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PSO Governance Subgroup Report

Submitted by Carl Pheasey

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1 EXECUTIVE SUMMARY

The PSO Governance Subgroup ("the Subgroup") is a part of the Simplifying Access to Markets Working Group (SAMWG), which was established by the Payments Strategy Forum (PSF) to consider how access to payment systems could be improved. The Subgroup was set up specifically to independently and objectively assess whether the impact of the solutions being proposed by the SAMWG to address the identified detriments may be made more effective, or the benefits achieved more rapidly, if PSO structure and governance were reformed. Taking into account a narrower set of detriments identified by the Payments Community related to complexity and excessive cost around access and compliance with rules, the Subgroup was asked to assess a number of options for reform, including no reform. The assessment would be passed to the SAMWG and the PSF for further consideration. In all of its discussions the Subgroup has been cognisant of the outcome it is seeking. There are a number of principles and objectives that have been put in place by the Payment Systems Regulator (PSR) and the PSF which provided the context for the Subgroup's discussions around the outcomes it is seeking. These included the PSF's objectives that the industry should be:

- secure and resilient
- versatile and responsive to user needs
- efficient

1.1 WHAT HAS THE PSO GOVERNANCE SUBGROUP DONE?

The Subgroup has met three times since it was established in April 2016. It considered the options for reform with reference to the detriments; agreed the criteria against which the options would be assessed; sought input from PSOs; held a workshop to discuss the options; and held a further meeting to agree the analysis.

The long-list of options it considered were:

- Option 1: Work in progress, no structural reform to existing PSOs
- Option 2: Consolidated rulemaking entity only, with existing PSOs procuring and managing contracts for infrastructure
- Option 3: Two consolidated entities, excluding LINK, one for rulebook management and the other for procuring and managing contracts for infrastructure
- Option 4: One consolidated entity excluding LINK, responsible for both rulemaking and infrastructure procurement, excluding LINK
- Option 5: One consolidated entity including LINK, responsible for both rulemaking and infrastructure procurement, including LINK

This long-list of options was short-listed to three options after initial Subgroup discussions (see sections 1.2 and 1.4 below). Options 1, 3, and 4 were taken forward for further consideration, and renumbered 1, 3, and 2 respectively.

1.2 SCOPE

The Subgroup discussed which PSOs should be in scope for potential reform. It was agreed quickly that card schemes would be out of scope. The focus for analysis was on interbank PSOs: CHAPS, BACS, FPS, C&CCC and LINK. There was considerable discussion about whether CHAPs and LINK should be in scope and it was determined that they should not. The Bank of England is undertaking a review of the Real Time Gross Settlement (RTGS) system which could materially affect CHAPS, which reports at the end of 2016. It was deemed that the Subgroup should not prejudge the outcome of that review, so CHAPS was excluded. The benefits of including LINK did not appear to outweigh the potential risks to the organisation and its role in supporting cash payments from physical terminals made it sufficiently distinct to leave it out of scope, whilst noting that it is fully engaged in the wider PSO simplification workstreams. This excluded option 5. Options 1, 3, and 4 were taken forward for further evaluation, after option 2 was deemed to offer very little benefit. Options 1, 3, and 4 were taken forward and renumbered as options 1, 3, and 2 respectively.

The Subgroup also discussed the nature of competition around the existing PSOs. The group concluded that PSOs should be on the whole viewed as utilities which facilitate and enable downstream (and potentially upstream, infrastructure) competition rather than as entities which compete with each other.

1.3 EVALUATION CRITERIA

The options were assessed against a set of seven criteria which were agreed by the Subgroup and based on the PSF's Evaluation Framework published in December 2015. The criteria are:

1. How does the option affect entry and access to payment systems, for example by improving complexity and transparency?
2. How does the option facilitate and enable PSPs to innovate?
3. How responsive is the option to user needs?
4. How does the option affect the ability to innovate and promote competition upstream and downstream?
5. How flexible and versatile is the option in response to potential changes to the industry? For example, to regulatory requirements, standards, and/or innovation?
6. How does the option affect the PSOs' infrastructure procurement/contracts management incentives and outcomes at this layer of the market?

7. How does the option affect the ability of the resultant payment system operator(s) to fulfil its role as a systemic risk manager, and how does it affect overall payment systems resilience?

1.4 SUMMARY OF ANALYSIS OF THE SHORT-LIST OF OPTIONS

This long-list of options was short-listed to three options after initial Subgroup discussions. Options 1, 3, and 4 were taken forward for further consideration, and renumbered 1, 3, and 2 respectively.

1.4.1 Option 1: Work in progress, no structural reform to existing PSOs

There are a number of existing initiatives that are expected to have a positive impact on the payments ecosystem from SAMWG. These are expected to help reduce complexity, improve market entry, reduce costs, and facilitate greater innovation and competition. The existing structure is considered to be extremely resilient, and moving to common messaging standards (ISO20022) is likely to improve that resilience further.

Complexity is seen in multiple layers of the payments ecosystem and not just at the PSO level. Indeed, larger PSPs, as sponsor banks, potentially have a role to play in opening up access, improving transparency, and reducing the complexity experienced by indirect PSPs.

However, there is no single strategic body for payments to formulate strategies that develop the interbank ecosystem as a whole (rather than just the individual PSOs) without external pressure or input. Furthermore, collaborative efforts risk dwindling over time because individual PSOs have a fiduciary duty to act in the interests of the PSO, so decision making between PSOs may diverge.

Even after the implementation of existing SAMWG solutions, there are likely to still be considerable time and cost requirements for PSPs to gain entry and participate. While aggregators connecting to multiple PSOs may allow PSPs to outsource the complexity element to some extent, the cost of joining and participating still needs to be borne by the participant. Additionally, it is not certain that competitive aggregators will emerge because this solution is still in an early stage of development, and their emergence will be subject to market forces.

The Simplified Payments Platform (SPP) currently in conceptual development by the Horizon Scanning Working Group (HSWG) would offer one possible way to create a simpler framework for payments which promotes competition and facilitates innovation. However, it is still in very early stages of development and developing it as a separate PSO alongside the other systems could potentially complicate the market further, even if this was a time limited measure before migrating existing PSOs to the new platform.

1.4.2 Option 2 (was Option 4): One consolidated entity

A consolidated entity should provide a single strategic view for retail payments (excluding LINK, cards, and CHAPS). This would provide for a more coherent and joined up approach to developing retail interbank systems. The Subgroup deemed that a consolidated entity would generally complement and support the existing SAMWG workstreams, thus helping to address the detriments more quickly. Consolidating three entities into one would simplify the PSO landscape, reduce complexity, and improve the user experience, as well as facilitate innovation and competition among PSPs. Having one entity to deal with instead of three would significantly reduce the inefficiencies that currently exist and which make change slow and time consuming. Competition at the infrastructure layer is unlikely to be impacted negatively, assuming the new body was established with appropriate objectives in this regard. An objective to deliver increased interoperability could potentially be established, leading to improved future resilience.

However, there is significant change already taking place in the payments sector (e.g. ring-fencing, the relatively new PSR, cheque imaging, and PSD2), and reform could stretch resources, putting at risk SAMWG short-term wins or PSO services being developed for users and consumers. Equally with fewer organisations there might be less diversity of thinking or competition for ideas.

The new consolidated entity would need to be monitored to ensure that it properly considered potential conflicts of interest that arise from having control of both the rulemaking and procurement functions, which may undermine incentives to pursue significant reform, and therefore could reduce transparency. A primary aspect of consolidation would be to consider board constitution and representation, senior management appointments, and new objectives for resilience, operational effectiveness, and culture. Without these, consolidation may not achieve the outcomes sought by the Subgroup and the wider PSF.

1.4.3 Option 3: Two consolidated entities

This option is distinct in that it splits the rulemaking/rules administration entity from the infrastructure procurement and contract management entity. There are benefits and risks to this option.

Separating the functions could be desirable because it mitigates the conflict of interest that would potentially be faced by an entity which manages both functions. This conflict of interest results from the entity being responsible for making the rules, following the rules in its procurement and contract management activities, and enforcing the rules. The conflict of interest could be sufficiently great so as to hinder effective operation from an overall market perspective. Additionally, as noted above, it could hold back the development of an innovative Simplified Payments Platform.

However, there are risks around systemic risk management in this option. Splitting the functions could potentially lead to uncertainties in the allocation of responsibility around risk management and service operation. This, in turn, could add additional complexity and risk around incident management and crisis resolution via the presence of an additional "layer"/body which does not exist today. The rule making entity would set the rules (and be responsible for making sure all parties comply with the rules) and the procurement entity would be required to follow the rules (including those around systemic risk management). Even if this were to be made clear, there are still concerns that responsibilities for management of risks could remain blurred between the two entities. It would be very difficult to create a risk management framework which could be sufficiently robust to address this.

1.4.4 Analysis conclusions

The solutions identified by the SAMWG and the SPP will go some considerable way to helping open up payments and improve competition and innovation while reducing the cost of complexity. However, Option 1 arguably takes a piecemeal approach to the detriments, seeking to deal with the individual detriments as they arise. While the SPP is designed to deal with the detriments holistically, it is still being developed conceptually. It was difficult for the Subgroup members to assess the weight of the benefits SPP might bring in the light of the SPP's early stages of development.

Option 2 allows consolidation to a single entity to improve the outcomes from the SAMWG while offering a more strategic overview of the payments industry and a simpler regime for industry and regulators. This should help to address the detriments more quickly and effectively. It is not without its risks though and the underlying culture will ultimately determine its success in delivering the benefits of reducing complexity, increasing transparency, promoting wide user representation and facilitating upstream and downstream competition. Therefore, Option 2 is preferred over Option 1.

Option 3 has the strengths of Option 2 but brings with it the added benefit of dealing with potential conflicts of interest and paving the way for a future Simplified Payments Platform. However, in doing so it could compromise systemic resilience and the ability of PSOs to manage both day to day operational risk and systemic risk. Maintaining stability and resilience is paramount, and is a minimum requirement for any option to be taken forward. It is therefore considered that Option 2 is preferable to Option 3.

Following our analysis of the various options, the PSO Subgroup offers the following ranking of options for the PSF's consideration. It does not 'recommend' a specific option at this time as there are further considerations (noted below) related to the cost benefit analysis and the transitional phases which could have a material effect on the options and would need to be considered fully before a decision was made.

Considered against the criteria for evaluation and the objectives of the Payments Strategy Forum, the group ranks the options in the following order:

1. **Option 2: Consolidation of Bacs, FPS, and C&CCC into one entity responsible for both rules and infrastructure**
2. **Option 3: Consolidation of Bacs, FPS, and C&CCC into two entities: one responsible for rules and the other responsible for infrastructure**
3. **Option 1: Work in progress; no structural reform**

1.5 CONCLUDING REMARKS

The PSO Governance Subgroup has provided the PSF with a clear view that consolidating FPS, Bacs and C&CCC into one single entity is likely to be the most advantageous option to pursue. Continued uncertainty over the future model creates risks which the Forum should seek to avoid. However, before this work can be agreed it is of vital importance that the cost benefit analysis is completed and further consideration given to the impact on end users of the approach taken. A target operating model needs to be clearly articulated with a transition plan put in place. This should be led by the PSOs themselves in agreement with the Bank of England, HM Treasury and PSR.

2 INTRODUCTION

The PSO Governance Subgroup (the "Subgroup") is a part of the Simplifying Access to Markets Working Group (SAMWG) established by the Payments Strategy Forum (PSF) to consider how access to payment systems could be improved. The Subgroup was set up to assess whether structural reform of the Payment System Operators (PSOs) would be beneficial or not. This document outlines the work undertaken by the Subgroup and its findings.

2.1 BACKGROUND

The PSF held a Payments Community Event in October 2015 and identified a list of problems – also known as 'detriments' - faced by various participants within the payments ecosystem. A number of these detriments relate to the difficulties experienced by participants in *accessing* payment systems. PSOs are considered expensive, complex and time consuming to join; there is limited transparency; and PSO rules and procedures are deemed to be complicated, which adds a time and compliance challenge to participating Payment Service Providers (PSPs). There are specific concerns that indirect access PSPs struggle in particular because they rely on incumbent PSPs with direct access ("sponsors") for indirect access, meaning that sponsors may gain an unfair competitive advantage. The varying rules and standards between PSOs mean there is limited interoperability and also ineffective competition in the infrastructure market. This undermines PSPs' ability to innovate, and reduces potential benefits to business and end users of new payment options (Payments Strategy Forum, 2016).

The SAMWG was set up by the PSF to assess how these detriments identified by the Payments Community could best be addressed. The SAMWG agreed a number of tactical solutions. However, PSO governance and structural reform came under consideration as being a potential solution to some of the identified detriments.

There have been long running discussions on the scope for reform of the structure of the PSO landscape to simplify market access. However, given the impact such reform would have on PSOs, the sensitive nature of these discussions, and the need to ensure the PSF's strategy is objective, robust, and credible, and following initial discussions in the SAMWG, it was deemed appropriate that a separate and independently chaired Subgroup should be established. Members of the Subgroup were drawn from several organisations including direct and indirect participants of PSOs. Potential conflicts of interest[1] were discussed and addressed by the

[1] 'Conflict of interest' was defined as being a member of a PSO or having a published opinion on scheme governance reform

independent Chair. Reflecting widespread interest in this work, the Bank of England[2] and HM Treasury[3] joined the group as observers.

2.2 THE PURPOSE OF THE PSO GOVERNANCE SUBGROUP

The Subgroup was set up to independently and objectively assess whether the impact of the solutions being proposed by the SAMWG to address the identified detriments may be made more effective, or the benefits achieved more rapidly, if PSO structure and governance were reformed. Taking into account a narrower set of detriments identified by the Payments Community related to complexity and excessive cost around access and compliance with rules, the Subgroup was asked to assess a number of options for reform, including no reform. The assessment would be passed to the SAMWG and the PSF for further consideration.

The Subgroup's role was not to review the governance arrangements of individual PSOs but rather PSO structure within the context of the payments ecosystem.

2.3 WHAT THE PSO GOVERNANCE SUBGROUP HAS DONE SINCE IT WAS ESTABLISHED

The Subgroup has met three times since it was established in April 2016. It considered the options for reform with reference to the detriments; agreed the criteria against which the options would be assessed; held a workshop to discuss the options; took input from PSOs; and held a further meeting to agree the analysis.

2.3.1 Relevant detriments

Multiple detriments were identified by the Payments Community relating to access and a list of these can be found in section 10.1. They cover issues relating to choice and competition among PSPs needing to connect to PSOs in order to offer services to end users; the lack of innovation; the difficulties caused by a lack of common standards and rules between PSOs; and schemes' rules and governance arrangements. In particular, the SAMWG identified three particular detriments for consideration by the Subgroup. These were:

- Multiple PSOs are expensive, complex, and time-consuming to join for PSPs, to connect to by retailer and commercial companies, and confusing for end-users (SA16)

[2] The Bank of England stated it had no pre-conceived ideas about the outcome. The Bank's primary interest is in maintaining resilience and robustness.
[3] HM Treasury similarly stated it had no pre-conceived ideas about the outcome. HM Treasury's interest is in the strategic nature of the work and the desire to reach a durable position on the long-running question of PSO governance.

- There are no transparent on-boarding processes or requirements for participants to join a scheme, and the joining process can be lengthy and costly for participants (SA14); and
- PSO procedures and rules are considered complex, adding both a time and compliance challenge for participants (SA14)

2.3.2 Identify options around reform, including no structural reform

The Subgroup agreed initially to consider five options for evaluation including one option which specifically considered the impact of existing SAMWG solutions and the work of the Horizon Scanning Working Group's (HSWG) long term vision for a Simplified Payments Platform (SPP), and to what extent, if at all, structural changes to PSOs would be merited in this context. The options were:

- Option 1: Work in progress, no structural reform to existing PSOs
- Option 2: Consolidated rulemaking entity only, with existing PSOs procuring and managing contracts for infrastructure
- Option 3: Two consolidated entities, excluding LINK, one for rulebook management and the other for procuring and managing contracts for infrastructure
- Option 4: One consolidated entity excluding LINK, responsible for both rulemaking and infrastructure procurement
- Option 5: One consolidated entity including LINK, responsible for both rulemaking and infrastructure procurement

These options are described fully in sections 5 and 7 below.

2.3.3 Developed evaluation criteria

Further to this the Subgroup examined the principles for evaluation of Simplifying Access solutions that were agreed by the PSF in December 2016 (Payments Strategy Forum, 2016):

- Principle 1: Competition upstream and downstream from the schemes should be enhanced, not reduced
- Principle 2: Potential for entry and expansion by companies providing new solutions and new operators should not be foreclosed
- Principle 3: There should be a focus on interoperability both in the UK and across the EU
- Principle 4: Service users should have an active role in advancing future innovations, including through the Forum
- Principle 5: Direct access should be facilitated

These were developed further to enable them to be used as a set of criteria (see section 6) against which to assess the options. During consideration of the evaluation criteria the group also considered the cultural and historical context of payments in the UK and the values which should underpin payments going forward (see section 3).

2.3.4 Taking evidence from PSOs

To inform the Subgroup on PSO views a meeting was held with the senior staff and board members from the PSOs. Card schemes were also invited. Further to this a list of questions were sent to the PSOs to request information and evidence to help inform the discussions of the Subgroup. A list of the questions is attached in section 10.2. Feedback was received from three of the interbank PSOs.

2.3.5 Discussing the options and agreeing the analysis

The Subgroup met to consider the options for discussion and also whether the PSOs were 'competitive' or 'collaborative' before proceeding to assess each option against the criteria. A further meeting was held to agree the analysis. This report has been written and disseminated to the PSF for further consideration.

This document outlines the group's discussions, assessments, and conclusions.

3 PRINCIPLES AND OUTCOMES FOR THE INDUSTRY

In all of its discussions the Subgroup has been cognisant of the outcome it is seeking. There are a number of principles and objectives that have been stated by the Payment Systems Regulator (PSR) and Payments Strategy Forum (PSF); they provided the context for the Subgroup's discussions around the outcomes it is seeking for the industry. A summary of these is outlined below.

The Subgroup operates within the purview of the PSF. In turn the PSF is overseen by the PSR. Both bodies have stated objectives. The PSR has the following statutory objectives:

- to ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them
- to promote effective competition in the markets for payment systems and services - between operators, PSPs and infrastructure providers
- to promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems

While the PSF has agreed that its strategy should aim to ensure that payment systems are:

- secure and resilient
- versatile and responsive to user needs
- efficient

In addition to this, one of the key strategy setting principles which is pertinent to the Subgroup is that it should be 'more important to address a small group of fundamental root causes of detriments, rather than lots of individual detriments in isolation' (Payments Strategy Forum, 2016). In considering the structural reform (or not) of the current PSOs, it is important for the SAMWG and the PSF to consider if structural reform would indeed provide the foundation for the resolution of a number of detriments, in particular those identified for this Subgroup's attention (see 2.3.1).

It is worth noting that the current payment systems are considered to be extremely reliable and resilient. PSOs take seriously their role as risk managers, as does the Bank of England, which supervises those that have been designated by HM Treasury under the 2009 Banking Act. At the point of this report's publication, all of the retail payment systems within scope of this review were designated with the exception of C&CCC. Payments for end users are reliable and generally efficient, allowing a variety of alternatives for making and receiving payments. As noted by the Horizon Scanning Working Group (HSWG - a working group of the PSF) and the payment system ownership and access model comparative analysis produced by Lipis Advisors (Lipis Advisors, 2016), UK payments are currently competitive at an international level and offer reasonable access to PSPs. There is also innovation in the ways that end users (individual consumers and businesses) can make payments through commercial propositions, for example Paypal and Amazon.

However, as identified by the Payments Community in the detriments list (see section 10.1), and as referred to often in multiple PSF working groups, there are some important characteristics missing from the existing payments ecosystem which the broader Payments Community believe are desirable in a context of increased global digitalisation and cross-border trade. These characteristics include:

- a framework for innovation and change now and in the future
- simple and open access for PSPs to the UK systems, appropriate to user needs and level of risk
- interoperability
- alignment with international standards
- more enhanced and ubiquitous data capabilities in payments than are currently available

Underpinning these characteristics is a set of cultural values – some already being demonstrated by PSOs – that underpin the success of any payments system. It is important to highlight that none of the options for structural reform considered will achieve the intended objectives without these values being more clearly demonstrated as part of PSOs' organisational culture. In order to exemplify these values and characteristics an appropriate budget must also be made available to PSOs, as it requires resources to do this well.

The values identified by the PSO Governance Subgroup include:

- Independence
- Strength of and depth in leadership
- Strong expertise and professionalism
- Collaboration
- Effectiveness
- Pace and agility

These attributes identified by the Subgroup resonate with the objectives set out by the PSF, that the strategy must lead to payment systems that are secure and resilient, versatile and responsive to user needs, and efficient.

4 PSOs IN SCOPE FOR POTENTIAL REFORM

The Subgroup discussed which PSOs should be in scope for potential consolidation. It was agreed quickly that card schemes would be out of scope because of their competitive positions. The focus for analysis was therefore on interbank PSOs: Bacs, FPS, C&CCC, CHAPS, and LINK. There was considerable discussion about whether CHAPS and LINK should be in scope and it was determined that they should not. The following section summarises the Subgroup's analysis.

4.1 COMPETITION OR COLLABORATION

The discussions to establish which PSOs should be in scope were focused, in part, on to what extent existing PSOs exhibited competitive and/or collaborative behaviour. If they currently operate competitively, any reform option promoting consolidation would be likely to have an adverse impact on competition, which could harm consumer outcomes.

Card schemes operate for profit, provide substitutable services, and offer choice to PSPs, which are not required to join all card schemes in order to offer a competitive retail service. Card schemes were therefore deemed to operate in the competitive space.

However, in order to offer a competitive retail offering it is typically necessary to join most, if not all, of the interbank PSOs. This process is deemed excessively complex, time consuming and costly (see 2.3.1) for PSPs, which discourages and impedes entry into the retail market, thus adversely affecting competition at the retail level. Because interbank PSOs are not substitutable in the same way as the card schemes, and given their 'not-for-profit' status, they were deemed to operate more collaboratively.

Evidence submitted by PSOs generally supports this. PSOs operate at a number of levels, offering complementary services to end users, collaborating where there is end user need benefit, and in some aspects competing. There has been, and will continue to be, some migration of payment volumes between PSOs (e.g. CHAPS to FPS as the transaction limits increase), and there are some specific products which could be deemed as substitutable for each other.

Taking all of the above into account, the Subgroup concluded that the interbank PSOs should on the whole be viewed as utilities which act as enablers of downstream (and potentially upstream) competition, rather than as entities which compete with each other. As such, consolidation of these PSOs should not result in substantial harm to competition in the market. However, there are specific concerns around CHAPS and LINK, below.

4.2 CARD SCHEMES

It was agreed that card schemes, Visa, MasterCard, and Amex would be out of scope because of their competitive positions. Additionally, although the Payments Community identified some detriments related to cards, these were largely not related to access. PSPs are not required to join all card schemes to offer a competitive retail service but can choose between them.

Including the card schemes in any proposal for structural reform would not help to address the detriments and could cause harm through adverse effects on competition.

4.3 LINK

LINK was initially included in-scope. However, during the course of the Subgroup's assessment of the various options, and informed by written evidence submitted by LINK, it was deemed that, across all scenarios, consolidating LINK would unnecessarily increase risk and complexity and may not achieve the intended benefits. Therefore, LINK was subsequently excluded.

LINK does not compete with the interbank payment schemes (evidenced by the fact that LINK's operations relate solely to supporting ATMs). However, LINK has expressed the view that it regards itself to be in competition with the card schemes, domestically and internationally. Consolidation could lead to difficulty in maintaining this competitive position, which could cause risk to the stability and future of the scheme. Additionally, because LINK's operations relate to supporting access to ATMs (which are focused on the provision of cash rather than interbank transfer), there would fundamentally be much less scope for simplification of rules and technical requirements in the event of its rulebook being integrated with those of the interbank payment schemes.

LINK is fundamentally different to the other schemes in its operations and its strategic focus, meaning that consolidation would be likely to have only limited benefits in terms of a new consolidated entity being able to gain a more holistic, strategic view of the entire retail payments landscape. This would be because LINK's strategic focus is on developing its ATM network in a competitive manner to meet consumer and service user demand, while the focus of the other schemes is around collaboration, system resilience, and innovation.

Including LINK in consolidation could also lead to a conflict of interest, where LINK attempts to develop a strategy focused on cash usage which balances the interests of issuers and acquirers while other parts of the entity could be driving a movement away from cash usage towards electronic transfers.

These factors led to LINK being excluded from any recommendation of consolidation.

4.4 CHAPS

After considerable discussion, CHAPS was deemed out of scope for this exercise. This is because the Bank of England is currently undertaking a review of the Real Time Gross Settlement (RTGS) system, which is the infrastructure on which CHAPS relies. The outcome of this review could materially affect how CHAPS operates, so the Subgroup should not pre-judge the outcome.

There were however, several arguments put forward for including CHAPS:

- From a practical perspective, many PSPs still need to access CHAPS in order to be able to provide a 'complete' downstream retail offering since it is used as the primary vehicle for house purchase conveyancing payments. Including it would help to address the detriments. Furthermore, CHAPS' organisation and governance cost base (and PSR fee allocation) still needs to be borne by its participants.
- CHAPS is one of the schemes designated by HM Treasury and supervised by the Bank of England as a systemic risk manager alongside Bacs and Faster Payments. CHAPS is subject to very similar requirements (e.g. on Cyber Resilience and Resolution & Recovery) to the other Schemes which must then be acted upon through its governance structure, again with costs borne by its Participants.
- Finally, there were concerns that excluding CHAPS could lead to a divergence in rules if the other schemes are consolidated, in turn leading to adverse impacts on interoperability.

The Subgroup agreed that it would ultimately be desirable to encourage continued migration of retail flow from CHAPS to FPSL, leaving CHAPS as a wholesale entity only. This would reduce the extent to which the relevant detriments apply to CHAPS, and provide an appropriate balance between the competing concerns.

4.5 Conclusion

Following the discussions above, it was agreed that the PSOs in scope for assessment against the evaluation criteria would be Bacs, FPS and C&CCC.

5 LONG-LIST OF OPTIONS FOR EVALUATION

The PSOs currently perform multiple functions:

- Administering and maintaining their rule books
- Procuring and contract managing infrastructure services
- Acting as systemic risk managers, identifying risk and acting to mitigate it
- Promoting service user needs and interests
- Setting strategy for evolving their respective payment systems in response to (for example) service users and regulatory requirements

Although all of these are important functions (particularly their roles as designated systemic risk managers), the options for structural reform focus primarily on the first two because the other three are performed through undertaking these two core functions. The remaining functions are considered as part of the assessment criteria outlined in section 6 below, which consider to what extent a new structure could fulfil these important objectives.

The Subgroup started with five options for evaluation. Once CHAPS was excluded this reduced to four options. Removing LINK did not materially change the number of options. However, option 2 – which would create a new rulemaking entity but retain separate procurement and contract management entities - was not deemed to add significantly to the debate and was also excluded. Three options were left for serious analysis. The five options initially considered are explained below.

It is important to emphasise that, across all options, consideration was given to what extent the existing work of the Simplifying Access to Markets Working Group (SAMWG) and the Horizon Scanning Working Group (HSWG) (see sections 10.3 and 10.4) could address the detriments sufficiently. It was agreed that any structural reform should not create barriers to the other potential solutions being developed in future.

It was also noted that 'consolidation' could happen at a number of different levels: governance and rule-making power; integration of the rulebooks into one truly integrated rulebook (as opposed to one rulebook with three separate chapters for each of the existing schemes); and infrastructure procurement. Integration of the rulebooks into one rulebook would likely lead to a single common denominator – a push rail, which may reflect a technical end state similar to that envisioned by the HSWG with a Simplified Payments Platform (SPP).

5.1 Option 1: Work in progress, no structural reform to existing PSOs

Under this option, existing governance and organisational structures would remain in place, with each of the four PSOs responsible for managing its own rulebook and infrastructure procurement activities. It is important not to consider this as the 'do nothing' option, but rather a consideration of the extent to which existing work under way with SAMWG and HSWG would be sufficient in addressing the detriments.

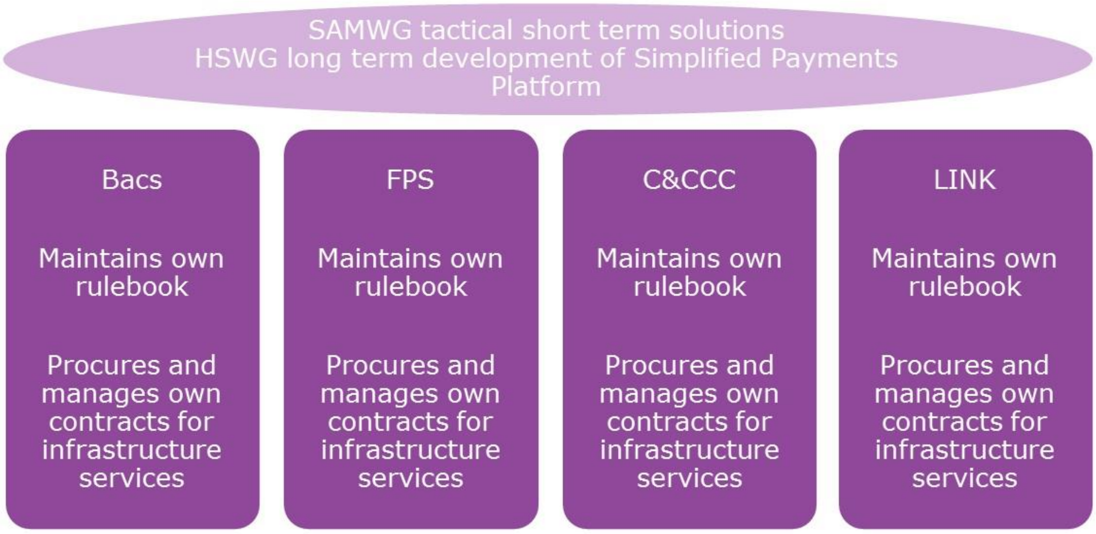


Figure 1: Option 1: Work in progress

The activities of the Forum's SAMWG are detailed in section 10.3 but focus in particular on developing a common PSO participation model and rules; moving to modern payments message standards (in particular ISO20022); aggregator solutions; and sort code availability.

Additionally, the Horizon Scanning Working Group (HSWG) has proposed the development of a Simplified Payments Platform (SPP) as part of its long term strategy, and the details of this are described in section 10.4. Although the SPP is conceptually at an early stage at the time of writing (May 2016), it could have a material effect on the outcomes if it is implemented so should therefore not be ignored. The SPP is also a long term solution, so its benefits would take time to be realised.

It is envisaged that the SPP would be responsible for rule-making, standard setting and the accreditation of those that meet the standards. It is also likely to be responsible for the master register of PSPs connected to the platform. More details are provided in section 10.4.

Other options outlined below do not preclude the development of a new SPP because an existing PSO or consolidated PSO could be mandated with the task of delivering the SPP. However, in this option it is envisaged as a new entity; existing PSOs would be expected to become overlay services that migrate to the new platform over time.

5.2 Option 2: Consolidated rulemaking entity only

This option would maintain the organisational structure, but remove the rules management function from the PSOs. Instead, the rules management functions would be consolidated into one entity. Over time, the rulebooks themselves would be integrated into one. The existing four PSOs would continue to be responsible for procuring and contract managing their own infrastructure services.

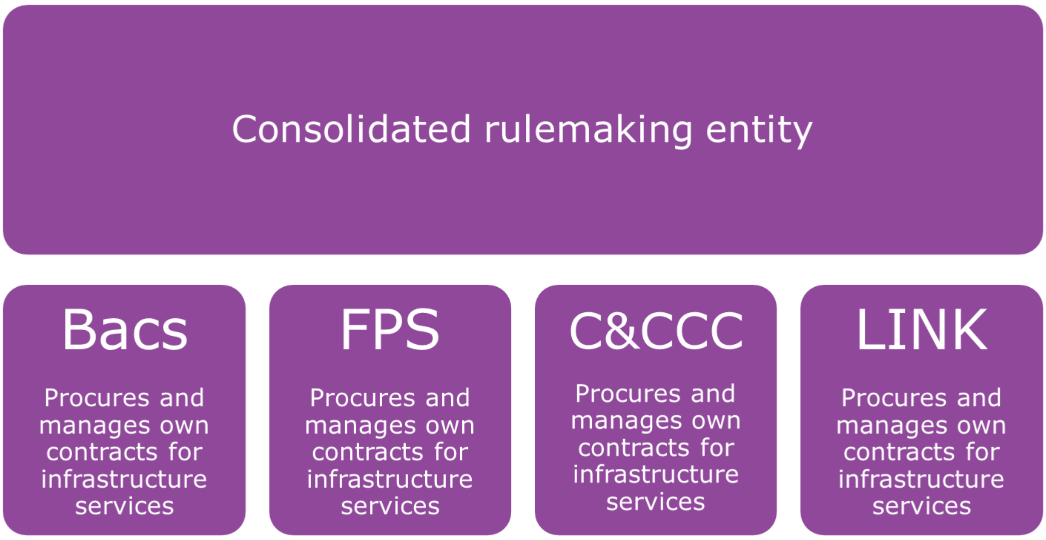


Figure 2: Option 2: Consolidated rulemaking entity only

As previously mentioned, there seemed to be little added benefits in terms of the assessment criteria from this approach and it was therefore excluded from the following analysis. There was no clear rationale for consolidating the rule making entity but leaving the infrastructure procurement entities separate.

5.3 Option 3: Two consolidated entities

This option would consolidate all three entities into two, leaving LINK out of scope. Each 'new' entity would be responsible for a different primary function that PSOs currently perform. Over time, the rulebook management entity would integrate the rulebooks into one.

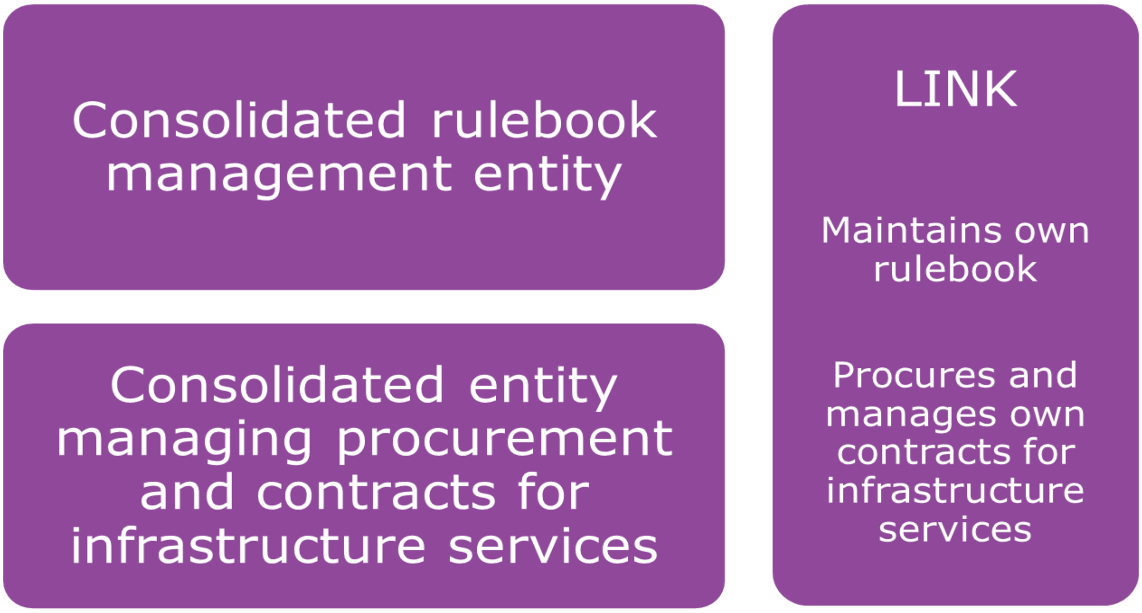


Figure 3: Option 3: Two consolidated entities

It is envisaged that a single entity ("consolidated rulebook management entity") would be responsible for establishing the rules that PSPs in the three retail payment systems would need to comply with. The rules would decree how participants interact with the systems that the entity manages and ensure compliance with the regulatory standards that apply to PSOs (for instance the CPMI IOSCO Core Principles that the Bank of England uses as its 'foundation stone' for FMI Supervision).

The consolidated entity for managing the procurement of contracts and infrastructure services would be responsible for managing contracts and service level agreements for central infrastructure (IT and network), and service desk and crisis resolution.

The two bodies could work together in different ways; although it is envisaged that they would be equal entities with service level agreements between them, an alternative scenario could be that one is a subsidiary of the other.

5.4 OPTION 4: ONE CONSOLIDATED ENTITY

This option would consolidate Bacs, FPS, and C&CCC into one entity with responsibility for managing their rulebooks (with the aim of integrating their rulebooks into one over time) and procurement of infrastructure. LINK would not be part of the consolidation.

Figure 4: Option 4: One consolidated entity

5.5 OPTION 5: ONE CONSOLIDATED ENTITY WITH LINK IN SCOPE

This option would consolidate all four PSOs into one entity, with one consolidated rulebook entity (with a view to integrating their rulebooks into one over time) which is also responsible for procurement and contract managing infrastructure services.

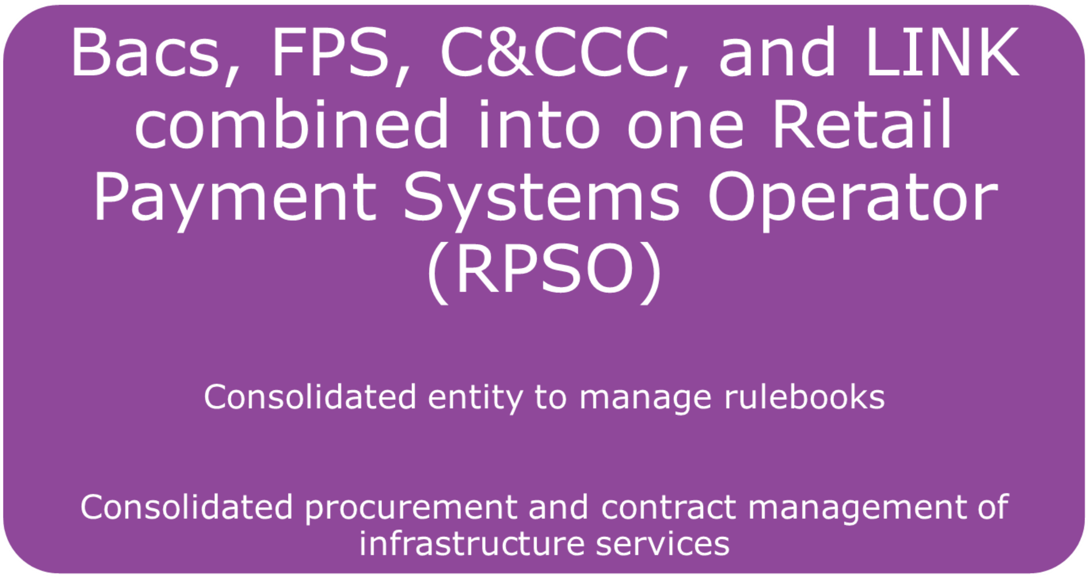


Figure 5: Option 5:One consolidated entity with LINK in scope

As discussed in section **Error! Reference source not found.** it was agreed that LINK would emain out of scope by the group. Therefore, this option is excluded from the commentary below.

6 EVALUATION FRAMEWORK

The evaluation framework comprises a set of seven criteria against which the options are assessed. They are:

1. How does the option affect entry and access to payment systems, for example by improving complexity and transparency?
2. How does the option facilitate and enable PSPs to innovate?
3. How responsive is the option to user needs?
4. How does the option affect the ability to innovate and promote competition upstream and downstream?
5. How flexible and versatile is the option in response to potential changes to the industry? For example, to regulatory requirements, standards, and/or innovation?
6. How does the option affect the PSOs' infrastructure procurement/contracts management incentives and outcomes at this layer of the market?
7. How does the option affect the ability of the resultant payment system operator(s) to fulfil its role as a systemic risk manager, and how does it affect overall payment systems resilience?

The following section explains these criteria and why they are important in addressing the detriments identified by the Payments Community.

6.1 HOW DOES THE OPTION AFFECT ENTRY AND ACCESS TO PAYMENT SYSTEMS, FOR EXAMPLE BY IMPROVING COMPLEXITY AND TRANSPARENCY?

Improving transparency and complexity could make it easier for PSPs to enter the retail payments market. Facilitating access is one of the principles set out in the evaluation framework. One of the detriments is that multiple PSOs are expensive, complex, and time-consuming to join for PSPs (SA16). This may form an unnecessary barrier to entry for PSPs and therefore impede effective competition at the PSP level. There are also issues around indirect access: reducing complexity and increasing transparency could facilitate direct access, leading to a greater number of sponsors offering indirect access and therefore greater choice for those seeking indirect access, addressing detriment SA1 and potentially SA5.

6.2 HOW DOES THE OPTION FACILITATE AND ENABLE PSPS TO INNOVATE?

Factors which facilitate and encourage PSPs to innovate include transparency and interoperability. The Payments Community identified several detriments which hinder innovation currently. There are no clear or transparent on-boarding processes or requirements for PSPs to join a scheme and the process can be lengthy and costly for participants to join as a result (SA14). There are currently too many standards and too much complexity which reduces front end simplicity and stifles innovation (SA9). A lack of interoperability and common standards in the payments infrastructure reduces the ability for PSPs to innovate (SA7). Interoperability domestically and internationally is key to achieving the payments system fit for the future desired by the PSF.

6.3 How responsive is the option to user needs?

Service user experience and confidence in the system are important considerations. Multiple payment schemes are expensive, complex and time consuming to join for PSPs (SA16). PSO procedures and rules are considered complex, adding both a time and compliance challenge for participants (SA14). The lack of transparency (SA14) may indicate a lack of responsiveness. The lack of common standards and interoperability compounds the problem. A responsive payments system would need to show pace and agility as an outcome of any option recommended.

6.4 How does the option affect the PSOs' ability to innovate and promote competition upstream and downstream?[4]

Consolidation is likely to have an effect on PSOs' behaviour, including around their incentives and ability to innovate. PSOs' behaviour affects both competition in the upstream infrastructure market and the ability for downstream PSPs to compete with each other. Several detriments identified by the Payments Community relate to this, including the lack of choice of sponsors (SA1&2), the difficulty of switching between sponsors (SA3), and the lack of interoperability which reduces PSPs' ability to innovate and compete (SA7). PSOs should enable and help to create an environment for innovation and change.

6.5 How flexible and versatile is the option in response to potential changes to the industry? For example, to regulatory requirements, standards, and/or innovation?

One of the PSF's strategic objectives is that the industry should be flexible to respond to change, for example to advances in technology, global digitalisation, innovation, and regulatory requirements.

[4] This criterion was originally 'How does the option affect potential competition between PSOs, particularly their incentives and ability to innovate'? However, the Subgroup decided that the PSOs in scope do not compete. Rather they are utilities which should facilitate competition upstream and downstream. This criterion was therefore changed to reflect this.

Change is currently slow and cumbersome. It also makes compliance time consuming and costly (SA14). When the Bank of England requires regulatory changes it must deal with each scheme separately to make changes. Because of the high interdependency between schemes, any individual scheme which wants to implement changes must seek agreement from other schemes which will be affected. Those schemes then need to implement their own changes to accommodate the original scheme's changes. Each PSO has to engage multiple participants and service users to agree to and adopt any proposed change. This acts as a disincentive to innovate.

6.6 How does the option affect the PSOs' infrastructure procurement/contracts management incentives and outcomes at this layer of the market?

A change in the structure could alter PSO's incentives around infrastructure procurement and contract management, leading to a change in market outcomes at this layer of the market. Currently, there is a dominant infrastructure provider (VocaLink) which provides central level services to Bacs, FPS, and LINK. Although there are other providers for other supplementary services, it is a reasonable assertion that competition at this layer of the market can be presently characterised as competition *for* the market as opposed to competition *in* the market[5]. If there were more competition at the infrastructure level this could improve access as well as innovation. The current lack of interoperability and common standards in infrastructure is identified as a problem by PSPs (SA7).

6.7 How does the option affect the ability of the resultant payment system operator(s) to fulfil its role as a systemic risk manager, and how does it affect overall payment systems resilience?

Payment systems' stability is paramount to ensure end user needs and customer experience are protected. It is imperative that the resultant option is able to manage end-to-end risk. Systemic resilience is important in ensuring confidence in payment systems. The option needs to be assessed on its ability to identify risks and take mitigating action if necessary. Resilience will increase ease of supervision and oversight. Transparency is a key aspect of resilience as an opaque industry could increase the risk of lower resilience and/or standards of conduct deteriorating over time.

[5] The PSR published an Interim Report in February 2016 on its Market review into the ownership and competitiveness of infrastructure provision. It found that competition for the provision of infrastructure services was currently not effective because the PSOs do not hold competitive procurement exercises. Consolidation is looked at in the context of being able to improve competition for the market at this level.

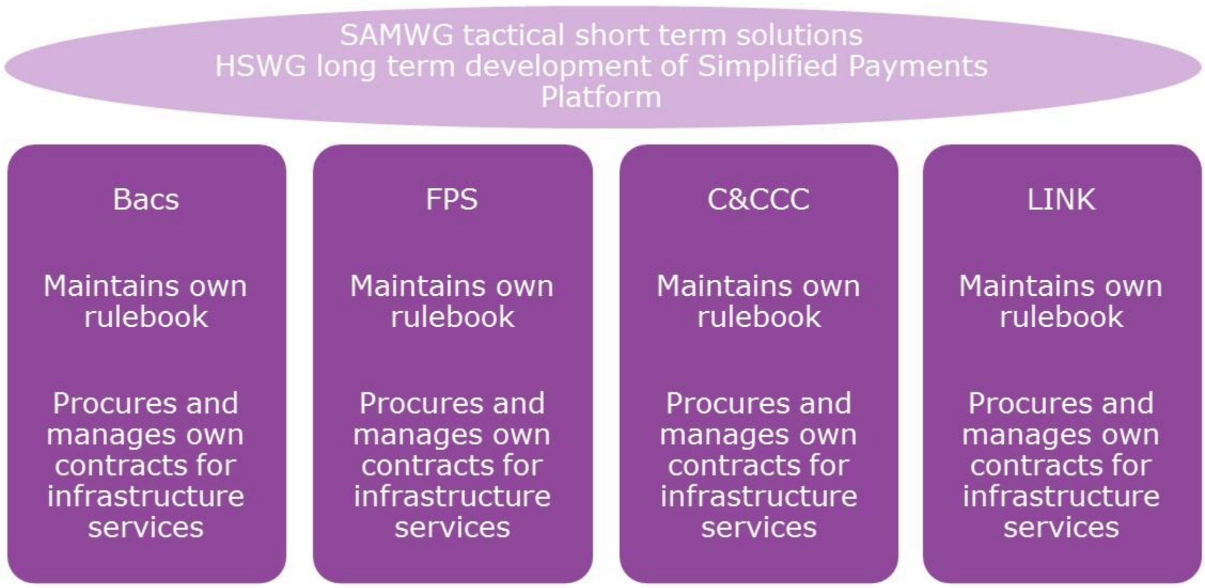
7 SUMMARY OF DISCUSSIONS ON SHORT-LIST OF OPTIONS

The following provides a commentary of the discussions by the Subgroup about the options left for consideration. These are re-numbered below for the reader's ease.

Option 1: Work in progress, no structural reform to existing PSOs (see 5.1)
Option 2 (was Option 4): One consolidated entity responsible for both rulebook management and infrastructure contracts (see 5.4)
Option 3 (was Option 3): Two consolidated entities, one responsible for rulebook management and the other for infrastructure contracts (see 5.3)

It is worthwhile to note that during the workshop the Subgroup looked at each criterion in turn rather than at each option, which allowed ease of comparison and aided discussions. However, the analysis below has been written up by each option, highlighting the key themes of discussion most relevant to that option. **The analysis presented below is 'chronological' in that each section serves to provide a foundation for the next. As such the analysis of the options should be read together and consecutively, rather than in isolation, which could be misleading.**

7.1 OPTION 1: WORK IN PROGRESS, NO STRUCTURAL REFORM TO EXISTING PSOS



There are a number of existing initiatives that are expected to have a positive impact on the payments ecosystem from SAMWG. These are expected to help reduce complexity, improve entry, reduce costs, and facilitate greater innovation and competition. The existing structure is considered to be extremely resilient, and moving to common messaging standards (ISO20022) is likely to improve that resilience further.

Complexity is seen in multiple layers of the payments ecosystem and not just at the PSO level. Indeed, larger PSPs, as sponsor banks, potentially have a role to play in opening up access, improving transparency, and reducing the complexity experienced by indirect PSPs.

However, there is no single strategic body for payments to formulate strategies that develop the interbank ecosystem as a whole (rather than just the individual PSOs) without external pressure or input. Furthermore, collaborative efforts risk dwindling over time because individual PSOs have a fiduciary duty to act in the interests of the PSO, so decision making between PSOs may diverge.

Even after the implementation of existing SAMWG solutions, there are likely to still be considerable time and cost requirements for PSPs to gain entry and participate. While aggregators connecting to multiple PSOs may allow PSPs to outsource the complexity element to some extent, the cost of joining and participating still needs to be borne by the participant. Additionally, it's not certain that competitive aggregators will emerge as hoped because this will be subject to market forces.

The Simplified Payments Platform offers a way to create a simpler framework for payments which promotes competition and facilitates innovation. But it is still in very early stages of development and developing it as a separate PSO alongside the other systems was felt to complicate the market further, even if this was a time limited measure before migrating existing PSOs to the new platform.

7.1.1 Existing work under way

A number of the SAMWG workstreams being taken forward, which are outlined in section 10.3, will have a positive impact on the detriments and improve access. Consolidation will need to be assessed on whether, and to what extent, it can improve on the existing work, and whether this improvement can justify undertaking structural reform.

Common participation models and rules will minimise the non-essential differences between PSOs in areas such as terminology, PSP eligibility criteria and the on-boarding process. This should speed up joining times and encourage direct access. In turn, this should improve the likelihood of innovation being brought to market and thus facilitate competition between PSPs. More direct sponsors should also create more choice for PSPs that rely on indirect access. However, there are limitations to what this solution can achieve within the existing PSO structure. These are described more clearly in the analysis of the next option (section 7.2.2). Overall, common participation models and should reduce complexity and facilitate innovation, but is only effective to a certain extent.

The move to modern payments messaging standards, in particular ISO20022, should improve innovation. This move will create more open standards and improve interoperability. This should reduce barriers to market entry by payment service suppliers, challenger banks, and PSPs. It may also facilitate and encourage international PSPs to enter the UK market, which increases competition at the PSP level. However, migrating to these standards is likely to take time and is currently estimated to between a 5 and 15 year project. Individual PSOs, like Bacs, are already gearing up to common standards: it is presently mapping Standard 18 to ISO20022 and considering the strategic approach and any transitional activity required.

Aggregator solutions will potentially provide PSPs a gateway for simpler accessibility, effectively allowing them to outsource some of the complexity and potentially focus resources on innovation instead. However, this solution cannot, at this point, be relied upon to emerge because it is being left to the commercial space. Furthermore, there are no plans at present for collaborative efforts to develop new aggregators that connect to multiple PSOs and compete with each other. There may be a strong business case to suppose that PSPs would welcome an intermediary to help access the system. It is worth bearing in mind however, that an aggregator solution of this kind, if successful, may create little incentive for the PSOs to simplify their systems in the long term as they increasingly come to rely on aggregators.

Sort-code availability will facilitate entry and access for those PSPs seeking direct access and will stop them being required to go to an existing direct participant – and competitor – for access.

7.1.2 PSO innovation and responsiveness

PSOs submitted evidence that shows they have a number of strategic, user-led workstreams underway. For instance, driven by its understanding that traditional industry solutions to PKI Trust services were expensive to the industry, FPS undertook a competitive tender and is now expecting to provide this new service at around XX%[6] of the cost of current alternatives. Bacs has introduced, among other things, flexible direct debits which offer direct debit users more control by allowing them to 'skip', increase, or reduce their payments.

Given the concerns about access, a number of PSOs have responded as independent organisations to address access issues. For example, FPS has its 'Access Model'. Bacs cites its collaborative work through the Interbank Systems Operator Coordination Committee (ISOCC) to develop a scoping document for a collaborative approach to Common PSO participation models and rules. FPS is also expecting to streamline its governance participation requirements for participants, making it easier, less time consuming and thus cheaper to deal with them.

Overall, PSOs can evidence that they are listening to users' and consumers' needs, have innovated, and brought new products to market.

[6] Redacted

7.1.3 Stability and resilience

'Stability' and 'resilience' refer to the smooth functioning of the systems, for example in ensuring that final settlement is achieved quickly and correctly, and maintaining continuity of service to users in the event of a system failure. It was suggested that governance and structure are not the primary drivers of stability and resilience. Instead, it is the robustness of the rules which are set in the context of relevant legislation (e.g. the EU Settlement Finality Directive) and the technical processes behind the payment systems themselves which are arguably far more important in ensuring and maintaining stability and resilience. As it is, the current systems are very resilient – both technically and in their legal framework.

The primary risk to this stability in the short to medium term is the potential uncertainty created by structural reform. PSOs correctly point out the lack of certainty creates real concerns and worries for real people whose jobs are likely to be materially affected. The Subgroup therefore recommends that a decision on future PSO governance is made as quickly as is practically possible and the PSOs be involved in developing a clear roadmap for any change necessary.

7.1.4 Understanding the drivers of complexity

Complexity is highlighted as a significant detriment in the PSO market. It is important to understand what drives this complexity. One given reason is the history of the developing payment systems – each system has been introduced at a different time to meet a different need. However, as noted above, the PSO landscape compares favourably internationally, even if there are now concerns that it is holding back the payments industry.

It has been considered that PSPs are required to join every PSO if they want to offer a 'complete', and therefore competitive, downstream retail banking offering. The more PSOs that a PSP is required to join, the greater the complexity the PSP faces, and vice versa. However, evidence submitted by one of the PSOs suggests that the landscape may be changing. It shows that many of the applicants to its service are seeking a combination of PSO offerings, rather than needing the full suite. All of the PSOs submitting evidence reported they had strategic workstreams under way which looked at improving access.

Another possibility is that complexity is not driven primarily by structure, but by other factors such as risk aversion and liability concerns in relation to PSO's roles as designated risk managers which impacts on the rules in terms of mandatory requirements the PSPs must undertake. As noted by the Payments Community, complexity of access may also be driven by sponsor banks: 'new types of PSPs may encounter difficulties in finding direct PSPs to sponsor them and get access to a payment system, due to having new models where current sponsor bank risk appetite will not support such entities' (SA5). The indirect model itself increases complexity and reduces transparency.

Complexity and transparency is also affected by the way the boards of these systems are constituted. 'Indirect PSPs do not own the schemes so change and governance of schemes is driven by big banks. There is no effective voice for indirect participants' view to be taken into consideration by the Schemes' (SA13). This reduces transparency for indirect PSPs about decision making and also creates complexity for smaller PSPs seeking to influence outcomes for their benefit.

7.1.5 Lack of a single strategic view and the problem of fiduciary duty

There is no single strategic body for payments which makes it difficult to develop strategies that develop the whole interbank ecosystem, rather than just the individual PSOs. Individual PSOs are rightly focussed on developing their area of the payments sector. As noted by one PSO, collaboration occurs where there is an end user benefit in mind, economy of scale, or cost/effort efficiency. However, it does not occur in a way which considers the overarching vision or long term plan for payments. As a result, opportunities for innovation at a more strategic level are potentially being missed. One PSO noted that a single consolidated entity would make 'strategic sense': it is not a question of whether to consolidate, more when and how to do so.

In addition, it is worth noting that the operation of PSOs, their boards and directors are constrained by the Memorandum & Articles of Association of each company, corporate governance best practice and the statutory responsibilities of directors as covered by the 2006 Companies Act. Specifically, they have a duty to promote the long-term success of their company. This duty could be a particular risk to some of the collaborative work that is needed (in some cases over several years) to implement the solutions agreed by the SAMWG, if decision making diverges as each board seeks to carry out the best course of action for its company.

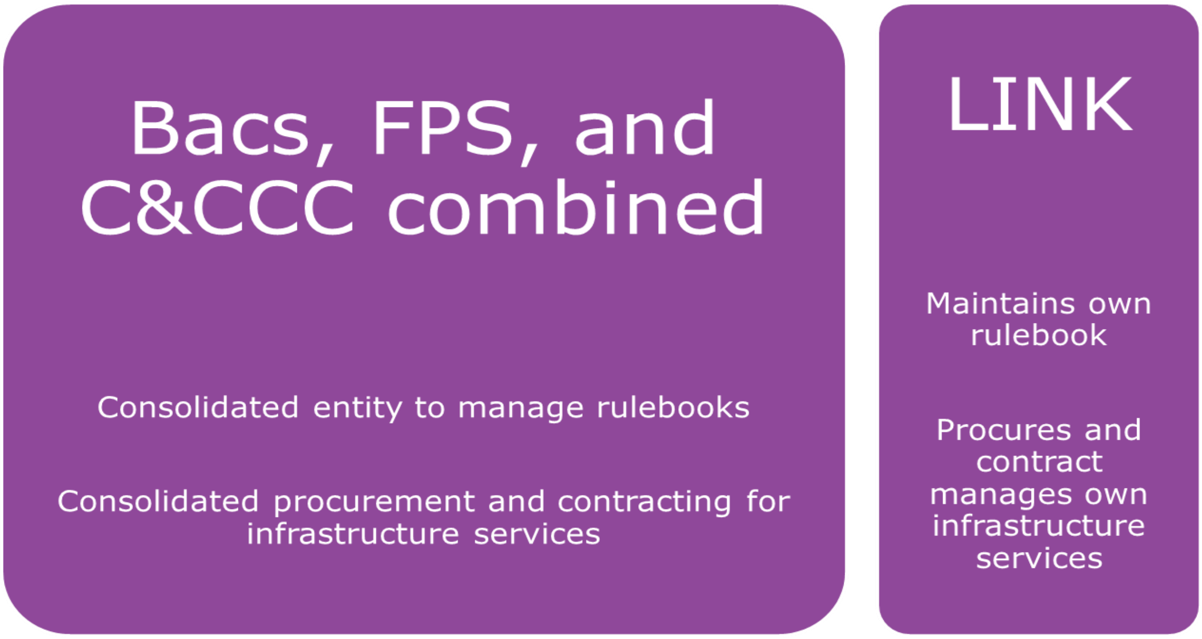
7.1.6 Future work and the Simplified Payments Platform

In this option it is envisaged that over the long term (5-7 years) a new Simplified Payments Platform (SPP) may be delivered and the individual PSOs could redevelop their offerings as overlay services on the new platform or, over time, leave the market. The premise of the SPP is that it will enable simpler and more direct access for more PSPs and remove the need to join multiple schemes. In design, it will offer a framework for change and innovation. There is expected to be competition, as well as collaboration, in the development and deployment of new overlay services to serve the needs of different target groups, allowing PSPs to innovate more easily. The layered architecture of the SPP should also isolate layers so that changes can be made to the components within layers without requiring the rest of the system to change with it. This ability to make changes more easily without requiring all the other participants in the ecosystem to agree and make their own changes facilitates easier innovation, trial and testing, and reduces costs.

Additionally, allowing the SPP to be developed as a wholly new entity would bring advantages of pace, agility and flexibility and avoid any legacy issues. The SPP would allow a more diverse and dynamic market for overlay services which promotes competition. Although in the current context PSOs are considered generally collaborative, in the 'new world' of SPP, there could be many different providers competing to offer these services as overlays. Keeping the PSOs separate now could facilitate the emergence of competitive market players in the future.

However, the Simplified Payments Platform is also at a very early stage of development. Subgroup members considered that developing it as a separate PSO alongside the other systems might complicate the market further, even if it was a time-constrained measure before migrating existing PSOs to the new platform. Additionally, the other options do not preclude the SPP from developing in due course.

7.2 Option 2 (was Option 4): One consolidated entity



A consolidated entity should provide a single strategic view across the retail interbank payments landscape. This would provide for a more coherent and joined up approach to developing interbank systems. The Subgroup deemed that a consolidated entity would generally complement and support the existing SAMWG workstreams, thus helping to address the detriments more quickly. Consolidating three entities into one would simplify the PSO landscape, reduce complexity, and improve the user experience, as well as facilitate innovation and competition among PSPs. Having one entity to deal with instead of three would significantly reduce the inefficiencies that currently exist and slowing the implementation of change. Competition at the infrastructure layer was unlikely to be impacted negatively, assuming the new body was established with appropriate objectives in this regard. An objective to deliver increased interoperability could potentially be established, leading to improved future resilience.

However, there is significant change already taking place in the payments sector (consider ring-fencing or PSD2) and reform could stretch resources both within PSPs and PSOs, putting at risk SAMWG short-term wins or PSO services being developed for users and consumers. With fewer organisations there could be less diversity of thinking or competition for ideas.

The new consolidated entity would need to be monitored to ensure that it properly considered potential conflicts of interest that arise from having control of both the rulemaking and procurement functions, which may undermine incentives to pursue significant reform, and therefore could reduce transparency. A primary aspect of consolidation would be to consider board constitution and representation, senior management appointments, and new objectives for resilience, operational effectiveness, and culture. Without these, consolidation may not achieve the outcomes sought by the Subgroup and the wider PSF.

7.2.1 A single strategic view

A consolidated entity should provide a single strategic view across the retail interbank payments landscape and develop them strategically, offering a coherent approach to developing new overlay services and/or assessing the long term viability of payment instruments. The weaknesses identified above in section 7.1.5 would be addressed, including the problem of having a duty to promote the long term success of the individual organisation. Consolidation would be likely to increase interoperability and create incentives to cut inefficiencies over time.

A single entity would help to reduce complexity and increase transparency by making it easier for PSPs to join, participate in, and influence the entity because dealing with one entity instead of three is most likely to simpler, and possible cheaper. This could benefit smaller PSPs in particular, which may lack the resources to engage with multiple entities/process as effectively as the larger PSPs. However, as noted in section 5, consolidation could happen at various layers within the PSO layer of the market. Simply consolidating the governance arrangements could provide a useful strategic view, but integration of the rulebooks would be required to reduce the complexity of three different payments systems operating to different rules on different technology.

7.2.2 Existing work underway

The Subgroup considered if consolidating the PSOs in scope would come at the cost of SAMWG solutions. Members agreed that consolidation was likely to complement and enhance existing SAMWG solutions rather than act as a substitute for it. One PSO submission agreed with this, suggesting that it would improve the decision making associated with the simplification programme; however, another PSO believed it would hinder the work.

Consolidation would enable more processes to be combined than the existing SAMWG work on Common Participation Models and Rules, for example in legal identity verification, risk management, and industry services such as sort-code allocation and participant assurance. This would lead to further elimination of the duplication and inefficiencies in the cost of entry. The

Common Participation Model and Rules could also be achieved more effectively, and potentially more quickly, under a single entity rather than three because of the single strategic view that the entity would gain.

Consolidation could also improve the aggregator solutions by removing unnecessary costs that stem from duplication and inefficiencies. It would incentivise aggregators to develop services that connect to all the payment schemes within the one entity, and reduce the risk of aggregators focusing on providing services that only connect to one PSO.

The work on common messaging standards and the move to ISO20022, and the benefits this brings, would likely be enhanced by consolidation. There is currently a need to secure consensus from three separate entities. With one entity, decision making would be quicker, bringing interoperability and innovation sooner.

Consolidation could reduce the time, cost, and effort required to collaboratively deliver the sort-code solution, which is currently being led by Bacs.

The overarching argument above is that consolidation is likely to facilitate the existing work to be delivered more effectively and quickly. A consolidated scheme with more resources and people with more diverse skills could find itself in a better position to simplify onboarding and develop new technologies. There may be economies of scale and scope that could be exploited by the consolidated entity in its work to implement the existing work. The strategic view it would gain should enable it to make better long-term decisions.

7.2.3 Responsiveness and board level governance

It is considered that there is currently scope for improvement in being responsive to user needs. Improvements are largely dependent on other governance issues such as service user representation on the board(s) and transparency of decision making processes. Fewer entities would make it easier for service users to engage with payment systems. This may again help smaller service users in particular, which may lack the resources to engage with multiple entities and processes as effectively as the larger services users.

It was also suggested by two PSO submissions that whatever reform options were considered, unless they dealt with the issue of user representation and the perception of bias towards larger PSPs, the Subgroup would not have done its job. This is a fair point. There is currently very limited smaller or indirect PSP voice represented at board level, and no representation at all for end users. The Subgroup recommends this is dealt with as a matter of urgency. Indeed it would seem to be very much in the interests of the PSOs as they stand now to ensure they have wider, independent representation at board level (it was noted that, following its governance review, LINK now had a majority independent board).

The Subgroup welcomes the work of the Bank of England which has recently reviewed the current board structures and composition in some payment systems to assess whether they are enabling them to fulfil their role as risk managers. The Bank may publish a consultation paper later in the summer to set out draft proposed requirements.

7.2.4 Flexibility and efficiency

The industry structure is currently considered to be inflexible, and unable to easily and effectively respond to change. There are two issues here. Firstly, if changes are required by, for example, the Bank of England, it needs to (arguably unnecesarily) deal with four different entities in order to reach agreement and for the changes to be implemented. Secondly, because of the high interdependency between schemes, any individual scheme which wants to implement changes must seek agreement from other schemes which will be affected. Those schemes then need to implement their own changes to accommodate the original scheme's changes.

Members of the Subgroup were able to provide numerous examples of inefficiency that occurs as a result of the current industry structure. One example is that Bank of England requirements on traditional payment instruments are generally applicable to both Bacs and FPS. However, each needs to respond separately in the current structure, which is less efficient and slower from both the Bank of England's perspective because they must deal with two entities, and the PSOs' perspective because they are likely to have duplicated elements of each others' work.

Therefore, reducing the number of entities from three to one would contribute to solving these issues.

7.2.5 Infrastructure

There was some discussion about the impact of consolidation on the market for infrastructure. There is a risk is that with fewer PSOs this would facilitate less competition at the infrastructure level. Currently, there is a dominant infrastructure provider (VocaLink) which provides central level services to Bacs, FPS, and LINK. Although there are other providers for other supplementary services, it is a reasonable assertion that competition at this layer of the market can be presently characterised as competition *for* the market as opposed to competition *in* the market[7].

However, it may not be the case that having less PSOs would facilitate less competition. As it does today with five PSOs it would depend very much on the approach that was taken by the entity. It is important to note that, in the short term at least, a consolidated procurement entity will still need to procure for separate contracts for each payment scheme. In the longer term,

[7] The PSR published an Interim Report in February 2016 on its Market review into the ownership and competitiveness of infrastructure provision. It found that competition for the provision of infrastructure services was currently not effective because the PSOs do not hold competitive procurement exercises. Consolidation will need to be looked at in the context of being able to improve competition for the market at this level.

when rulebooks are consolidated, the procurement entity may choose to consolidate its contracts together or maintain multiple contracts.

Regardless of what it chooses to do, a single procurement entity could encourage competition for the market. In the case that it consolidates its contracts, it may be able to attract more providers to bid to supply the market if the contract on offer is sufficiently larger and therefore more lucrative than before. The procuring entity's bargaining power could also be increased because there will only be (at the limit) one contract for the entire market – at the limit it becomes "all or nothing" for the infrastructure service provider. A possible danger of this first approach is that competition both for and in the market could be harmed in the long term if alternative infrastructure providers are foreclosed from entering the market. This could be the case if demand is concentrated on one provider for a long period of time, switching costs are high (so the procurement entity has reduced incentive to consider switching), and there are high costs of entry for the infrastructure service provider.

Alternatively, the procurement entity may gain the ability to split its contracts in terms of scope and timing to its advantage by encouraging competition. There could also be efficiency gains if the consolidated procurement entity is able to structure its user requirements and contracts to eliminate duplication of common costs which would have resulted from procuring three separate contracts.

In conclusion, the impact of consolidation on competition at the infrastructure layer depends on the procurement behaviour of the new entity. Procurement practices which encourage competition between infrastructure service providers are more likely to lead to better outcomes.

7.2.6 Resilience

As mentioned in 7.1.3, existing payment systems are considered to be extremely resilient. However, it was deemed that a consolidated entity could further improve resilience. A single entity with a broader view of the payments industry and a more diverse skill set in its people would be able to mitigate risks better.

Consolidation which affects the rules could have an impact on stability and resilience. However, it is anticipated that any 'integrated rule book(s)' would not be weaker than the current rules because BACS and FPS, along with CHAPS, and now LINK, are designated by HM Treasury and supervised by the Bank of England. Bank of England supervised schemes must ensure that their rules and underlying technical and member agreements meet the CPMI Core Principles that they are assessed against on an annual basis. Moving to a fully integrated approach would mean that the integrated rulebook could not be weaker than those already in place for the recognised Schemes. This option would not be allowed to weaken any of the existing supervised schemes and would likely strengthen them.

Another potential benefit of consolidation is that a single entity would likely find it beneficial to converge the payment systems that it controls over time, including its user requirements when procuring infrastructure contracts, and rulebooks. This in turn leads to greater interoperability, which is an important factor in systemic resilience by, for example, allowing continuity of service to users in the event of a system failure.

7.2.7 Simplified Payments Platform and conflicts of interest

Consolidating the PSOs into a single entity should not harm the prospects of the SPP. Indeed, one option identified by the HSWG and SAMWG for achieving the SPP would be a 'slow migration' to common standards. Technically should the entity decide to fully integrate its rulebooks, it may come to the 'single push' rail identified by the SPP.

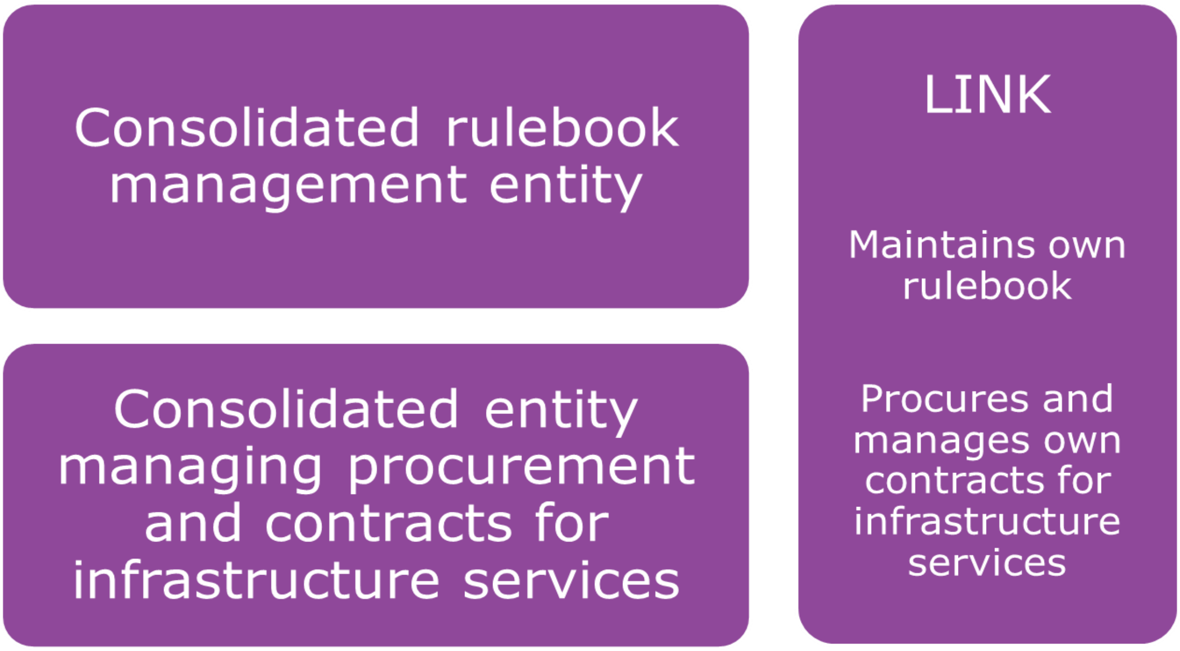
This consolidated option would however reduce the opportunity for the SPP to be developed more quickly and it would be encumbered by the 'baggage' of existing schemes. It may also lead to potential conflicts of interest within the organisation as it reconciles the old with the new. Part of the PSF's potential long-term strategy for the SPP involves decentralising the provision of infrastructure services and introducing competitive infrastructure services. As a single consolidated entity managing both functions, it would eventually be responsible for setting the rules in the market in which it competes with its 'legacy' services, potentially leading to concerns around it having an unfair competitive advantage. There may also be concerns that a single entity would have no natural incentives to facilitate a move towards this future state, and could even have an incentive to resist in order to maintain its control of the centralised infrastructure services (see section 7.3 for more discussion on this potential conflict of interest).

7.2.8 Change programme and other risks

One PSO submission made the valid point that there is a full programme of change underway within payments which is already putting PSOs under pressure. The regulatory programme includes: 'ring-fencing', individual PSP change agendas (including bank divestment), cheque de-materialisation, and responding to PSD2, APIs, and the open banking agenda. It was subsequently pointed out by Subgroup members that reform would likely come at a cost and more resources in the short term may be needed to enable it.

Equally valid was the point made that in consolidating three organisations into one, there is some diversity of thinking lost which could hinder innovation and therefore competition. It would be necessary for the culture of the new entity to place innovation at its heart.

7.3 Option 3: Two consolidated entities



This option is very similar to option 2, and the analysis is largely the same so it is not repeated here. It is distinct in that it splits the rulemaking/rules administration entity from the infrastructure procurement and contract management entity. There are benefits and risks to this option.

Separating the functions could be desirable because it mitigates the conflict of interest that would potentially be faced by an entity which manages both functions. This conflict of interest results from the entity being responsible for making the rules, following the rules in its procurement and contract management activities, and enforcing the rules (see section 7.2.7). The conflict of interest could be sufficiently great so as to hinder effective operation from an overall market perspective. Additionally, as noted above, it could hold back the development of an innovative Simplified Payments Platform.

However, there are risks around systemic risk management in this option. Splitting the functions could potentially lead to uncertainties in the allocation of responsibility around risk management and service operation. This, in turn, could add additional complexity and risk around incident management and crisis resolution via the presence of an additional "layer"/body which does not exist today. The rule making entity would set the rules (and be responsible for making sure all parties comply with the rules) and the procurement entity would be required to follow the rules (including those around systemic risk management). Even if this were to be made clear, there are still concerns that responsibilities for management of risks could remain blurred between the two entities. It would be very difficult to create a risk management framework which could be sufficiently robust to address this.

8 ANALYSIS CONCLUSIONS AND RANKING OF THE OPTIONS

Following our analysis of the various options, the Subgroup offers the following ranking of options for the PSF's consideration. It does not 'recommend' a specific option at this time as there are further considerations (noted below) related to the cost benefit analysis and the transitional phases which could have a material effect on the options and would need to be considered fully before a decision was made. Considered against the criteria for evaluation and the objectives of the Payments Strategy Forum, the group ranks the options in the following order most preferred to least preferred:

4. Option 2: Consolidation of Bacs, FPS, and C&CCC into one entity responsible for both rules and infrastructure
5. Option 3: Consolidation of Bacs, FPS, and C&CCC into two entities: one responsible for rules and the other responsible for infrastructure
6. Option 1: Work in progress; no structural reform

As noted at the beginning of this document the Payments Strategy Forum has agreed that its strategy should aim to achieve the following objectives in payment systems, that they are:

- secure and resilient
- versatile and responsive to user needs
- efficient

In addition to this, one of the key strategy setting principles it that it should be 'more important to address a small group of fundamental root causes of detriments, rather than lots of individual detriments in isolation'.

The solutions identified by the SAMWG (and potentially the SPP) will go some considerable way to helping open up payments and improve competition and innovation while reducing the cost of complexity. However, Option 1 arguably takes a piecemeal approach to the detriments, seeking to deal with the individual detriments as they arise. While the SPP is designed to deal with the detriments holistically, it is still being developed conceptually. It was difficult for the Subgroup members to assess the weight of the benefits SPP might bring in the light of the SPP's early stages of development.

Option 2 allows consolidation to a single entity to improve the outcomes from the SAMWG while offering a more strategic overview of the payments industry and a simpler regime for industry and regulators. This should help to address the detriments more quickly and effectively. It is not without its risks though and the underlying culture will ultimately determine its success in delivering the benefits of reducing complexity, increasing transparency, promoting wide user representation and facilitating upstream and downstream competition. Therefore, Option 2 is preferred over Option 1.

Option 3 has the strengths of Option 2 but brings with it the added benefit of dealing with potential conflicts of interest and paving the way for a future Simplified Payments Platform. However, in doing so it could compromise systemic resilience and the ability of PSOs to manage both day to day operational risk and systemic risk. Maintaining stability and resilience is paramount, and is a minimum requirement for any option to be taken forward. It is therefore considered that Option 2 is preferable to Option 3.

In conclusion, the PSO Governance Subgroup ranks Option 2 as the first option for consideration by the PSF.

9 FURTHER CONSIDERATIONS

It is important to recognise that there is further work to be done before any process of consolidation is begun. This Subgroup has qualitatively evaluated some options and ranked first Option 2, the consolidation of Bacs, FPSL, and C&CCC. However, there are critically important considerations and tasks that still need to be addressed before this Option can be fully recommended. These include considering how this consolidated entity will fit into the other Payments Strategy Forum initiatives; the pathway towards the end state and the transition phase; conducting a quantitative cost benefit analysis; and exploring the impact of consolidation on end users.

9.1 HOW CONSOLIDATION WOULD FIT INTO THE OTHER FORUM INITIATIVES

Further analysis needs to be done in order to explore and ensure that consolidation fits together with other work that the PSF is doing. The role of the consolidated entity will need to be properly defined in the context of other developments in the industry, for example the Simplified Payments Platform in the long term. The governance of this consolidated entity would then need to be designed so as to allow it to fulfil its role effectively and efficiently.

9.2 THE TRANSITION PHASE

A vitally important consideration is to determine the pathway towards the end state. There are a number of potential risks that could emerge during the transition stage which would need to be mitigated. The risks include:

- Risks to payment instrument stability and systemic resilience. As previously mentioned, ensuring financial stability and resilience is paramount, and actions that compromise this should not be taken forward without sufficient mitigation plans.
- Risks around the PSOs and their people, including PSO staff and their expertise. If the transition is managed poorly, the ability of existing staff to feel motivated and to apply

their considerable expertise and knowledge could be jeopardised, leading to poorer outcomes overall.

- Risks around delivery. Consolidation will require resources and intense collaboration between the PSOs and regulators such as the Bank of England, HM Treasury, and the Payment Systems Regulator, as well as wider stakeholders (including PSPs). PSOs are currently considered to be relatively small and 'lean' organisations without much spare resource capacity. Additionally, there are already reforms stemming from regulators in the industry which take up considerable resource, such as 'Ring Fencing' and responding to the proposed remedies of the Competition and Markets Authority Retail Banking Investigation.

To address these concerns, a number of options for the transition phase have been suggested. The transition options are below; however, they are by no means exhaustive, and further work is required to determine the optimal transition method that minimises the non-exhaustive list of risks above as well as time required:

- Agree with the Bank of England an appropriate plan to migrate towards a more consolidated governance structure. The consolidated entity could deliver the PSF's recommendations to develop a more common approach to rules and procedures across the schemes within that organisation.
- Create a new entity which implements the PSF's strategy, addresses the issues around PSO ownership and governance, and takes over PSOs' current functions gradually. The current scheme operators will gradually cease to exist.
- Create a new entity and migrate staff to the new entity at some point in the future to be determined, which will take over the relevant functions from the schemes faster than the previous option.

Regardless of the option, there are some principles which would likely be desirable for any transition to adhere to. This would serve to minimise uncertainty and risks; uncertainty is a major driver of risk. The principles are:

- The PSOs themselves should drive the change process, because the expertise and legal and regulatory accountability sits within them, not regulators, PSPs, or other trade bodies.
- The target governance structure and operating model should be transparently decided and clear from the beginning of the transition. This will avoid indecision unnecessarily exacerbating the risks above and have negative effects on PSO staff.
- Ambitious yet realistic timeframes for implementation would need to be established, to minimise uncertainty and therefore risk.

More work is required on planning the transitional phase, including considering any alternatives to the above options. It is not possible for this Subgroup to complete that work in this phase given the time constraints. This Subgroup has therefore focused primarily on the outcomes in the end-state, but the significant issues around transition pathways cannot be ignored. The PSF is requested to provide an additional steer on this next phase of work.

9.3 COST BENEFIT ANALYSIS

In the time available to the Subgroup it has not been possible to conduct a quantitative cost benefit analysis. However, this is an essential piece of work that must be completed in order to rigorously analyse the proposal for consolidation. It is recommended that this work be undertaken as soon as possible, and the PSF is requested to provide an additional steer on this.

The Subgroup has identified a list of non-exhaustive quantitative measures which could potentially feed into the cost benefit analysis. They are:

- The costs of transition and implementation to the new governance structure.
- Net impact on total PSO operating costs, with a distinction between changes to contracting and procurement costs, and costs associated with maintenance and administration of the rulebooks.
- Net impact on PSOs' costs of acting as systemic risk managers.
- Net impact on initial access cost for PSPs, including the monetary price and time required.
- Net impact on the day-to-day operational cost for PSPs, including monetary and time cost of adhering to technical and operational requirements.
- Net impact on the cost of regulation for the Bank of England, Financial Conduct Authority, and the Payment Systems Regulator.
- Impact on PSR fee analysis and distribution at PSO level

9.4 IMPACT ON END USERS

This Subgroup has not explicitly considered the impact of PSO governance reform on end users. End users are defined as individual consumers who use payment systems, and businesses that rely on payment systems to conduct their business.

Because end users in general do not interact directly with the PSOs, any potential impact on end users is likely to be indirect, through PSPs. If PSO consolidation results in PSP behavioural change, then end users that interact with PSPs could be affected.

It is expected that the effect on end users will be positive or, at worst, neutral. If PSPs find it easier to access payment schemes this could stimulate entry into the retail market, leading to enhanced competition in this layer, in turn leading to better outcomes for end users.

However, evidence to support the above hypothesis has not been gathered. Further work will need to be done on this in order to gain insight on exactly how end users could be affected by PSO consolidation.

9.5 CONCLUDING REMARKS

The PSO Governance Subgroup has provided the PSF with a clear view that consolidating FPS, BACS and C&CCC into one single entity is likely to be the most advantageous option to pursue. However, before this work can be agreed it is of vital importance that the cost benefit analysis is completed and further consideration given to the impact on end users of the approach taken. A target operating model needs to be clearly articulated with a transition plan put in place. This should be led by the PSOs themselves in agreement with the Bank of England, HM Treasury and PSR.

payments strategy forum

10 APPENDICES

10.1 APPENDIX 1: DETRIMENTS FOR THE SIMPLIFYING ACCESS TO MARKETS WORKING GROUP

This is a list of the detriments related to the SAMWG identified by the Payment Community in October 2015.

Category	Detriment	Code
Choice and competition	Small number of sponsor/commercial solutions for indirect PSPS	SA 1
	Consumers have little choice if they require a PSP with real-time FPS. There are 10 members of the FPS and only these banks offer real-time FPS to their customers. If customers want real-time payments they need to bank with one of the 10 members	SA 2
	Existing sponsor banks can limit competition as there are only a few that offer indirect access. Indirect PSPs are reliant on the Sponsor Bank solution and innovation	SA 3
	It's difficult for PSPs to switch indirect access providers as Sponsor Banks' solutions may make it difficult to switch to another provider	SA 4
	New types of PSPs may encounter difficulties in finding direct PSPs to sponsor them and get access to a payment system, due to having new models where current sponsor bank risk appetite will not support such entities	SA 5
	Lack of competition between schemes	SA 6
	Lack of interoperability and common standards in the payments infrastructure reduces the ability for PSPs to innovate and businesses to benefit from new payment options	SA 7
	There is no level playing field for PSPs that are not a credit institution. Difficulty in obtaining a BOE settlement account as a new direct participant	SA 8
Common standards and rules	Too many standards and too much complexity reducing front end simplicity and stifles innovation, unlike the EU where SEPA has aligned rules for DC/DD	SA 9
	Different rules and standards within EU to the UK. SEPA has largely aligned EU standards/rules for DC/DD & should do for instant payments. Still in-country variances.	SA 10

	Range of standards could limit infrastructure competition. If operators set the rules, there could be multiple infrastructure providers, provided they are all aligned to an ISO standard.	SA 11
	No real substitutability between payment systems in the event of system failure	SA 12
Schemes for rules and governance	Indirect PSPs don't own the schemes so change and governance of schemes is driven by big banks. There is no effective voice for indirect participants' view to be taken into consideration by the Schemes.	SA 13
	There is no clear/transparent on-boarding process or requirements for PSPs to join a scheme and the process can be lengthy and costly for participants to join. Scheme rules are too complex, therefore expensive to join and/or comply with.	SA 14
	Expense for card issuers/acquirers to be direct members of card schemes.	SA 15
	Multiple payment schemes are expensive, complex, time consuming to join for PSPs and confusing for end-users. Cheque imaging is an added scheme, which risks this reinforcing the multiple operator model	SA 16
	Card scheme governance does not adequately represent merchants and can be inflexible when translating USA-based rules into rules for EU firms.	SA 17
Third party	Third party users (end user PSPs) can't initiate real time payments and access data as they have difficulty gaining access	SA 18

10.2 APPENDIX 2: QUESTIONS SENT TO PSOs

The following letter was sent to all the PSOs, excluding CHAPS.

During our meeting on 10th May, Carl Pheasey stated that the PSO Governance Subgroup would welcome written submissions on PSOs' views surrounding the issue of PSO governance and structural change. We are keen to fully and accurately capture PSOs' views on this, so that they can be considered formally by members of the Subgroup before making a recommendation to the Payments Strategy Forum.

We have provided a framework of questions below. **In your responses, please be as concise as possible, and ensure that arguments are supported wherever possible by facts and evidence.**

We would be grateful for a response by COB Wednesday 18th May, to allow adequate time for Subgroup members to consider. We understand, of course, that this short turnaround time will limit the detail you are able to provide.

1. There are a number of solutions, other than governance and structure reform, being developed by the Simplifying Access to Markets Working Group to address the relevant detriments.
   In this context, would remaining as separate organisations (rather than combining your governance and/or organisations) more swiftly address the detriments being addressed by other work streams? Why?

2. Are there any potential impediments to the detriments being addressed effectively as a result of remaining as separate organisations? If so, are there factors which mean that retaining the existing organisational structure is desirable even if they limit the ability to address the detriments effectively?

3. Could consolidating the interbank schemes into one organisation be detrimental to service users and end users? Why?

4. Is there a point in the future where it would be appropriate for Bacs, FPS, and C&CCC (and potentially LINK) to consolidate? What would determine whether it is appropriate?

5. If the payments schemes were to be consolidated, what would the ideal transitional arrangements would be?

6. At the meeting on 10th May, certain participants told us that changes have been 'imposed' on PSOs. Are there conditions under which you think 'imposed' change and innovation could be desirable?
   a. Please provide evidence of the ways in which your organisations have innovated without external pressure being required.

7. There are different 'parts' of the organisation that could be consolidated: the overseeing governance body with rulemaking power, the staffed organisations, the rulebook itself, and the infrastructure procurement
    a. Do you agree with this statement and why, and have you any views about which aspects could be successfully merged and which should remain separate?
    b. How does your preferred view deliver better in terms of:
        i. Improving access and time/cost for PSPs to join
        ii. Reducing complexity in the systems
        iii. Driving innovation at the PSO level
        iv. Improving flexibility, versatility and responsiveness
        v. Improving resilience
    c. How long would any of the possible permutations of consolidation take? What would be the sequencing?

8. There is some suggestion that competition between schemes is beginning to emerge. Do you consider competition between schemes or PSOs to be desirable? What evidence do you have that such competition may help to address the detriments the Subgroup is considering?

9. The Horizon Scanning Working Group's proposals may imply the creation of a 'simplified payments platform'. Were it considered beneficial and viable would you have any interest in delivering this? Or should it be established a new PSO? Please explain your answer.

10. What else should the PSO Governance Subgroup consider as it debates these issues?

10.3 APPENDIX 3: SOLUTIONS IN DEVELOPMENT BY THE SIMPLIFYING ACCESS TO MARKETS WORKING GROUP

This section gives a descriptive overview on the work of the Simplifying Access to Markets Working Group (SAM WG). For a more comphrensive summary, see the SAM WG's Executive Summary & Solution Descriptions document[8]. At the time of writing (May 2016), there are currently four solutions being taken forward. They are:

- Common PSO Participation Model and Rules
- Moving the UK to Modern Payments Message Standards
- Aggregator Solutions
- Sort Code availability

10.3.1 Common PSO Participation Model and Rules

The detriments for this work stream are the same as those outlined at the beginning of this paper. More specifically, participants that want to join multiple PSOs face:

- Different applications processes
- No common entry point into the PSOs
- Significant costs in replicating work across the PSOs
- Different terminology across PSOs which may describe the same activity

The objective of this workstream is therefore to minimise non-essential differences between PSOs. Ten areas for collaboration between PSOs have been identified as a basis for the solution; any retention of differences must be justified. The ten areas are:

1) Terminology
2) Eligibility criteria
3) Categorisation of Participants
4) Articulation of payment products common between PSOs
5) Engagement with indirect participants, prospective entrants, and providers
6) Rules, procedures, and participant agreements
7) Technical accreditation process
8) Assurance process
9) On-boarding process and migration to common connectivity models
10) Access to information and documentation

Collaboration between PSOs should lead to each having only essential differences in rules which reflect its own specific product set. The objective is to extend this across each of the retail focused PSOs (Bacs, FPS, C&CCC, LINK, Visa, and Mastercard). However, the card based

[8] Simplifying Access to Markets WG Executive Summary & Solutions Description, April 2016

schemes (LINK, Visa, and Mastercard) will have a range of competitve, systemic, and operational differences which could make creating a fully common participation model difficult.

A consolidated and simplified governance structure for retail PSOs may help to deliver these changes, with potential to make the cross scheme collaboration simpler.

The estimated time required for this is between 1 and 3 years.

Costs	Benefits
Amendment to current processes and systems in PSOs will require resources and time to deliver across multiple schemes.	Clearer, simpler processes for participation in payment schemes will enable easier direct access.
Collaborative effort will require commitment, resources, and compromise to deliver.	Creation of a common minimum set of rules, security levels, and a clear compliance process across schemes will speed up joining times when access to multiple schemes is required.
	Time, resource, and cost in new entrant's businesses will be saved rather than having to meeting different requirements for multiple schemes.
	Similar savings in time, resource, and cost will be made by existing PSPs in dealing with common requirements across schemes, e.g. dispute resolution, reporting, compliance requirements.
	With a simpler and common approach to participation models, costs of entry should be reduced, reflecting the new environment.
	Innovation will be encouraged as new entrants and non-bank PSPs can more easily gain access and develop payment products to suppoer new business models.
	Will be complementary to improved connectivity for aggregators and PSPs across multiple schemes and further simplify this connectivity option.

10.3.2 Moving the UK to Modern Payments Message Standards

The detriments that this workstream seeks to address are:

- Too many standards and too much complexity reducing front end simplicity and stifles innovation, unlike the EU where SEPA has aligned rules for DC/DD;
- Different rules and standards within EU to the UK. SEPA has largely aligned EU standards/rules for DC/DD & should do for instant payments. Still in country variances;
- Range of standards could limit infrastructure competition. If operators set the rules, there could be multiple infrastructure providers, provided they are all aligned to an ISO standard;
- No real substitutability between payment systems in the event of system failure.

This led the WG to conclude that the UK domestic payment market, comprised of multiple PSOs operating with different domestic payment message types is increasingly outmoded, with competitor countries and regions moving to messages based on the global ISO 20022 financial messaging standard.

The solution comprises early tactical actions and a strategic direction for the UK to adopt ISO20022 messaging. While some of the tactical actions could be completed before end-2017, agreement and wider implementation of the ISO 20022 standard could be a 5 to 15 year project, based on experience in other countries.

Cost	Benefit
Identification/setting up of Standards Setting body building on current work performed by Payments UK	Consistent payment standards in the medium to long term, driving efficiencies
Resources to work on development of standards mappings to ISO20022	Consistent off-the-shelf mappings will significantly facilitate the role of aggregators and other participants needing interoperability
Work to promote standard translation software via web-site(s) where mapping information is published	Challenger banks and PSPs will be more aware that translation software exists and can save them both time, money and risk during implementation
Implementation work to agree common ISO20022-based standard	Consistency across payment types and ease of interfacing and switching between types
Migration of current payment systems to the new ISO20022 based standard, most likely in parallel with supporting their current message standards for a limited period	A more competitive payments market through more open standards

Investment in central infrastructure changes, payments technology and wider systems. Sunk costs of legacy systems. IT maintenance costs, networks/communications costs, training costs, incremental technology replacement etc.	Reduced cost of future system innovation Reduced barriers to market entry by payment service suppliers and challenger banks/PSPs Long term opportunity to benefit from new functionality in ISO20022 and to decommission current standards Lower implementation and support costs by leveraging ISO20022 investments globally. Optimised data interoperability across payment channels. Potential to optimise data carrying to improve supply chain efficiency and additional commercial services.

10.3.3 Aggregator Solutions

This solution aims to ensure a broader range of connectivity options for direct and indirect PSPs exist in the market, by encouraging the development of commercial aggregator solutions capable of supporting both direct and indirect access to any PSO through a single gateway.

It is important to point out that the term "aggregator solutions" used here refers to solutions for multiple PSPs to access one scheme **and** solutions for one PSP to access multiple schemes.

The proposed solution is a range of commercially developed, competitive access solutions, accredited for use by, or on behalf of the payment systems operators (PSOs) and forming an integral part of the future payment system community. Such solutions exist already or are in course of development to support the ambitions of a growing number and type of PSPs to participate directly in the payment systems.

It is important to build on the experience of LINK and the progress being made with respect to FPS, BACS and C&CCC aggregator solutions and to engage and understand the approach of Visa and MasterCard in these areas.

The timescale for this is approximately 18 months, although complexity of changes will vary by PSO. This work requires action in both the collaborative and competitive space; it is likely that the collaborative effort is likely to prove more challenging than work done in individual PSOs.

Cost	Benefit
Investment by PSOs to facilitate aggregator access	Broadening of connection options for PSPs and other new entrants
Promotion of the service by PSOs	Development of multiple payment scheme access through aggregators further simplifying connection
Collaborative effort to deliver change in all affected PSOs	Increased competition between aggregators and sponsors and as an alternative to indirect sponsorship models
	Reduced costs of access expected for lower volume challenger banks, innovative new providers and existing PSPs
	When combined with a settlement bank provider alongside a technical aggregator provides an integrated solution for connection needs
	Encourages innovation as resources and time can be focused on product development rather than on the need to satisfy multiple connection models
	Interoperability is encouraged as aggregators would be better placed to support revised future standards when compared to indirect sponsorship models
	Aggregators can broaden services to include translation capabilities and mapping
	Aggregators themselves can support innovation to develop products to compete and more directly meet the needs of PSPs and their end

	users

10.3.4 Sort code availability

New participants that wish to connect directly to a payment system currently have to arrange to use a sort code within the range of an existing Bacs direct participant. This means they have to approach an existing participant, who by definition may be a competitor. In addition, there are various restrictions to the use and transfer of sort codes that particularly constrain new participants.

Bacs is progressing this activity in its role as operator of the Bank Reference Data for the industry. Work underway will see the establishment of a 'utility bank' of sort codes which may be applied for by new participants.

Sort codes are a key routing mechanism for payments in the UK, whereas bank codes are a way of grouping sort codes together. Through the industry Sort Code Directory, a participant's status as direct or indirect in a payment scheme is recorded.

Work relating to this solution is already underway to reduce current restrictions on sort codes, and significant progress has already been made. The following are the key elements of the solution:

- Bacs in its role as operator of the Bank Reference Data for the industry will make available a new range (04) sort codes. This will be done by setting up a utility (pseudo) bank to hold 04 sort codes, combined with the VocaLink technical release in April 2016 that will enable the changes to Bacs to support the changes to sort codes;
- New FPS/Bacs/CHAPS participants will be allocated one or more of these sort codes. The application process is being developed at present, with pilot usage planned April 2016. The solution also needs to accommodate participants who want a sort code (for example to be able to issue a UK IBAN) but don't want to participate in any schemes;
- C&CCC will continue to have some sort code constraints due to the use of the leading two digits of the sort code for cheque sorter configuration. This will be addressed in the planned 2017 launch of the Image Clearing Service (ICS). It would be expensive to reconfigure cheque sorters before that time;
- There will be potential transition risk for a new FPS participant with multiple indirect access sort codes, may short term require a new Bank Code for their direct access sort code;
- Bacs is leading a strategic review of the governance and operating model for the Bank Reference Database (BRD) which holds the master sort-codes, including developing the tactical solution described above on behalf of the industry (governance through the cross-Scheme Clearing Codes Management Group);

- The Working Group recognises that in the longer term (within 5 years) it should be considered whether sort code governance should be run and governed transparently/ independently from Bacs. We may need to develop a new technical solution to support this as volumes increase.

In terms of timescale, this is a 'quick win', with delivery expected in mid 2016 followed by ICS deliverr in mid-2017.

Cost	Benefit
Introduction of 04 sort code range has already been budgeted and funded	Additional sort code availability
Amendment to current sort code allocation processes will form part of PSO development budget	Clearer, simpler processes for participants in payment schemes to obtain sort codes
Collaborative effort will require commitment, resources and compromise to deliver	Early delivery of a simple improvement to payment systems access which will benefit new participants.
	Potential for changes to governance of the Bank Reference Database will offer a more independent approach to sort code allocation.

10.4 Appendix 4: The Simplified Payments Platform concept in development by the Horizon Scanning Working Group

The concept of a Simplified Payments Platform (SPP) is the result of work done by the PSF Horizon Scanning Working Group. It was developed on the basis of qualitative analysis undertaken by a range of participants from the Payments Strategy Forum and put forward for further development at the last PSF meeting in April.

The output of the qualitative analysis shows that most of the detriments, relating to access to payments systems and end user needs listed by the Payments Community could now be solved by adopting a holistic approach to applying new technologies. The Simplified Payments Platform concept emerged after bringing together learning about the global push towards digitalisation and real-time, 24/7 payments, work done in Australia on the New Payments Platform and elsewhere, the use of layer modelling in the telecoms industry, advances in distributed ledger technology and the developing legislative environment underpinning APIs.

The Simplified Payments Platform concept is a framework for seeking to address multiple detriments. Among other things it should:

- Open up payments and improve direct access, thus creating a level playing field for PSPs
- Increase competition at all levels of the payments ecosystem
- Allow frequent and agile innovation of overlay services to suit user and end user needs
- Allow scalability
- Ensure and improve security and resilience in the system
- Align with international standards and allow international interoperability

The SPP concept is still being developed and discussed by the Data and Standards Group for submission to the PSF. However, there are some clearly agreed characteristics of the Platform. These include a single push rail, the aspects of governance necessary, common messaging standards, a layered model architecture and overlay services.

10.4.1 Single push rail

The single push rail is a payment system that only performs one task. It is the common denominator of any payment. It simply pushes a payment instruction from A to B quickly, reliably and efficiently and it is not concerned with the context of the payments, instead allowing a reference to additional information. The single push rail would be concerned with the payment, which would be dealt with as an overlay service. The single push rail allows for 24/7 payments in real-time or near-real-time and for any value with a minimum of exceptions.

The agreement and design of the specifications which constitute the single push rail will be a collaborative effort.

10.4.2 Governance

There would be an independent body to ensure governance of the standards set for the single push rail, ensuring overlay services worked within the specification. The role of the governance body would be to own the standards and protocols used; certify technology providers that their technology works according to the standards; authorise PSPs to connect to and leave the system; and to maintain the master register of PSPs to allow routing.

10.4.3 Common Messaging Standards

The messaging for the single push rail would be as lean as possible to enable it to pass as quickly as possible through the system. This underpins real-time payments. ISO20022 is the necessary standard which is already being adopted by systems and PSPs. However, ISO20022 affords messages a great deal of verbosity, which needs to be mapped correctly to work across the various APIs the messaging must transit through. Therefore work would need to be done to define the leanest common messaging standard for the push rail. The leanest message incudes however all information required to identify payor and payee and to allow PSPs to perform their obligation of payment screening and the verification of matching of payee and beneficiary of the destination account. As noted above, additional contextual information would be provided by an overlay service.

10.4.4 Layered model architecture

The layer modelling approach is established best practice in the IT and telecoms sector where end-to-end systems are built in layer stacks. Importantly each layer has functions to isolate capabilities from the layer above and below it. This means that it is possible to make changes to components of the layer – for instance, an overlay service like PayM, preserving the service characteristics, without it affecting all the other layers.

At present when a PSO needs to make a change to its service all other PSOs and PSPs must also make contingent changes to their own systems. This makes change painful and costly. It also reduces the speed of innovation. A layered model architecture means changes can be made more easily without affecting the whole eco-system.

The layers have been identified and described and the work of the HSWG relates to the definition of the key interfaces connecting some of the model's layers., for consideration by the PSF.

10.4.5 Overlay services

Overlay services should be understood as specific applications and services that provide context to a payment and use the single push rail to perform such payment. A current example would be the internet: The internet transports information in the same way that the single push rail will ensure the payment instruction is carried: http, email or Whatsapp, for example, use the internet to transport information suitable for their purpose yet each provide a very different service to their users. In the same way payment overlay services will provide specific services to end-users. The initial overlay services are conceived as offering services already provided by existing PSOs as well as new and as yet, unimagined payment services.

For existing services, overlay services are the embodiment of the rules and standards associated with existing scheme processes translated into a mechanism for using the new scheme platform. For example, for Direct Debit, the rules and standards for handling direct debit indemnity, returns and liability etc would be translated on top of the new simplified scheme platform in conjunction with secure Enhanced User Needs APIs (also a solution being considered by the PSF).

It is envisaged at this stage that existing payment services would be provided as overlay services as a basic minimum on top of the development of the single push rail. Additional overlay services could be developed competitively or collaboratively, depending on the type of service participants wanted to create.

10.4.6 Models for implementation

There could be more than one way in which the single push rail is implemented and there is some discussion continuing about this. However, the model being proposed by The Horizon Scanning Working Group is consistent with the findings and original proposals of the work agreed by the PSF and resolved the greatest range of identified detriments. The key characteristic of this model is that of a distributed system, where PSPs connect peer to peer. This emulates the way in which the telecoms industry has developed to push the 'intelligence' away from the centre of the system to the edges.

In this system the specifications for the single push rail, while agreed collaboratively, can be implemented by anyone in a competitive way. This is similar to the way in which the internet networks operate now, there are many browser implementations, accessing across the internet many web applications and services, but remaining decoupled in implementation and scalable.

The 'intelligence' is now 'pushed to the edges', like it is with mobile phones in telephony. Thus there are a set of basic overlay services provided to PSPs, which would likely incorporate everything we have today (credit transfer, direct debit etc) but would also allow for the evolution of new and as yet, unimagined payment services. One might consider these as value-adding 'apps' on the mobile phone which provides minimum basic services. In the new context overlay services are cheaper to build, sell and purchase in a competitive market. They promote innovation, competition and versatility.

Clearing is undertaken directly between PSPs across the network, rather than centrally through a single infrastructure. Risk is significantly reduced because there is no single point of failure. Should a single PSP fail the single push rail will still continue to operate.

Settlement will be managed separately, depending on the risk and needs of the overlay service. The solution will specify how the clearing instructions and settlement instruction will be verifiably coordinated and not result in a systemic risk of financial uncertainty between member PSPs and the Bank of England.

11 REFERENCES

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