Title: **The regulation of small payments institutions**	Impact Assessment (IA)
	IA No: HMT1140
Lead department or agency: HM Treasury	**Date:** 13 January 2011
Other departments or agencies: HM Revenue and Customs Financial Services Authority	**Stage:** Final
	Source of intervention: Domestic
	Type of measure: Secondary legislation
	Contact for enquiries: Brian Garcia. HM Treasury 020 7270 5219

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

Small Payments Institutions are mainly small businesses who are money remitters, registered by the Financial Services Authority (FSA).

The FSA does not have sufficient powers to enable it to oversee Small Payments Institutions effectively. Customers are exposed to the risk of fraud, and the risk of failure of Small Payment Institutions without adequate protection. This was exposed by the failure of Crown Currency Exchange which went into administration in October 2009 owing more than £18m to c13,000 customers.

What are the policy objectives and the intended effects?

To give greater protection to customers of Small Payment Institutions through regulations that provide for:

(i) the FSA to check that owners and managers of small payments institutions are fit and proper persons;
(ii) customers' funds to be held in a segregated account and protected from creditors if a firm becomes insolvent.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 0 (baseline): To provide for customers of Small Payment Institutions to be better informed about the limited statutory protection that is currently available within the existing regulatory framework;

Option 1: To raise the level of consumer protection by requiring small firms to submit information to the FSA to enable the FSA to carry out fit and proper persons tests (objective (i) in the box above);

Option 2: To maximise the level of consumer protection by requiring Small Payment Institutions to safeguard customers' funds, in addition to being subject to a fit and proper persons' test by the FSA (objectives (i) and (ii) in the box above). The preferred option is option 1.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** December 2016 **What is the basis for this review?** Duty to review. **If applicable, set sunset clause date:** December 2018	
Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Yes

SELECT SIGNATORY Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: M Hoban Date: 6/7/12

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Summary: Analysis and Evidence

Policy Option 1

Description:

Raise the level of consumer protection by requiring small firms to submit information to the FSA and enable the FSA to carry out fit and proper persons tests, and refuse to register persons who do not pass.

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2011	Year 2011	Years 10	Low: £3.5m	High: £29.0	Best Estimate: £19.9m

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional	10	Optional	**Optional**
Best Estimate	0.270		0.17	**1.8**

Description and scale of key monetised costs by 'main affected groups'

90% of the costs apply to small businesses. 80% of the businesses affected are micro enterprises. The costs arise from submission of information to the FSA (based on 1,136 firms rising to 2,400 after 10 years, and one off nominal costs of £270,000 in total and ongoing annual nominal costs of £20 0,000 pa). Most of the costs apply to firms. 13% of the costs apply to the FSA, these arise from the FSA processing more information and carrying out fit and proper persons tests.

Other key non-monetised costs by 'main affected groups'

Some high risk firms will no longer qualify for registration - around 270 firms it is estimated.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0.5	**5.3**
High	0	10	3.8	**30.8**
Best Estimate	0		2.2	**21.7**

Description and scale of key monetised benefits by 'main affected groups'

The failure rate of Small Payments Institutions can be expected to decline significantly by screening out the highest risk firms - around 270 firms would no longer qualify for registration.
The annual average loss to consumers is expected to be cut from between £700,000 and £5 million per year to near zero (0.5m - £3.8m pa in constant terms), with a mid point of £2.85m (2.2m constant).

Other key non-monetised benefits by 'main affected groups'

Small firms will enjoy qualitative benefits through increased consumer confidence in the money transmission industry, as a result of a lower failure rate.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

The main assumption is that introducing a fit and proper persons test will cut the rate of failures of SPIs which the record shows is caused by lax controls and financial impropriety.

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: 0.17	Benefits: 0	Net: -0.17	Yes	IN

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			30/06/2012		
Which organisation(s) will enforce the policy?			Financial Services Authority		
What is the annual change in enforcement cost (£m)?			£0.027		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			Yes		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** na	**Non-traded:** na	
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** na	**Benefits:** na	
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?	No	No	No	Yes	Yes

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
Statutory equality duties[1] Statutory Equality Duties Impact Test guidance	No	
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	Yes	All
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Summary: Analysis and Evidence

Policy Option 2

Description:

Maximise consumer protectiion by requiring small firms to safeguard customers' funds, and undergo fit and proper persons tests.

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: - £170.7	High: - £145.2	Best Estimate: - £154.3

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	10	Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0.270		17.6	**176.0**

Description and scale of key monetised costs by 'main affected groups'

98% of the costs will be borne by small businesses. 80% of the businesses affected are micro enterprises. The costs arise from bank account maintenance fees and cash handling fees charged by banks. These will be incurred by Small Payments Institutions who would be required to open a business bank account in which to safeguard client funds (840 firms or 35% of the total). Additional costs arise from submission of information to the FSA (these additional costs are the same as those set out for option 1).

Other key non-monetised costs by 'main affected groups'

Some firms may experience 6 - 9 month delays in being able to open a business bank account, and some firms may not be able to open a bank account at all.
Some high risk firms will no longer qualify for registration - around 270 firms it is estimated.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0.5	**5.3**
High	0		3.8	**30.8**
Best Estimate	0		2.2	**21.7**

Description and scale of key monetised benefits by 'main affected groups'

The failure rate of Small Payments Institutions can be expected to decline significantly by screening out the highest risk firms - around 270 firms would no longer qualify for registration.

The annual average loss to consumers is expected to be cut from between £700,000 and £5 million per year to near zero (0.5m - £3.8m pa in constant terms), with a mid point of £2.85m (2.2m constant).

Other key non-monetised benefits by 'main affected groups'

The qualitative benefits are that:
i) there is likely to be increased consumer confidence in the money transmission industry.
ii) Small firms will enjoy qualitative benefits through increased consumer confidence in the money transmission industry, as a result of a lower failure rate.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

i) that introducing a fit and proper persons test will cut the rate of failures of SPIs which the record shows is caused by lax controls and financial impropriety.

ii) It is not possible to estimate with any accuracy the number of businesses that may be unable to open a bank account in which to segregate customers; funds. The estimate in this assessment is based on the rate at which applications for registration as a small payments institution are declined or withdrawn.

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: 17.5	Benefits: 0	Net: -17.5	Yes	IN

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom			
From what date will the policy be implemented?			01/06/2010			
Which organisation(s) will enforce the policy?			Financial Servies Authority			
What is the annual change in enforcement cost (£m)?			£0.027			
Does enforcement comply with Hampton principles?			Yes			
Does implementation go beyond minimum EU requirements?			Yes			
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** na		**Non-traded:** na	
Does the proposal have an impact on competition?			Yes/No			
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** 0		**Benefits:** 0	
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**	
Are any of these organisations exempt?	No	No	No	Yes	Yes	

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

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Does your policy option/proposal have an impact on…?	Impact	Page ref within IA
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Economic impacts		
Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	Yes	All
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessments of earlier stages (e.g. Consultation, Final, Enactment) and those of the matching IN or OUTs measures.

No.	Legislation or publication
1	Payment Services Directive (2007/64/EC)
2	Payment Services Regulations (SI 2009/209)
3	
4	

+

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	Y_9
Transition costs	0.270	0	0	0	0	0	0	0	0	0
Annual recurring cost		0.193	0.186	0.180	0.174	0.168	0.163	0.157	0.152	0.147
Total annual costs	0.270	0.193	0.186	0.180	0.174	0.168	0.163	0.157	0.152	0.147
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	0	2.754	2.661	2.571	2.484	2.400	2.318	2.240	2.164	2.091
Total annual benefits	0	2.754	2.661	2.571	2.484	2.400	2.318	2.240	2.164	2.091

* For non-monetised benefits please see summary pages and main evidence base section

Microsoft Office
Excel Worksheet

Evidence Base (for summary sheets)

Problem under consideration

Consumers are currently exposed to the risk of failure of Small Payment Institutions, without adequate protection. Small Payment Institutions are almost entirely money remitters who arrange money transfers from one party to another, such as migrants sending money home to their families.

Recent failures of money remitters include (*table 1*):

Table 1

Failures of Small Payments Firms			
	Date	**Firm**	**Client money losses (est)**
Pre-regulation*	2007	First Solution Money Transfer	£2 million
	2009	AJ Global Services	£230,000
	2010	Interchange FX	Uncertain
Post regulation*	2010	Crown Currency Exchange	£18 million
	2010	R F Transfer	£500,000

** The Payment Services Regulations 2009. (SI 2009/110). Prior to these regulations money remitters were, and still are, subject to the Money Laundering Regulations.*

Background

The money remittance industry facilitates remittance outflows from the UK of some £4 billion per year. It is used each year by 1.5 million people to send money home, mainly to the Indian sub-continent, Sub-Saharan Africa and Eastern Europe. There are 3.5 million such transactions per year with a median value of £400. Money remitters may also provide other services, such as currency conversion. They often work in cash.

There are 2,732 businesses providing money transmission in the UK. Many of these operate their business through agents, via 28,994 outlets such as High Street branches and corner shops. Around 2,400 of these businesses are thought to be eligible for registration as Small Payments Institutions (the others may be undertaking activities like cheque cashing and money changing that are not regulated by the FSA).

The Payment Services Directive (2007/64/EC) brought this industry within the scope of financial services regulation. It was implemented in the UK through the Payment Services Regulations in 2009. The Regulations created a new class of regulated entity known as Payment Institutions. These are individuals or firms (not banks or building societies) who provide payment services such as transferring money or enabling money to be placed in or withdrawn from a payment account. They include money remitters; mobile network operators; electronic money issuers, non-bank credit card issuers; and other categories. All are subject to conduct of business rules under the Payment Services Regulations.

There are two categories of regulated Payments Institution: Authorised Payment Institutions (APIs) and Small Payment Institutions (SPIs). A business whose average monthly payment transactions does not exceed €3million over the preceding 12 months can be registered as a SPI.

APIs and SPIs have separate regulatory regimes:

APIs are subject to full regulatory requirements. These include minimum capital requirements, safeguarding client funds received for payment services, detailed reporting obligations and oversight of robust governance, risk management and accounting procedures. There are controls over the owners and managers, and qualifying holdings in an API as well as those with close links to an API.

SPIs are subject to minimal regulatory requirements. There are no mandatory capital controls or client fund safeguards. The conditions for registration are that none of the managers has unspent convictions for offences relating to money laundering, terrorist financing or other financial crimes. They must be located in the UK and comply with money laundering regulations. SPIs (and APIs) may carry on other activities (for example currency conversion or cheque cashing), which are not regulated by the FSA, and any other business activity.

Rationale for intervention;

(i) Intervention is justified by the experience of continuing regular failures of Small Payment Institutions, leaving customers with substantial irrecoverable losses. The failures have uncovered an element of financial impropriety in most cases. Without intervention, the rate of failures illustrated in table 1 may continue indefinitely.

(ii) In a few cases, the FSA has refused to register an agent of an Authorised Payment Institution, after carrying out a fit and proper persons test, only to see the same person applying for registration as a Small Payment Institution in their own right. The FSA does not have the powers to refuse such applications by persons it considers to be unfit to own or run such a business.

(iii) The monetary losses caused by the failures of Small Payment Institutions, averaging £5million per year, are a small fraction (less than 0.2%) of the payments that are processed successfully each year, but they often hit the poorest and least able to afford the losses (such as economic migrants).

(iv) The effect of regular failures of Small Payments Institutions damages the remittances industry through loss of consumer confidence. It undermines confidence in the regulatory system and the FSA, which does not currently have powers to conduct fit and proper persons tests on SPIs.

This is therefore a problem of small firms and the proposed measures are targeted at small firms. 80% of the small firms affected are micro enterprises with fewer than 9 employees, and many are one-man businesses.

Policy objective;

There is a need to improve the protection of consumers by providing that:

(i) the FSA can check that owners and managers of Small Payment Institutions are fit and proper persons, having regard to the sound and prudent management of affairs; that they are of good repute, and possess appropriate knowledge and skills to provide payment services. Unsuitable persons should be screened out.

(iii) customers' funds received for payment services should be held in a segregated account, and protected from claims by other creditors in the event of an insolvency, as provided for in the Payment Services Directive.

Options considered

Option 0: (Baseline): maintain the existing regulatory framework, but within this provide for customers of Small Payment Institutions to be better informed about the statutory and regulatory protection that is currently available through disclosures mandated by FSA rules.

This option will not prevent unsuitable persons from establishing Small Payment Institutions, and will not protect consumers from loss.

The Payment Services Directive constrains the information disclosures that can be mandated because it sets out the prior information requirements that must be made available to consumers. Member States are not permitted to go beyond these obligations. For example, the Directive prevents mandating a negative disclosure that a customer's money is not safeguarded in a segregated account, or that there is no protection for loss arising from unregulated activities. Nor can the FSA prevent Small Payment Institutions from misleadingly advertising their FSA registration when undertaking unregulated activities.

The FSA already mandate the disclosures provided for by the Payment Services Directive, and any changes to the current rules will be marginal, at minimal or zero cost. Therefore this option represents the baseline option.

Option 1: Raise the level of consumer protection by requiring Small Payment Institutions to meet fit and proper persons tests, and requiring them to submit information so that such tests can be carried out in order to screen out unsuitable persons.

Option 2: Maximise consumer protection by providing for Small Payment Institutions to safeguard customers' funds, in addition to meeting fit and proper persons tests and submitting information to the FSA to enable the FSA to carry out such tests.

The preferred option is option 1. Although it will not deliver all the policy objectives, option 1 strikes the right balance between setting a high standard for Small Payment Institutions to meet without imposing disproportionate costs. By comparison, option 2 imposes significant costs without corresponding benefits.

This measure qualifies as an "IN" under One In One Out rules. The offsetting "OUT" identified by the Treasury is the FSMA 2000 (Exemption) (Amendment) Order, which exempts registered housing associations in Northern Ireland from FSA regulation, ensuring parity of treatment with England, Wales and Scotland. It has an Equivalent Annual Net Saving to Business of £0.4m which more than covers the £0.177m "IN" from the preferred option for the Small Payment Institutions measure.

OPTION 0: Maintain the existing regulatory framework, but within this provide for customers of Small Payment Institutions to be better informed about the statutory and regulatory protection that is currently available through disclosures mandated by FSA rules.

This is the baseline option because it will generate no additional costs. The FSA would aim to review the information that Small Payment Institutions provide to consumers to ensure that consumers are aware of the protection that is available, and that they are aware whether any particular transaction is an area that is or is not regulated by the FSA. It would do this within the tight constraints imposed by the Payment Services Directive.

The benefits of this option are that consumers can expect to be better informed about the extent of the limited protection that is available when transacting with a Small Payment Institution.

<u>Option 1:</u> Raise the level of consumer protection by requiring Small Payment Institutions to submit enhanced information and meet fit and proper persons tests so that unsuitable persons can be screened out.

Option 1 Costs

Table 2

Costs Summary (nominal £)			
	One off	Ongoing	Total (10 years)
FSA's costs	£90,000	£20,000	£270,000
Firms' costs	£180,000	£180,000	£1,800,000
Total	£270,000	£200,000	£2,070,000

This option will require Small Payment Institutions to meet a fit and proper persons test, and to submit information to the FSA, so that the FSA can screen out unsuitable persons.

The costs have been mitigated as far as possible by measures to reduce the burden on firms of providing enhanced information. Instead of going directly to firms, the FSA will be able to request information that is already held by HMRC (such as the identity of the directors and managers, and the use of agents, or any adverse information that HMRC may hold), allowing the FSA to obtain information in a quicker time frame and less burden on firms. The costs have therefore been confined to collecting information that is not already held by the FSA or HMRC. The additional information relates to the organisational structure, and internal governance, accounting and controls, proportionate to the size of the business.

80% of the firms affected are micro enterprises and it is estimated that micro enterprises will bear 80% of the costs in this assessment.

(a) <u>One off costs</u>

FSA costs

Additional FSA resource will be required to conduct a fit and proper persons test on currently registered firms. There are 897, such firms. A further 239 firms are likely to be registered soon (897+239=1,136 firms). The FSA estimates that it will take approximately 5 hours to assess each one. Based on information from the "Real Assurance Risk Management report on the Estimation of FSA administration burden", the daily wage for an associate, including overheads, national insurance contributions and other costs, would be £81 for 5 hours. Therefore the likely cost to the FSA of re-assessment is:

1,136 x £81 = £92,016 **(£90,000)**

Firm costs

897 currently registered Small Payments Institutions and 239 in the pipeline (1,136 in total) will need to provide more information to undergo a fit and proper persons test. Based on feedback provided to the FSA by firms applying for registration under the current regulatory regime, it is assumed that it will take firms an additional 2 hours to provide the information to the FSA and that this is carried out by the business principal. However, in a small number of cases requiring more intensive investigation (fewer than 10%) the time taken may rise to 4-5 hours. Using information from the "Real Assurance Risk Management report on the Estimation of FSA administration burden", June 2006 - the hourly rate is c. £70 (after adjustment for inflation and overhead costs).
The estimated one off costs are therefore:

1,036 x £70 x 2 = £145,040
100 x 70 x 5 = £ 35,000
£ 180,040 **(£180,000)**

Total one off costs in year 0 **FSA** **£ 90,000**

	Firms	**<u>£ 180,000</u>**
		£ 270,000

(b) <u>Ongoing costs</u>

FSA costs

The additional information gathered by the FSA will result in a more rigorous application and ongoing monitoring procedure. Based on feedback provided to the FSA by firms, it is expected to add up to three extra hours per initial application in future at a cost of £48 per case (Using the daily wage of an associate 3 hours = £48).

The rate of applications for SPI registration, after an initial upsurge on introduction of the new regulatory regime, has stabilised at the rate of some 30 applications per month, or around 360 per year on average. Based on their assessment of the size of the population of firms in the industry, the FSA expects this application rate to continue. This estimate is supported by the experience of HMRC in registering new money transmitters under the money laundering regulations. The likely annual ongoing cost to the FSA of processing additional information is therefore:

360 x £48 = £17,280 pa **£20,000**

There will be some ongoing supervisory effort in reviewing the information that has been gathered. It is thought to be fairly minimal, but cannot be clearly quantified. It is expected to be offset in two ways:

a) by offsetting efficiency gains arising from a new memorandum of understanding with HMRC, in which the FSA and HMRC will collaborate more closely in sharing information and sharing supervisory visits to firms, thus releasing resources. However, the potential efficiency gains arising from the memorandum of understanding have not been quantified;

b) by the FSA re-prioritising current resources (this would nonetheless represent an opportunity cost to the FSA of not undertaking another activity).

This assessment therefore assumes that there will be no new, additional ongoing supervisory costs beyond the costs of dealing with the additional information in new applications.

The increase in costs to the FSA could potentially be passed on to Small Payment Institutions in the form of higher registration fees. If these costs were passed on in full to the population of SPIs, they would add:

Year 0 £80 per firm pa
(FSA one off cost £90,000 / 1,136 firms =£79)

Years 1 – 9 £8 - £13 per firm pa
(FSA ongoing costs of £20,000/ (between 1,500 and 2,400 firms).

The effect of these costs is likely to be mitigated by higher consumer confidence in the industry. FSA registration fees are classified as a tax on firms. They do not therefore count towards the calculation of One-In-One-Out costs.

Firm costs

(i) New applicants costs

As set out in the section on the FSA's ongoing costs, above, the rate of new applications for SPI registrations is expected to stabilise at around 360 per year on average.

Based on feedback provided to the FSA by firms applying for registration under the current regulatory regime, it is assumed that it will take firms an additional 2 hours to provide the required information to the FSA and that this is carried out by the business principal. Using information from the "Real Assurance Risk Management report on the Estimation of FSA administration burden", June 2006 - the hourly rate is c. £70 (after adjustment for inflation and overhead costs).

The estimated one ongoing annual costs attributable to new applications for registration is therefore:

360 x £70 x 2 = £50,400 pa **£50,000**

This is included in the table of firms costs below (*table3).*

(ii) Maintenance costs for existing registered firms

The ongoing requirements of keeping additional information up to date are expected to be minimal. It is estimated to average less than one hour per firm per year, based on feedback provided to the FSA. Using information from the "Real Assurance Risk Management report on the Estimation of FSA administration burden", June 2006 - the hourly rate is c. £70 after adjustment for inflation and overhead costs).

Table 3 below shows the expected growth and stabilisation of the number of registered Small Payment Institutions and the associated information provision costs:

Table 3

Firms' costs (£ nominal)				
Year	No of firms	Costs to new applicants	Maintenance costs	Total Cost (£ nominal)
0	1,136	180,000	0	180,000
1	1,496	50,400	79,520	129,920
2	1,856	50,400	104,720	155,120
3	2,216	50,400	129,920	180,320
4	2,400	50,400	142,800	193,200
5	2,400	50,400	142,800	193,200
6	2,400	50,400	142,800	193,200
7	2,400	50,400	142,800	193,200
8	2,400	50,400	142,800	193,200
9	2,400	50,400	142,800	193,200
Total		633,600	1,170,960	1,804,560

Est 360 new applications pa
Year 1-9 ongoing costs averaged to £180k in summary table 2.

(iii) The withdrawal rate for businesses that do not succeed in their applications for registration as Small Payment Institutions is likely to rise from 5% of applications to 15% (an increase of 10%) in line with the current withdrawal rate of businesses applying for full authorisation as Authorised Payment institutions. These are businesses that might be registered if they did not have to undergo a fit and proper persons test. Applied to the current population of 2,732 money transmission businesses, the 10% increase in the withdrawal rate suggests that an additional 270 businesses would no longer qualify for FSA registration and would not be able to undertake regulated activities as a Small Payment Institution. If applied to the costs table (table 3) this would reduce the potential ongoing costs by 10%. This would reduce the total ten year costs in the table from £1.8m to £1.7m.

Option 1 Benefits

The benefit of a more stringent approach to registering Small Payment Institutions is that unfit persons will no longer be responsible for the management of Small Payment Institutions. The failure rate of SPIs can therefore be expected to decline significantly, given the experience of financial impropriety as a principal contributory factor in the failures that have occurred.

In the case of the biggest single failure of a Small Payment Institution, Crown Currency Exchange, the failure occurred not in the regulated money remittance side of the business, but in an area of activity (money changing) that is not regulated by the FSA. Buying and selling currency is the same as buying and selling any other good. It is not subject to financial services legislation. Nonetheless, the measures in option 1 address the problem that an unregulated activity may cause a regulated Small Payment Institution to fail. They will ensure that a business like Crown that undertakes both regulated and unregulated activities is subject to a fit and proper persons test so that unfit persons will no longer be able to run a firm that is undertaking both regulated and unregulated activities through a Small Payments Institution. Such firms will benefit from FSA registration, which will gives consumers confidence that a firm is run by qualified owners and managers who have been vetted by the regulator.

The principal benefits are that:

(i) The annual average loss to customers is expected to be cut from between £0.7million and £5 million per year to near zero (see table 1 for annual losses 2007-10).

The total failures set out in table 1 are £20,730,000 over four years – averaging £5 million pa. Eliminating failures costing consumers an average of £5 million per year yields substantial benefits. £5 million pa is therefore taken as an upper estimate of the potential benefits of the measures in option 1 if the failure rate is reduced to zero.

Upper estimate: £5 million pa

However, this impact assessment takes a conservative approach to estimating the potential benefits because not all failures may be avoidable, and because the £18 million failure of Crown Currency Exchange may turn out to be an outlier, given the smaller scale of the other failures shown in table 1. The lower estimate of the potential benefits of option 1 therefore excludes the cost of Crown's failure. It estimated to be £2.73 million over 4 years = £683,500 pa (£0.7m)

Lower estimate: £0.7 million pa

The mid point between £0.7m and £5m is

Mid point estimate: £2.85 million pa

These estimates appear reasonable when cross checked against the value of transactions which industry sources advise that many Small Payments Institutions appear to be undertaking in practice. They therefore represent the potential benefits to consumers of preventing future failures due to financial mismanagement.

(ii) The withdrawal rate for businesses that do not succeed in their application for registration as Small Payment Institutions is likely to rise from 5% of applications to 15%, in line with the withdrawal rate of businesses applying for authorisation as Authorised Payment Institutions. This represents the proportion of Small Payment Institutions that are most likely to cause consumer detriment. Applied to the population of 2,732 money transmission businesses, this suggests that some 270 businesses would not be able to undertake regulated activities as a small payments institution.

(iii) The qualitative benefits to 90% of small firms are likely to be increased consumer confidence in them and the remittances industry in general.

<u>Equalities and small firms</u>

The Government has considered the proposed measures in option 1 in relation to its public sector equality duties in relation to Section 149 of the Equality Act 2010. It has concluded that no relevant issues arise.

<u>Option 2:</u> Maximise consumer protection by providing for Small Payment Institutions to safeguard customers' funds, in addition to meeting fit and proper persons tests.

Option 2 Costs

Table 4a

Summary of costs of applying a fit and proper persons test (option 1) and safeguarding customers' funds (option2) (nominal £)			
	One off	Ongoing	Total (10 years)
FSA's costs	£90,000	£20,000	£270,000
Firms' costs	£180,000	£190,000	£1,890,000
Account maintenance	£6,000,000	£15,400,000	£144,600,000
Cash handling	£3,000,000	£6,900,000	£65,100,000
Totals	£9,270,000	£22,510,000	£211,860,000

Table 4b

Costs of safeguarding customers' funds (nominal £)			
	One off	Ongoing	Total (10 years)
Account maintenance	£6,000,000	£15,400,000	£144,600,000
Cash handling	£3,000,000	£6,900,000	£65,100,000
Totals	£9,000,000	£22,300,000	£209,700,000

This option requires all Small Payment Institutions to safeguard customers' funds in a segregated account, as well as introducing a fit and proper persons test. The threshold for safeguarding has been set at a level of £50 (any amount over £50 would need to be safeguarded.The funds would be kept in a ringfenced account that would be protected from other creditors in the event of the insolvency of the small payments institution. A threshold of £50 has been selected because it is the existing threshold for safeguarding customers' funds that already applies to Authorised Payment Institutions under the Payment Services Regulations.

Only 21% of Small Payment Institutions have opted to safeguard customers' funds in a segregated account (as at November 2011, according to FSA data).

Most of the firms affected by this option currently operate in cash, and many do not have a business bank account. The main additional costs of this measure (compared to option 1) therefore arise through requiring firms to open and operate a business bank account in order to hold customers' funds safely, before the customers' funds are transmitted to the recipient. In normal circumstances, a business would operate a primary business bank account for itself, with a secondary, linked deposit account for customers' funds.

This option includes the option 1 measures for a fit and proper persons test and adds a requirement to safeguard customers' funds. The calculation of the option 1 measures are not replicated below but the costs are included in the summary table for option 2 (*table 4a*). For clarity, the additional costs of safeguarding customers' funds received for payment services are identified separately in table 4b.

80% of the firms affected are micro enterprises and it is estimated that micro enterprises will bear 80% of the costs in this assessment.

Small Payment Institutions without a bank account

HMRC have indicated that not all the money transmitters on the HMRC money laundering register are thought to have a bank account. HMRC records suggest that the proportion that hold a bank account is around 65%. However, some businesses will have failed to notify HMRC of their account, and some may have notified personal rather than business bank accounts. A cross check with the principal banks that specialise in offering banking services to money transmitters suggests that fewer than 50% hold a business bank account. 50% - 65% is therefore the best estimate of the number of money transmitters that hold a bank account. The remaining 35% - 50% are likely to be operating exclusively in cash or may be using the bank account or services of another business.

This means that 35% - 50% of money transmitters may be required to open their own business bank account by the FSA, if a safeguarding requirement is introduced. Money transmitters are required to register with the FSA as Small Payment Institutions (or become fully Authorised Payment Institutions) under the Payment Services Regulations 2009. Under option 2, it would be a condition of registration under the Regulations that a Small Payment Institution must safeguard customers' funds in a ringfenced account and so it would be compulsory to operate a business bank account to comply with this requirement. In fact it might be necessary to open two accounts,one for day to day business operations and a second account for customers' funds.

The number of existing FSA registered Small Payment Institutions and those in the pipeline for registration is 1,136 This number is expected to rise to 2,400 Small Payment Institutions (as set out in *table 3*). By year 4, the number of SPIs expected to reach a steady state with new arrivals being offset by departures at a rate of 360 per year.

Small Payment Institutions required to open a bank account

Table 3 sets out the pattern of existing registered SPIs and expected growth in numbers. Based on this:

(i) The minimum number of existing registered SPIs that would be required to open a bank account is (1,136 x 35%) 398.

(ii) The number of firms expected to be registered in future is expected to stabilise at around 360 per year on average, therefore:
(360 x 35%) 126 firms would be required to open a bank account in each year in future.

Table 5

Firms expected to have to open a bank account		
Year	No.	Cumulative total
0	398	398
1	126	524
2	126	650
3	126	776
4	126	902
5	126	1,028
6	126	1,154
7	126	1,280
8	126	1,406
9	126	1,532

Costs of operating a bank account

A Small Payment Institution opening and operating a business bank account will incur a facility or account maintenance fee (a standing charge, typically payable quarterly) and per transaction fees (typically cash handling fees).These fees apply to the primary bank account. A second account is needed in which to segregate customers' funds. However, the costs of this second account are zero or minimal (eg £5 per month). This is why the additional costs of safeguarding customers' funds apply only to firms that would not otherwise hold a business bank account.

In some cases, banks may charge a set up fee which might be as high as £5,000, and no quarterly fee. The more valuable a SPI is considered to be by their bank, the better the fee package they will be able to negotiate. According to the banks, charges are likely to be higher for the first three to six months of operation whilst the bank creates a profile for the SPI. Once this has been established costs are likely to fall.

Standing charges: discussions with SPIs and banks indicate that an account maintenance fee can range from as little as £10 per month (with the guarantee that a firm will process a minimum turnover through the bank of more than £4 million per month); to £2,500 - £5,000 per quarter with no conditionality, for new high risk businesses. The costs of maintaining a second safeguarding account exclusively for customer's funds is zero, or minimal. One bank provided this free, another quoted a £5 per month fee for this service.

Transaction charges: cash handling fees vary depending on how cash is deposited. Charges are lower when cash is deposited at the bank, and higher if a bank collects it from the SPI. Banks also charge according to the way that cash is presented. They offer incentive based pricing depending on the presentation standard. For example, a sum in mixed small denomination notes takes longer to process and physically move than the same sum in large single denomination notes. Coins are more expensive. In general, over-the-counter deposits are priced between £0.30 and £0.50 per £100 (but can go up to £0.80 per £100) paid in. For cash sent to a processing centre the costs are approximately £0.10 to £0.30 per £100 paid in. These rates apply to all businesses. Small Payment Institutions do not attract special rates. The full scale of charges quoted to one SPI is as follows (table 6):

Table 6

Indicative bank transaction charges per £100	
Cash paid in	50p
Debit transfer	15p
Credit transfer	25p
Automated credit	14p
Cash in at cash processing centre	25p
Other	
3 statements	95p
Source: Developing Market Associates	

Bank charges would therefore represent a significant cost to Small Payment Institutions, both in terms of account maintenance fees in the region of £2,500 - £5,000 per quarter and, because they work predominantly in cash, in terms of cash handling fees. Several banks offer free cash handling services to small businesses. However, very few banks offer accounts to Small Payment Institutions and SPIs are unlikely to benefit from free cash handling given their risk profiles and volumes of cash throughput.

Costs to Small Payment Institutions

(i) Account maintenance fees

It is assumed that SPIs will incur account maintenance fees in the region of £ 2,500 to £5,000 per quarter (£10,000 to £20,000 pa) as set out in the section above on the costs of operating a business bank account. The range of potential costs is illustrated in the table below. It builds up over 10 years to an annual total ranging between £8 million and £17 million. These are the estimated additional annual costs once the number of SPIs has reached a steady state of £17million pa by year 11:

Table 7

Annual account maintenance fees (£ nominal)						
Year	New firms	Cumulative no. of firms	Min fees	Cumulative Min	Max fees	Cumulative max
0	398	398	3,980,000	3,980,000	7,960,000	7,960,000
1	126	524	1,260,000	5,240,000	2,520,000	10,480,000
2	126	650	1,260,000	6,500,000	2,520,000	13,000,000
3	126	776	1,260,000	7,760,000	2,520,000	15,520,000
4	126	902	1,260,000	9,020,000	2,520,000	18,040,000
5	126	1028	1,260,000	10,280,000	2,520,000	20,560,000
6	126	1154	1,260,000	11,540,000	2,520,000	23,080,000
7	126	1280	1,260,000	12,800,000	2,520,000	25,600,000
8	126	1406	1,260,000	14,060,000	2,520,000	28,120,000
9	126	1532	1,260,000	15,320,000	2,520,000	30,640,000

A mid-point estimate for these annual account maintenance fees (included in summary tables 4a and 4b) is:

Table 8

Year	Cumulative annual account maintenance fees (£ nominal)
0	5,970,000
1	7,860,000
2	9,750,000
3	11,640,000
4	13,530,000
5	15,420,000
6	17,310,000
7	19,200,000
8	21,090,000
9	22,980,000
Yr 0 rounded to £6m in summary table *Yrs 1 to 9 averaged to £15m in summary table*	

(ii) Cash handling fees

SPIs can be expected to pay in the region of 30p- 50p per £100 on cash paid into a business bank account, as set out in the section above on the costs of operating an account.

According to industry experts and the FSA, each SPI is handling in the region of £15,000 to £50,000 of cash per week (although some SPIs do more). The total value of cash transactions handled by one SPI is therefore between £780,000 and £2.6 million per year. Assuming an average cash handling fee payable to a bank of 0.40p per £100, this translates into aggregate annual cash handling fees likely to be paid by the SPI's who do not currently have a business bank account rising to between £5 million and £16 million per year after ten years as shown in table 9:

Table 9

Annual cash handling fees (£ nominal)						
Year	New firms	Cumulative no. of firms	Min value of transactions	Min fees	Max value of transactions	Max fees
0	398	398	310,440,000	1,241,760	1,034,800,000	4,139,200
1	126	524	408,720,000	1,634,880	1,362,400,000	5,449,600
2	126	650	507,000,000	2,028,000	1,690,000,000	6,760,000
3	126	776	605,280,000	2,421,120	2,017,600,000	8,070,400
4	126	902	703,560,000	2,814,240	2,345,200,000	9,380,800
5	126	1028	801,840,000	3,207,360	2,672,800,000	10,691,200
6	126	1154	900,120,000	3,600,480	3,000,400,000	12,001,600
7	126	1280	998,400,000	3,993,600	3,328,000,000	13,312,000
8	126	1406	1,096,680,000	4,386,720	3,655,600,000	14,622,400
9	126	1532	1,194,960,000	4,779,840	3,983,200,000	15,932,800
Yr 0 averaged and rounded to 3m in summary tables 4 and 4a *Yrs13 – 9 averaged and rounded to £7m in summary tables 4a and 4b*						

These estimates do not take into account transactions of below £50 which would not need to be paid into a bank account, as the volume of such transactions is not known. Nor is any account taken of variations due to processing bills in different denominations.

There will also be opportunity costs of requiring safeguarding client funds, so that the funds are not available for use by a Small Payment Institution. These costs are expected to be negligible. This is because money transmitters usually remit funds within 24 hours, and do not usually hold any client funds for more than a few days, so that investment opportunities will be slight. In any event, interest earned on deposits will continue to accrue to a small payments institution.

Inability to open a business bank account

Money transmitters are viewed as a high risk business by banks (mainly due to money laundering and terrorism financing concerns). This means that a proportion of Small Payment Institutions that are not currently banked would be unlikely to be able to open a business bank account. Much will depend on the management of a SPI business, the risk controls that are in place, and the countries to which a firm is sending money. Even if a SPI is accepted by a bank, it may take a long time – typically six to nine months - to open an account while banks complete security checks.

One major bank has recently withdrawn from the market, and small money remitters report increasing difficulty in obtaining a business bank account.

It is not possible to estimate with any accuracy the proportion of money transmitters that may be refused a business bank account. One proxy for the proportion of money transmitters that may be refused a bank account is to use the withdrawal rate for money transmitters whose applications for registration as Small Payment Institutions do not succeed. This withdrawal rate is likely to be around 15% of applications, in line with the present withdrawal rate of businesses applying for authorisation as Authorised Payment Institutions. The present withdrawal rate for applications for registration as a Small Payment Institution is 5%. This implies that an additional 10% (15%-5%) of applications are likely to be withdrawn. Applied to the population of 2,732 money transmission businesses, the additional 10% of withdrawals suggest that an additional 273 businesses (2,732 x 10%) would no longer qualify for FSA registration. This is reflected in the table above showing the expected growth in numbers of Small Payment Institutions. The withdrawal rate for small businesses applying for registration may however exceed the rate for large firms significantly. It is also likely to be concentrated on firms trading with the highest risk countries, such as failed States.

Market Impacts

The additional costs as a result of these proposals could have an impact on firms' decisions to apply for registration as Small Payment Institutions. A proportion of the firms are likely to continue with their applications, however, others may decide not to apply. They may decide to become an agent of an authorised firm, or apply for full authorisation in their own right, or exit the market completely.

This is a low-margin sector, and it is likely that at least a proportion of any increase in compliance costs to firms will be passed on to consumers.

Equalities and small firms

The Government has considered the proposed reforms in relation to its public sector equality duties under the Sex Discrimination Act 1975, the Race Relations Act 1976, the Disability Discrimination Act 1995, section 75 of the Northern Ireland Act 1998 and the Equality Act 2010. It has concluded that no relevant issues arise.

Option 2 Benefits

The principal benefits are as for option 1,in that the annual average loss to customers is expected to be cut from between £0.7million and £5 million per year to near zero The benefits calculation from eliminating the costs to consumers of potential firm ranges from £0.7 million to £5 million annually. The midpoint is £2.85 million pa.

However, in the event that there are failures in future, it is expected that the requirement to safeguard client funds received for payment services in a segregated account would give customers an additional layer of protection, in the event of an insolvency, than that afforded by options 0 and 1. It would afford a higher level of protection because it would prevent customers' funds from being mixed with other funds, or being used as working capital of a Small Payment Institution. It would act to secure clients' funds directly. It would act directly because it would ensure that, in the event of a failure, customers' funds in a segregated account would be statutorily protected from claims by other creditors. An administrator would be required to immediately pay the funds back to the clients that owned them without going through a lengthy winding up process. The benefits would be limited to the period during which funds are held in a segregated account (typically no more than a day or two).

These estimates appear reasonable when cross checked against the value of transactions which industry sources advise that many Small Payments Institutions appear to be undertaking in practice. They therefore represent the potential benefits to consumers of preventing future failures due to financial mismanagement.

The qualitative benefits to small firms are likely to be increased consumer confidence in them and the remittances industry in general.

Equalities and small firms

The Government has considered the proposed measures in option 2 in relation to its public sector equality duties in relation to Section 149 of the Equality Act 2010. It has concluded that no relevant issues arise."

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), i.e. a sunset clause or a duty to review , or there could be a political commitment to review (PIR)]; Sunset clause in June 2019 and a duty to review by June 2017. In addition, the Payment Services Directive is scheduled for review by no later than 1 November 2012 by the European Commission.
Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?] The objectives include as assessment of the impact of the authorisation requirements on firms, and the application of the rules concerning safeguarding customers' funds.
Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach] The review will look at the effectiveness of the measures and impacts based on data collected by the FSA and HMRC. It be informed by the scope of the review of the Payment Services Directive, supported by research carried out on behalf of the Commission, and data and feedback supplied by Member States
Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured] The baseline is as set out for option 0 which imposes no new costs.
Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives] i) the reduction in the rate of failures of small payments institutions ii) successful implementation of the new procedures.
Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection systematic collection of monitoring information for future policy review] The FSA will be responsible for introducing the new procedures, and monitoring their implementation
Reasons for not planning a review: [If there is no plan to do a PIR please provide reasons here]

Add annexes here.