FEATURE ARTICLE

Stored value facilities and retail payment systems in Hong Kong: a proposed regulatory regime

by the Financial Infrastructure Department

The rapid development of innovative retail payment products and services is expected to see the emergence of new mainstream means of paying for a wide range of goods and services, including small transactions which are now paid for by cash. For these retail payment solutions to continue developing and become a truly mainstream means of retail payments, public confidence and innovation are key. A sound regulatory framework is essential to ensure the safety and soundness of the operation of such products and services. In this connection, the Financial Services and the Treasury Bureau and the Hong Kong Monetary Authority have recently proposed a regulatory regime for stored value facilities and retail payment systems in Hong Kong, and have issued a public consultation paper explaining our proposal in detail. The plan is to introduce an amendment bill to the Legislative Council after the public consultation. Members of the public are encouraged to study the proposal and give their views. The feedback will help us shape a better regime.

Introduction

Stored value facilities (SVFs) have become an increasingly important payment instrument in Hong Kong and elsewhere. SVFs are normally categorised in two ways:

(i) SVFs can be classified as either multi-purpose or single-purpose. Multi-purpose SVFs are used as a means of payment for goods and services provided by participating merchants, which is akin to an electronic surrogate for coins and banknotes. Single-purpose SVFs can only be used as a means of prepayment for goods and services provided by a merchant who is also the issuer of the SVF.

(ii) SVFs can also be classified as either device-based or non-device based. Examples of device-based SVFs include stored value cards and other stored value physical devices such as watches and ornaments. A typical example is the Octopus card in Hong Kong. Non-device based SVFs normally have their value stored on a computer network-based account or a mobile network-based account rather than on a physical device.

A **retail payment system (RPS)** refers to a payment system that typically handles the transfer, clearing and settlement of small-value transactions. Examples are credit card schemes, debit card schemes, large merchant acquirers, payment gateways and mobile payment infrastructure.

Latest developments

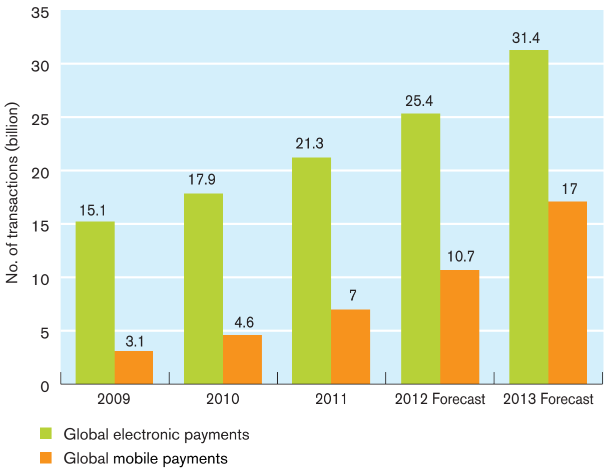
Over the past few years, there has been a notable development in the global retail payment landscape. Many innovative payment products and services have emerged, such as stored value payment cards, online stored value payment facilities, and mobile payment and Internet payment services.

A report released by the Bank for International Settlements (BIS) in 2012 shows that many innovative retail payment instruments have been developed over the past decade, and their variety and number continue to increase.[1] Many of these innovations were driven by technological developments such as the spread of smart phones and Near Field Communication (NFC) technology[2], as well as the rapid growth of e-commerce, as people have become more willing to make payments via electronic communication channels, such as Internet and mobile phones.

According to some market forecasts, globally the number of electronic payments for e-commerce activities is expected to double in five years, from 15 billion transactions in 2009 to 31 billion transactions in 2013. With the rapid rise in the number of smart phones, mobile payments are forecast to grow even faster than electronic payments, increasing more than five times from three billion transactions in 2009 to 17 billion transactions in 2013 (see Chart 1).

CHART 1

Number of global electronic payments and mobile payments (2009 – 2013)



Source: *World Payments Report 2012*, Capgemini, RBS and EFMA.

In Hong Kong, innovative retail payment solutions are emerging fast as well. The support provided by a sound and resilient information, telecommunications and financial infrastructure is a key reason, but the public's willingness to readily accept new payment technologies also makes Hong Kong fertile ground for e-commerce and online shopping.[3]

According to the research of a major payment service provider, the online shopping market in Hong Kong was worth around HK$16 billion in 2012, with participation of more than two million online shoppers.[4] The market is forecast to grow by about 70% to over HK$27 billion by 2015. There is also increasing interest from non-bank payment service providers to issue non-device based SVFs to users in Hong Kong.

Current regulatory regime

Device-based multi-purpose SVFs are now regulated under the Banking Ordinance, which has been providing for the regulation of multi-purpose stored value cards since 1997. However, the emerging non-device based SVFs are not subject to regulation.

As regards RPSs , the Hong Kong Monetary Authority (HKMA) has employed an informal regulatory approach targeting mainly payment cards – eight payment card scheme operators with credit or debit card operations in Hong Kong have committed to adopt and comply with a voluntary "Code of Practice for Payment Card Scheme Operators" that was endorsed by the HKMA. The Code sets out general principles for payment card scheme operators to observe to promote the safety and efficiency of payment card operations in Hong Kong and foster public confidence in their operations.

[1] See BIS Committee on Payment and Settlement System (2012), *Innovations in retail payments*, BIS, Basel, May.

[2] NFC technology enables consumers to install, among other things, mobile payment applications such as e-purse onto their mobile phones and make contactless payment at retail outlets by tapping their mobile phones to the readers installed at the outlets.

[3] According to the Office of the Communications Authority, the penetration rates of household broadband and mobile phones in Hong Kong in September 2012 were about 87% and 223% respectively, among the highest in the world.

[4] Sources: *PayPal Consumer Online and Mobile Shopping Insights*, September 2012 and PayPal analysis.

Table 1 shows an overview of the current regulatory regime for SVFs and RPSs.

Table 1

Overview of the current regulatory regime for stored value facilities and retail payment systems

Category	Current regulatory regime
Device-based stored value facilities	Multi-purpose stored value card regime under the Banking Ordinance
Non-device based stored value facilities	Not subject to regulation
Retail payment systems	Self-regulatory regime for payment cards under a voluntary code of practice

A need for an enhanced regulatory framework

As SVFs and RPSs have grown in size and significance in Hong Kong and are increasingly tied to a wide range of economic functions, the number of users and the aggregate values and volume of such transactions have become significant. Therefore, efficient functioning of SVFs and RPSs is important for maintaining the stability of the payment and financial systems as well as public confidence in Hong Kong's payment and financial systems.

The increased use of SVFs also calls for the need to ensure adequate protection of the "float" of the SVFs, i.e. the total sum of money paid by a user to an issuer for storage on the SVF.

Furthermore, enhancing the payment-related legislation in Hong Kong will help foster innovation in retail payment products and services in Hong Kong and maintain our competitive edge over other major financial centres. For instance, laws have been enacted in the UK, the EU, Australia and some major Asian countries to regulate SVFs and RPSs.

Legislative proposal

The Financial Services and the Treasury Bureau (FSTB) and the HKMA are jointly proposing to amend the Clearing and Settlement Systems Ordinance (CSSO) to give effect to a new regulatory framework for SVFs and RPSs. Specifically, it is proposed to

(i) introduce a mandatory licensing regime for SVFs;

(ii) establish a designation regime to empower the HKMA to designate and oversee RPSs that are of importance to the general public and the financial stability of Hong Kong; and

(iii) empower the HKMA to exercise supervisory and oversight functions over SVFs licensees and RPSs, as well as to conduct investigations.

Since the CSSO already provides a comprehensive framework for regulating important large-value clearing and settlement systems[5] by the HKMA, that framework forms a solid foundation for the regulation of RPSs. We therefore propose to give effect to the proposed new regulatory framework through amending the CSSO. This approach would avoid duplicating regulatory frameworks and promote policy consistency. It also follows the same arrangements in some other jurisdictions which prescribe the regulatory frameworks for large-value clearing and settlement systems, SVFs and RPSs in a single piece of legislation.

[5] Large-value clearing and settlement systems generally refer to systems that process transactions at interbank level. Six large-value clearing and settlement systems have been designated under the CSSO for oversight by the HKMA.

Benefits of the proposed regulatory regime

The new regulatory regime would facilitate the development of the financial system and benefit the general public by achieving four objectives. We set out the objectives below, and briefly explain how the key elements of the legislative proposal would help achieve each of them.

1. To ensure that SVFs and RPSs in Hong Kong are safe and sound

The two core elements of the proposed legislation are (i) a mandatory licensing regime for SVFs, and (ii) a designation regime for important RPSs.

(i) Mandatory licensing regime for SVFs

The regulatory focus would be on multi-purpose SVFs, rather than single-purpose SVFs. For instance, an SVF issued by a conglomerate for buying goods and services from its many affiliates would be subject to the licensing requirement, whereas a prepaid card issued by a coffee shop chain for purchasing its coffee and snacks is a single-purpose SVF and would not be subject to regulation.

To obtain a licence under the proposed regime, the issuer of the SVF must meet certain criteria on an on-going basis. For instance, the issuer should be a company incorporated in Hong Kong and maintain a paid-up share capital of not less than HK$25 million. There should also be proper policies and procedures in place to safeguard and manage the float and arrange for redemptions. Other criteria would concern the fitness of responsible persons, risk management process, etc.

(ii) Designation regime for important RPSs

The proposed legislation would also empower the HKMA to designate and oversee important RPSs. An RPS would be subject to designation if any disruptions to the RPS have implications for the monetary or financial stability of Hong Kong, public confidence in payment systems or the financial system of Hong Kong, or day-to-day commercial activities in Hong Kong.

Designated RPSs will be subject to safety requirements, which include, among other things, risk management and control procedures relating to the operation of the system; safety and integrity of information held within the system; soundness of the system including financial soundness; and efficiency requirements.

It is envisaged that the proposed meaning of RPS will cover credit card schemes, debit card schemes, large merchant acquirers, payment gateways and mobile payment infrastructure.

The legislation would give the HKMA supervisory and enforcement functions over SVFs and RPSs, and establish an appeal mechanism to handle appeals against the HKMA's decisions.

2. To better protect the "float" of the stored value facilities

The key focus of the proposed legislation is the better protection of the "float".

For SVF licensees which are themselves licensed banks, they will be deemed to be licensed to issue or facilitate the issue of SVFs. Also, they will be required, on top of other stringent prudential requirements, to implement sufficient control measures to protect the float. The HKMA will consider their proposed control measures and review their adequacy as part of the on-going supervision.

For non-bank SVF licensees, the proposed legislation would require that the float be kept separate from the licensee's other funds. The float should also be at least 100% protected by safeguard measures. For example, such measures could be a guarantee from a licensed bank in Hong Kong, or a trust account maintained with a licensed bank in Hong Kong. The HKMA will discuss with each non-bank SVF licensee about its float safeguard measures which, once agreed, would be a licensing condition of its SVF licence.

3. To foster innovation in retail payment products and services in Hong Kong

The proposed legislation has attempted to provide a reasonably wide definition of SVF so that the new law would be applicable to both existing as well as potential SVFs. Specifically, the proposed legislation should provide clarity on the regulatory framework for both device-based and non-device based SVFs.

The proposed legislation would also give the HKMA the discretion to exempt certain SVFs from the licensing requirements. In exercising the discretion, the HKMA would strike a balance between maintaining financial stability and avoiding regulatory "overkill" that would hinder the healthy development and innovation of smaller SVFs. For instance, there would be little point in putting an SVF used only by university students on campus under a licensing regime.

4. To put Hong Kong on par with other major financial centres in terms of retail payment regulations

Regulatory frameworks for SVFs and RPSs are already in place in jurisdictions such as the UK, the EU, Australia and some major Asian countries.

Under those regimes, SVFs are generally subject to a mandatory licensing regime and the float is subject to statutory safeguards that are the primary focus in the regulation of SVFs. The regulatory authorities can also designate important RPSs to be subject to their oversight.

Moreover, the regulatory authorities administering the regime for SVFs and RPSs are given explicit powers to carry out supervision and enforcement functions. This is essential to the effective regulation of SVFs and RPSs.

The proposed legislation in Hong Kong adopts common critical elements in the various regulatory frameworks in other jurisdictions, with appropriate modifications to suit our particular conditions.

Public consultation

The HKMA consulted with more than 40 stakeholders in the payment and IT industries, as well as the Consumer Council, about the proposed regulatory regime between December 2012 and January 2013. The consulted parties generally support the proposal, and believe that the regulatory regime should help further develop the payment industry in Hong Kong.

FSTB and the HKMA jointly issued a public consultation paper on 22 May 2013[6], inviting views and comments on the proposed regulatory regime. We encourage members of the public to study the proposal set out in the consultation paper, and offer their opinions during the three-month consultation period. We intend to introduce the legislative proposal to the Legislative Council after considering the views and comments received from the public consultation.

[6] See joint FSTB-HKMA press release "Consultation on the proposed regulatory regime for stored value facilities and retail payment systems begins" issued on the same date, which is available on the websites of the FSTB (www.fstb.gov.hk/fsb) and the HKMA (www.hkma.gov.hk).