£10.92
PSP 6	0.83%	1%	£0.74
PSP 7	14.62%	16%	£12.99
PSP 8	16.61%	19%	£14.76
PSP 9	8.64%	10%	£7.67
PSP 10	6.48%	7%	£5.75
Total	100%	100%	£90