



FINANCIAL CONDUCT AUTHORITY  
**PAYMENT SYSTEMS  
REGULATOR**

Market review into the  
supply of indirect access  
to payment systems

**MR15/1.2**

# **Interim report**

March 2016

This interim report sets out the interim findings of our indirect access market review.

We are asking for comments on our interim report by 5 May 2016. You can send your comments and responses by email to [iamr@psr.org.uk](mailto:iamr@psr.org.uk).

You can also respond in writing to the address below (although we ask all respondents to also provide electronic Word and PDF versions of their response).

Payment Systems Regulator  
Indirect Access Market Review Team  
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Canary Wharf  
London E14 5HS

Generally we will seek to publish views or submissions in full or in part. This reflects our duty to have regard to our regulatory principles, which include those in relation to:

- publication in appropriate cases
- exercising our functions as transparently as possible

As such, we would ask respondents to minimise those elements of their submission which they wish to be treated as confidential – we will assume consent for us to publish material which is not marked as confidential. If respondents include extensive tracts of confidential information in their submissions, we would ask that they submit non-confidential versions which they consent for us to publish. We will also not accept blanket claims of confidentiality, and will require respondents to identify specific information over which confidentiality is claimed, and to explain the basis on which confidentiality is sought.

Respondents should note that generally we will not disclose confidential information that relates to the business or affairs of any person, which we receive for the purposes of our functions under the Financial Services (Banking Reform) Act 2013 (FSBRA), unless:

- the information is already lawfully publicly available
- we have the consent of the person who provided the information and, if different, the person to whom it relates
- the information is published in such a way that it is not possible to ascertain from it information relating to a particular person (for example, if it is anonymised or aggregated), or
- there is a 'gateway' permitting this disclosure and it is appropriate to do so. Among the gateways is the 'self-help' gateway whereby the PSR may disclose confidential information to any third party to enable or help it to discharge its statutory functions<sup>1</sup>

The places in this report where confidential material has been redacted are marked with a [X].

You can download this interim report from our website ([www.psr.org.uk](http://www.psr.org.uk)).

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<sup>1</sup> The Gateways are set out in the Financial Services (Banking Reform) Act 2013 (Disclosure of Confidential Information) Regulations 2014, S.I.2014/882

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# 1

## Executive Summary

Our role is to promote competition and innovation in payment systems, and ensure they work in the interests of the organisations and people that use them.

For banks, building societies, and other payment service providers (PSPs) to operate, they need to be able to move money between accounts. To do this they need access to a payment system. Access to payment systems is therefore essential to enabling effective competition and innovation in payments.

We are committed to supporting entry of PSPs by fostering an environment that enables them to choose the access that best suits their needs. We have a wide programme of work to achieve this, of which this interim report is one part.

We have already taken a number of steps to promote better choice in access services and improve service quality. In particular, we are opening up direct access to interbank payment systems so that larger PSPs such as challenger banks have a real choice between direct and indirect access. Indeed, we expect a number of them to get direct access in the coming year. In addition, the emergence of technical access solutions such as the use of aggregators will also improve the technical functionality and choice for more PSPs.

We have also made entry easier by increasing the amount of information available to PSPs and supporting the industry Code of Conduct to improve indirect access. Alongside our programme of work, the Payments Strategy Forum is also considering how payment systems can be developed to simplify access for PSPs.

A number of other initiatives are also underway or anticipated; some led by us and some by the market or other regulators. For example, four new indirect access providers (IAPs) plan to start supplying indirect access to a range of 'indirect PSPs' (IPSPs) this year, some existing IAPs are expanding or improving their indirect access offerings, and new ways of accessing payment systems are emerging.

Alongside these many developments, we are conducting this market review to develop a deeper understanding of the supply of indirect access and to determine whether competition is working well for those who use payment systems – or whether we need to take further action to make it more effective.

Our interim conclusion is that, although competition in the supply of indirect access is producing some good outcomes for IPSPs, we have specific concerns about choice, service quality and the ability of IPSPs to switch providers. In particular, industry responses to financial crime regulation are still limiting the provision of indirect access for some IPSPs.

We have carefully considered what actions we might take to address our concerns. Our interim view is that there are significant recent, current and likely developments that should address them – particularly entry by new IAPs, new forms of access arrangement and our own existing work on access.

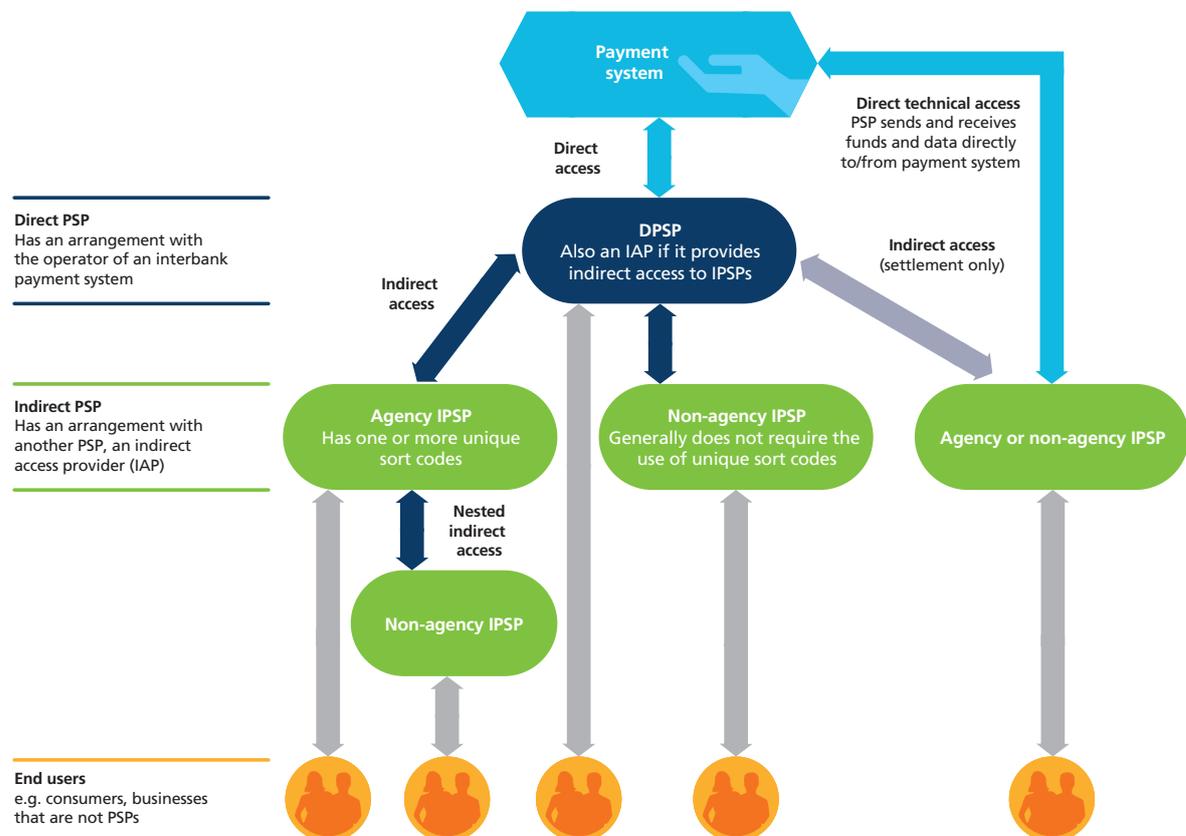
We expect these developments to improve choice, quality and price for service-users. Therefore we are proposing that we support the developments and monitor their impact, rather than take regulatory action now which could hinder progress.

We will continue to monitor these developments and will take further action if our concerns are not sufficiently addressed over the next 12 months.

We welcome stakeholders' views on this interim report and will review any further evidence and responses to assess the effectiveness and proportionality of our proposed approach. These views will be reflected in our final report.

- 1.1 Payment service providers (PSPs), such as banks, building societies, credit unions, payment institutions and electronic money institutions, provide services to their customers (consumers, businesses and charities) that enable the transfer of funds using payment systems. These services include the provision of payment accounts (such as current accounts), the issuing of electronic money, the acquiring of payment transactions, and money remittance. To be able to transfer funds for their customers, PSPs need access to interbank payment systems.
- 1.2 PSPs can have either direct or indirect access to interbank payment systems. PSPs with indirect access (indirect PSPs – IPSPs) can be agency or non-agency IPSPs. We explain these distinctions in Figure 1.

**Figure 1: How different PSPs access payment systems**



- 1.3 An indirect access provider (IAP) can be a direct PSP (DPSP) or an indirect PSP (IPSP). The fact that IAPs are themselves PSPs means that IAPs often compete with their IPSP customers in the provision of payment services to end users.

**1.4** Our aim is to ensure PSPs can access payment systems without facing anti-competitive barriers or unnecessary burdens. Our work to improve direct access to interbank payment systems means this is becoming a realistic option for more PSPs. Developments in direct technical access, and the emergence of aggregators, are also changing the access options for some PSPs. However, these options are not available to all PSPs, and some will continue to rely on indirect access as their only method of accessing payment systems.

**1.5** Table 1 provides a simplified summary of the typical options suitable for different types of IPSP (a small non-agency IPSP would typically process no more than a few thousand transactions per year, while a large agency IPSP would typically process in excess of ten million transactions per year).

**Table 1: Current access options for IPSPs**

IPSP type	Access options
<b>Large agency</b> e.g. challenger bank, building society, acquirer*	<ul style="list-style-type: none"> <li>• Direct access</li> <li>• Direct technical access (e.g. via an aggregator)</li> <li>• Indirect access</li> </ul>
<b>Medium agency or non-agency</b> e.g. smaller bank and building society, large money remitter	<ul style="list-style-type: none"> <li>• Direct technical access (e.g. via an aggregator)</li> <li>• Indirect access</li> </ul>
<b>Small non-agency</b> e.g. small electronic money institution, money remitter, credit union	<ul style="list-style-type: none"> <li>• Indirect access</li> <li>• For Bacs only: direct technical access (e.g. via an aggregator)</li> </ul>

\*There are a few large IPSPs which are non-agency IPSPs (e.g. acquirers). They are currently not eligible for direct access.

## Our interim conclusion on indirect access to interbank payment systems

**1.6** Based on the data we have collected and the responses and information which have been given to us to date, our interim conclusion is that competition in the supply of indirect access is producing some good outcomes:

- large IPSPs have **a number of options** to access payment systems
- there is a reasonable level of **overall satisfaction with the quality** of the indirect access offering that IPSPs receive
- the overall feedback we have received to date does not indicate a widespread level of concern with **price**
- we are seeing **investment and innovation** in new and improved service offerings, which should improve quality and choice outcomes for all IPSPs

**1.7** However, we have identified specific concerns that limit competition and innovation in the provision of payment services, and the interests of service-users such as people and businesses that use them. Our concerns are:

- While large IPSPs tend to have a wider choice of access options, and many are exercising that choice (for example, through options such as direct access or aggregators), many small non-agency IPSPs have a **limited choice** of IAPs. This limited choice constrains the ability of these smaller non-agency IPSPs to negotiate on price, or to find an alternative provider if they are not satisfied with the services they receive.
- IPSPs in all categories are experiencing a number of specific **quality-related issues** with indirect access. Large agency and medium agency IPSPs, particularly banks and building societies, have concerns about the quality of technical access to FPS and its availability. Small non-agency IPSPs have raised concerns about notice periods for the termination of indirect access agreements and the relationship management provided by IAPs. These issues limit some IPSPs' ability to compete in related markets, such as retail banking.
- IPSPs in all categories face **barriers to switching** IAPs, which reduces the competitive pressure on IAPs and prevents IPSPs from securing the best possible price and quality outcomes.

**1.8** The nature and extent of specific concerns differs among small, medium and large IPSPs. We consider these concerns are primarily a result of three market characteristics:

- **Industry responses to financial crime regulations:** The perceived risk of compliance failures under financial crime regulations influences the behaviour of IAPs. These responses could be limiting the provision of indirect access for some IPSPs.
- **Lack of entry of IAPs:** The historic rate of entry of new suppliers of indirect access has been low, which limits the competitive pressure on IAPs to improve their indirect access proposition and limits the choice available to IPSPs wanting to find an alternative provider.
- **Increase in demand for real-time payments:** When FPS was launched, IAPs primarily supplied FPS services to IPSPs based on the SWIFT messaging service, since they considered it was the most cost-effective and convenient option for IPSPs at that time. The growing demand for real-time services has since brought into question whether the technical solutions provided to IPSPs still meet customer needs.

## **A number of developments should address our concerns**

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**1.9** Our wider programme of work and a number of current and anticipated developments have the potential to address our concerns and improve outcomes for service-users. These developments include:

- **Our programme of work on direct access:** We have introduced various measures to improve PSPs' ability to become DPSPs of interbank payment systems, which could also increase the number of IAPs.
- **Market entry and expansion:** The potential entry of four new IAPs, and existing IAPs expanding their current offering, should lead to greater choice for IPSPs and more competitive pressure on IAPs.
- **Improved IAP FPS access offerings:** Two of the four main IAPs are making or have made investments which should offer agency IPSPs options for an improved quality of technical access to FPS (including 24/7 availability).

- **Improved direct technical access for IPSPs:** Emerging direct technical access models and Bacs' and FPS' reviews of their access models should provide improved technical functionality and choice for IPSPs.
- **Development of the Image Clearing System:** The Image Clearing System for cheques is aiming to make sort codes fully transferrable, which should improve the ability of agency IPSPs to switch IAP.
- **The Bank of England's strategic review of its real-time gross settlement (RTGS) infrastructure:** The Bank of England is currently reviewing its settlement account policy in response to changes in payments arising from 'technological innovations' and 'a more dynamic focus on competition and innovation driven by the PSR'.
- **IAP Code of Conduct:** In September 2015, Payments UK, working with us and the four main IAPs, published an interim Code of Conduct setting out a range of measures and commitments to improve indirect access to interbank payment systems.
- **Information-related initiatives:** The PSR's Sponsor Bank Information Direction and the industry information hub should help switching by increasing transparency and reducing the search costs for IPSPs when considering and choosing between different IAP offerings.
- **Reviews of financial crime regulation:** We are aware of at least six reviews underway or recently concluded which are aimed at improving the transparency, clarity and effectiveness of the UK's anti-money laundering and counter terrorist financing framework.
- **Payments Strategy Forum (the Forum):** Amongst other issues, the Forum will examine whether and how payment systems can be developed to simplify access, consider commonality of messaging standards and consider centralised functions aimed at preventing financial crime and ways to reduce the costs of compliance.
- **The CMA's proposed measures to improve switching as part of its Retail Banking Market Investigation:** The CMA's proposed measures could help some smaller IPSPs who receive indirect access primarily through a business bank account to switch IAPs.
- **Current Account Switch Service (CASS):** A number of small, non-agency IPSPs who get indirect access through a business bank account are likely to be eligible for CASS, which could help to address their concerns about business continuity when switching.

**Figure 2: How we expect the developments to address our concerns**

	Small IPSPs	Medium IPSPs	Large IPSPs
<b>Choice</b>	Reviews of financial crime regulation	Bank of England RTGS review	
		Improved technical access for IPSPs	
		PSR Programme of work on direct access	
	Market entry and expansion		
<b>Quality</b>	PSR Sponsor Bank Information Direction		
	Improved IAP access offerings		
	IAP Code of Conduct		
<b>Switching</b>	Current Account Switch Service + CMA's proposed measures	Image Clearing System	
	Payments Strategy Forum – working groups on access and financial crime		

## Our proposed approach

- 1.10** Indirect access has been, and will remain, a priority area in the PSR's ongoing work programme. We consider effective competition in the provision of indirect access to be an important means of delivering good outcomes to service-users. We therefore propose to support the developments outlined above rather than take immediate regulatory action, which may affect the incentives for such developments to take place. We expect these developments to improve choice, quality and price outcomes for service-users.
- 1.11** We will monitor these developments over the next 12 months and we will consider taking further regulatory action either as part of this review, or if our concerns are not sufficiently addressed. We will intervene only where we have clear evidence that we need to do so and where we expect the benefits of our intervention will outweigh any costs or unintended consequences.
- 1.12** We recognise that switching IAP can be important in driving competition. Some developments should make switching easier for some IPSPs: CASS could help address smaller IPSPs' concerns about business continuity when switching, the CMA's proposed measures could help smaller IPSPs to switch IAP, and the Forum's work could make it easier for larger IPSPs in particular to get access and switch IAPs. We are also seeking input now about whether there is anything more we can do to assist in making switching easier as part of this review.
- 1.13** We also have powers under the Financial Services (Banking Reform) Act 2013 (FSBRA) and UK and EU competition law to further address or investigate individual cases relating to the supply of indirect access. We are developing a framework for how we will handle applications under sections 56 and

57 of FSBRA to take specific regulatory action regarding granting of new access or varying existing agreements in relation to payment systems. We intend to consult on this framework either as part of or alongside our final report for this market review.

- 1.14** Further regulatory developments are also expected to be implemented into UK law in accordance with the requirements of Articles 35 and 36 of the second EU Payment Services Directive (PSD II). These provisions include rules for objective, non-discriminatory and proportionate access to payment systems, and full reasons for any rejection to be provided to PSPs and/or the authorities.

### Next steps

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- 1.15** We welcome views on our interim conclusions, the questions in Annex 6 of this interim report, and our proposed approach. We will review any further evidence and responses to this report to assess the effectiveness and proportionality of our proposed approach. We expect to present our final report in July 2016 (alongside any consultation as appropriate on measures).
- 1.16** Please send responses to this interim report to [iamr@psr.org.uk](mailto:iamr@psr.org.uk) by **5pm on 5 May 2016**.

## 2 Our approach

**2.1** In this chapter we describe how we have approached our review of the supply of indirect access to payment systems. Specifically, we look at:

- the purpose of this interim report
- why we are reviewing the supply of indirect access to payment systems
- the scope of the market review
- the role of the PSR and other regulators
- the evidence we have gathered to date

### **The purpose of this interim report**

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**2.2** This interim report has two purposes:

- To set out our interim findings based on the evidence we have gathered and our analysis to date. This includes our current thinking on possible measures to improve indirect access to payment systems.
- To invite stakeholders to comment on these interim findings and possible measures.

### **Why are we reviewing the supply of indirect access to payment systems?**

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**2.3** Access to payment systems is essential to create effective competition and innovation in the provision of payment services. Access has been a priority area for the PSR since our establishment in 2014. We want those who use payment systems to be able to access them on a non-discriminatory, open and transparent basis, and be able to choose the form of access that best suits them. The PSR has already taken a number of steps to improve access and indirect access options for users of payment systems. This includes the general directions we issued last year and our ongoing monitoring and review of compliance with those directions. We have recently issued an interim report for our market review into the ownership and competitiveness of infrastructure provision, which finds that there is not effective competition for the provision of payments infrastructure and proposes a number of remedies to improve competition.

**2.4** Payment service providers (PSPs), such as banks, building societies, credit unions, payment institutions and electronic money institutions, need to access payment systems so their customers (including consumers, businesses, government and charities) can receive and make payments. As a result, access to payment systems is critical to PSPs' ability to compete in the provision of payment services such as retail banking. Access is therefore an important driver of competition and innovation in payment services; it supports competition between PSPs, who in turn develop innovative new services to meet users' needs. Well-functioning payment systems underpin economic activity within the economy, and more competition and innovation in this sector can contribute to improving economic productivity.

- 2.5** If the supply of indirect access was working well, we would expect indirect access providers (IAPs) to respond to the price and quality needs of different types of indirect payment service providers (IPSP). We would also expect low barriers to entry for new IAPs and a choice of providers for IPSPs. This should result in benefits to customers of IPSPs and, more broadly, end users of payment systems, in terms of good price, quality and choice outcomes.
- 2.6** As set out in our terms of reference<sup>2</sup>, this market review was prompted by concerns raised by stakeholders during the Financial Conduct Authority's (FCA) call for inputs<sup>3</sup> and our own evidence gathering process that led to our November 2014 consultation paper, *A new regulatory framework for payment systems in the UK*.<sup>4</sup>
- 2.7** In our March 2015 policy statement we outlined various initiatives and measures designed to address concerns raised about indirect access.<sup>5</sup> We are determined to ensure these developments are successful in improving access and promoting competition.
- 2.8** With this market review our primary aim is to gather further detailed evidence to develop a deeper understanding of the supply of indirect access to payment systems. This will help us determine the extent to which competition in the supply of indirect access is working well for service-users, and whether we need to take any further action to make it more effective.<sup>6</sup> We are considering the four key questions set out in our terms of reference:
1. What prices, service and choice do IPSPs want and receive? (Chapter 4)
  2. What factors may limit the number of IAPs in the market? (Chapter 5)
  3. What is the state of competition in the provision of indirect access? (Chapter 5 and 6)
  4. What options are there to improve indirect access to interbank payment systems? (Chapter 8)
- 2.9** This review will also inform decisions under our *Administrative Priority Framework*<sup>7</sup> if we receive applications for new access, or for variation of existing agreements in relation to payment systems, under sections 56 or 57 of the Financial Services (Banking Reform) Act 2013 (FSBRA).

<sup>2</sup> PSR MR15/1.1, *Market review into the supply of indirect access to payment systems*, Terms of reference (May 2015): <https://www.psr.org.uk/psr-publications/market-reviews/mr1511-final-terms-reference-indirect-access>

<sup>3</sup> FCA, *Payment Systems Regulation*, Call for Inputs (March 2014): <https://www.fca.org.uk/your-fca/documents/payment-systems-regulation-call-for-inputs>

<sup>4</sup> PSR CP14/1, *A new regulatory framework for payment systems in the UK* (November 2014): <https://www.psr.org.uk/psr-publications/consultations/consultation-paper-141>

<sup>5</sup> PSR PS 15/1, *A new regulatory framework for payment systems in the UK* (March 2015): <https://www.psr.org.uk/psr-publications/policy-statements/policy-statement-151>

<sup>6</sup> In accordance with the PSR's general duties under FSBRA.

<sup>7</sup> Administrative Priority Framework (March 2015): <https://www.psr.org.uk/administrative-priority-framework>

## The scope of the market review

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- 2.10** This review covers indirect access to the main interbank payment systems in the UK: Bacs, CHAPS, Cheque & Credit (C&C)<sup>8</sup> and Faster Payments Service (FPS).
- 2.11** Access arrangements for LINK are different to the other systems, so the scope of this review differs for LINK accordingly. It is not possible to have indirect access to LINK. Instead, PSPs must be LINK members and have direct technical access in order to:
- issue cards that can access LINK ATMs
  - operate ATMs that can access the LINK system
- 2.12** However, these PSPs do not necessarily need their own Bank of England settlement account to complete settlement within LINK. PSPs without a settlement account must come to an arrangement with a LINK member that has one to complete settlement on their behalf.
- 2.13** The scope of this review for LINK is limited to the relationship between members without settlement accounts and the members that provide them with settlement services. However, we have not seen any evidence of concerns about these relationships.
- 2.14** As we set out in our terms of reference, stakeholders did not identify significant concerns regarding indirect access to the regulated card payment systems (MasterCard and Visa Europe (Visa)). Therefore, we have excluded them from this market review.
- 2.15** For the remainder of this report, when we refer to ‘payment systems’ we mean the regulated interbank payment systems which are in the scope of this market review, namely Bacs, CHAPS, C&C and FPS. Unless otherwise explicitly stated, the findings and policy proposals set out in this report do not apply to Northern Ireland Cheque Clearing, LINK, MasterCard or Visa.
- 2.16** As set out above, a PSP has indirect access to a payment system if it has a contractual arrangement with an IAP to enable it to transfer funds on behalf of its customers and to provide payment services to those customers. This review does not cover the provision of access to businesses that do not provide payment services, such as utility companies and retailers.
- 2.17** This market review considers the services provided to IPSPs that are registered with or regulated by the FCA. This includes a number of different types of IPSP, including both banks and non-banks (such as payment institutions and electronic money institutions). Although international correspondent banking provides some PSPs with a form of indirect access, we decided to focus the scope of this market review on PSPs which are registered or regulated to provide payment services in the UK.
- 2.18** We are considering the indirect access services of all IAPs. The primary providers of indirect access services are Barclays, HSBC, Lloyds Banking Group (LBG) and RBS. In this report, we refer to these four banks as ‘the four main IAPs’. The market review considers the services provided by these four main IAPs and by other PSPs that do or could provide indirect access services.
- 2.19** An important aim of this market review is to consider the extent to which the supply of indirect access is working well for service-users. For the purposes of this market review, the service-users most directly affected are IPSPs. Through IAPs, IPSPs use the services provided by payment systems to provide payment services to their end users. If the supply of indirect access is working well it will lead to better outcomes for IPSPs, and can be expected to lead to better outcomes for end users.

<sup>8</sup> Our consideration of the C&C system takes into account the development of the new Image Clearing System for cheques. We are not including Northern Ireland Cheque Clearing in this review as no concerns have been raised with us about that payment system.

## The role of the PSR and other regulators

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- 2.20** Although access to payment systems is an important area of work for the PSR, other regulators such as the FCA, Bank of England and Prudential Regulation Authority all have an interest in this area and have powers, roles and responsibilities regarding access to financial services more broadly. In discharging its general functions, the PSR must have regard to financial stability considerations and how our work could impact on the stability of, and confidence in, the UK financial system.
- 2.21** Although we will take a lead on matters relating to access to payment systems for PSPs, we will continue to coordinate with other authorities, in particular on matters relating to financial crime and access to bank accounts.
- 2.22** In addition, the Competition and Markets Authority (CMA) is currently investigating the supply of personal current accounts and of banking services to small and medium-sized enterprises. We have liaised with the CMA over the course of our market review on issues relevant to both reviews, and will continue to do so.

## Evidence gathered to date

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- 2.23** We have analysed a wide range of data and information to understand better the supply of indirect access to payment systems. We have met with a wide range of stakeholders including IAPs, IPSPs, operators, potential entrants and trade associations. We have also received data from the four main IAPs, carried out case studies, conducted a survey of IPSPs and held a roundtable discussion with IPSPs.

## Previous consultations

- 2.24** We have reviewed and considered the evidence stakeholders submitted to us through previous consultations such as the FCA's call for inputs<sup>9</sup> and responses to our November 2014 consultation paper, *A new regulatory framework for payment systems in the UK*.<sup>10</sup>

## Survey of IPSPs

- 2.25** We conducted an online survey of IPSPs in September 2015. This focused on issues such as:
- IPSPs' use of indirect access
  - the cost of using payment systems indirectly
  - switching and the choice of IAPs
  - the quality of indirect access services
  - other issues and concerns IPSPs raised
- 2.26** We are grateful to the 68 IPSPs who responded to our survey. The survey questions are reproduced in Annex 3. You can see the anonymised results of the survey in Annex 2. The views recorded through the survey are not necessarily representative of the industry as a whole, and the data from questionnaire respondents does not necessarily extrapolate or scale to give an industry-wide view.

<sup>9</sup> FCA, *Payment Systems Regulation, Call for Inputs* (March 2014): <https://www.fca.org.uk/your-fca/documents/payment-systems-regulation-call-for-inputs>

<sup>10</sup> PSR CP14/1, *A new regulatory framework for payment systems in the UK* (November 2014): <https://www.psr.org.uk/psr-publications/consultations/consultation-paper-141>

## Requests for information and data requests to IAPs

**2.27** To inform our understanding of the supply of indirect access, we issued requests for information to 44 businesses that:

- our research had shown were or may be IAPs, or
- we considered may potentially become IAPs in the future, based on their activities and business models

**2.28** The requests for information consisted of a questionnaire and a data request. This was intended to provide us with information and a data set on the provision of indirect access over the previous five years. We received 24 responses to the questionnaire. Some firms replied to say the request did not apply to them as they were not an IAP and had no plans to become one.

**2.29** The data request was to be completed only by organisations that had supplied indirect access in the previous five years. It covered four areas:

- Descriptive data on each IPSP that the IAP had provided indirect access to.
- Payments transaction data: the volume and value of transactions made by each IPSP, in each payment system, in a given year.
- Revenue data: a breakdown of the revenues generated by inbound and outbound transactions for each IPSP, in each payment system, in a given year.
- Whether the IAP provided any non-payment related services to each IPSP (we did not request the non-payment related revenues or a breakdown of the non-payment related revenues).

**2.30** As we explain in Chapter 4, not all IAPs were able to provide all the data we requested, and there was some inconsistency in the way some elements were reported. The four main IAPs all gave us detailed data, and seven other IAPs gave us some information about their activities. We recognise that these were extensive requests for information and appreciate the efforts of all the organisations that responded.

## Evidence on individual participants' experiences

**2.31** We gathered information on the specific experiences of nine participants we selected to better understand different aspects of indirect access. These included participants with experience of:

- market entry as an IAP
- market exit as an IAP
- becoming a direct participant of a payment system
- switching IAPs
- market entry as an IPSP
- market exit as an IPSP

**2.32** We are grateful to the PSPs who gave us relevant information for their time and effort. The information we gathered as part of this exercise forms part of the evidence base referred to throughout this report.

## Meetings with IAPs and IPSPs

- 2.33** Over the course of the market review we have had more than 30 meetings with a number of IPSPs and IAPs, including all of the four main IAPs. We have also met payment system operators and trade associations. These meetings have made an important contribution to our understanding of specific issues related to the supply of indirect access.

## IPSP roundtable

- 2.34** We held an IPSP roundtable on 30 October 2015, attended by representatives of about 20 IPSPs. The purpose of this was to share our initial findings from our IPSP survey, and to hear comments and input from IPSPs on specific issues relating to the supply of indirect access.

## International comparisons

- 2.35** We commissioned Lipis Advisors to carry out an international comparison study to assist in our understanding of payment systems in other jurisdictions. The study involved 12 countries, and focused, among other things, on how PSPs access payment systems in other countries. We published a report on the study on 25 February 2016.<sup>11</sup>

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<sup>11</sup> <https://www.psr.org.uk/psr-publications/market-reviews/MR1522-lipis-report>

# 3

## Overview of PSPs and indirect access

Payment service providers (PSPs) provide services to users that enable the transfer of funds. These services include the provision of payment accounts, issuing of electronic money, issuing of payment instruments, acquiring of payment transactions, and money remittance. A range of different types of organisations provide these services, including banks, building societies, credit unions, payment institutions and electronic money institutions. These organisations vary widely in terms of size – examples include sole traders offering money remittance services, to large challenger banks, such as Metro Bank, offering a full suite of retail banking services.

We have categorised IPSPs into agency IPSPs and non-agency IPSPs. Agency IPSPs are provided with one or more unique sort codes by their IAP, while non-agency IPSPs are not. Having a unique sort code is an important requirement for IPSPs to provide some specific payment services, particularly the provision of payment accounts that are directly addressable for payment using the in-scope interbank payment systems.

Barclays, HSBC, LBG and RBS are the only IAPs that currently provide indirect access to agency IPSPs. They are also the primary providers of indirect access to non-agency IPSPs. However, there are a number of other IAPs that provide indirect access services to a relatively small number of non-agency IPSPs.

In addition to indirect access, IAPs also typically provide a range of additional services to IPSPs as part of a wider commercial relationship. This means that indirect access is rarely provided as a standalone service to most IPSPs.

### Introduction

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**3.1** In this chapter, we present an overview of:

- what a payment service provider (PSP) is
- how PSPs access payment systems – directly and indirectly
- the two broad types of indirect PSP (IPSP) – agency and non-agency
- the specific services that enable IPSPs to have indirect access
- who provides indirect access to IPSPs
- the wider relationship IPSPs have with indirect access providers (IAPs)

## What is a PSP?

- 3.2** PSPs (payment service providers) are businesses that provide payment services to their customers (people, businesses or organisations) that enable the transfer of funds using payment systems.
- 3.3** PSPs need access to payment systems for the purposes of providing payment services to end users. This distinguishes them from end users of payment systems (such as consumers and businesses that do not provide payment services, like utility companies and retailers). End users also need access to payment systems, but for purposes other than providing payment services (for example, to make and receive payments in the course of running their own manufacturing business). End users access payment systems using the services provided by PSPs.
- 3.4** Businesses need certain regulatory permissions to be legally allowed to provide payment services. Firms in the following regulatory categories are generally able to provide these services:
- banks and building societies
  - credit unions
  - electronic money institutions, which are organisations that are able to provide certain payment services that include electronic money issuing, but are not allowed to accept deposits (issuing electronic money is discussed further at paragraph 3.7)
  - payment institutions, which are organisations that are able to provide certain payment services, but are not allowed to either accept deposits or issue electronic money
- 3.5** Banks, building societies and credit unions obtain the permissions to provide payment services by virtue of their authorisation under the Financial Services and Markets Act 2000. Payment institutions are authorised and registered under the Payment Services Regulations 2009, and electronic money institutions are authorised under the Electronic Money Regulations 2011. In addition, PSPs authorised in other countries in the European Economic Area (EEA) may provide payment services in the UK by either exercising rights under the Treaty of the Functioning of the European Union (TFEU) or passporting rights under an EU Directive.
- 3.6** Table 2 shows estimates of the number of firms currently in each regulatory category in the UK.

**Table 2: Estimated number of firms by regulatory category with permission to provide payment services in the UK**

Regulatory category	Number of organisations
Banks and building societies	~700
Credit unions	~550
Electronic money institutions	~100
Payment institutions	~1,150
<b>Total PSPs</b>	<b>~2,500</b>

Source: Figures for number of firms by type sourced from the FCA. Includes inward passported EEA firms.

- 3.7** The business activities and payment services these PSPs undertake can vary substantially. We have looked at indirect access for a variety of PSPs, whose payment services include the following:
- **The provision of payment accounts:** This includes current accounts, cheque accounts and transaction accounts. These accounts are generally identified by a unique sort code and account

number combination, which allows them to be directly addressable for sending and receiving payments through interbank payment systems (see paragraph 3.19 for more details).

- **Electronic money issuing:** This relates to the provision of electronically stored monetary value that is used to make payment transactions and is accepted by a person other than the issuer. A common example of this type of service is the provision of prepaid cards.
- **Issuing of payment instruments:** This relates to the provision of a payment service which enables a payer to use a payment instrument to initiate and process payment transactions. An example is the provision of debit cards by banks and building societies.
- **Acquiring of payment transactions:** This relates to the provision of a payment service by a PSP contracting with a payee (such as a merchant) to accept and process payment transactions, which results in a transfer of funds to the payee. WorldPay is an example of an acquirer.
- **Money remittance:** This relates to the transmission of money (or any representation of monetary value), without any payment accounts being created in the name of the payer or the payee. The remitter receives funds from the payer and transfers a corresponding amount to a payee or PSP acting on the payee's behalf. Western Union and TransferWise are examples of firms offering money remittance services.

**3.8** Elements of these payment services can overlap. For example, providers of payment accounts will usually also issue payment instruments, such as debit cards for their customers.

**3.9** As well as differences in regulatory category and the services offered, PSPs can be differentiated by their size. At one end of the spectrum are the largest UK retail and commercial banks (Barclays, HSBC, LBG, and RBS). They provide payment services (primarily related to their payment account services) to millions of customers, ranging from individual consumers up to large multinational corporations. At the other end of the spectrum are small payment institutions and small electronic money institutions, which due to the nature of their regulatory status are capped at a relatively small size. In between are a range of businesses of different sizes offering an array of different payment services. These include money remitters, credit unions, 'challenger banks' (such as Metro Bank and Tesco Bank), building societies, UK branches of international banks, and online e-wallet providers (the relative size of different types of IPSPs is discussed further from paragraph 3.24).

## How do PSPs access payment systems?

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**3.10** PSPs need access to payment systems to enable customers to make and receive payments. PSPs can have either direct or indirect access to payment systems. Figure 3 shows the different ways PSPs get access.

**3.11** A PSP has direct access to a payment system if the PSP is able to provide services for the purposes of enabling the transfer of funds using that payment system as a result of arrangements made between the PSP and the payment system operator (and other participants, as applicable).

**3.12** PSPs with direct access are referred to as direct PSPs (DPSPs). DPSPs process their payments through a direct technical connection to the payment system's central infrastructure (or similar arrangement). They also settle their payments directly by holding a settlement account in their name with the system's settlement agent. For the payment systems in scope of this review, this is the Bank of England.

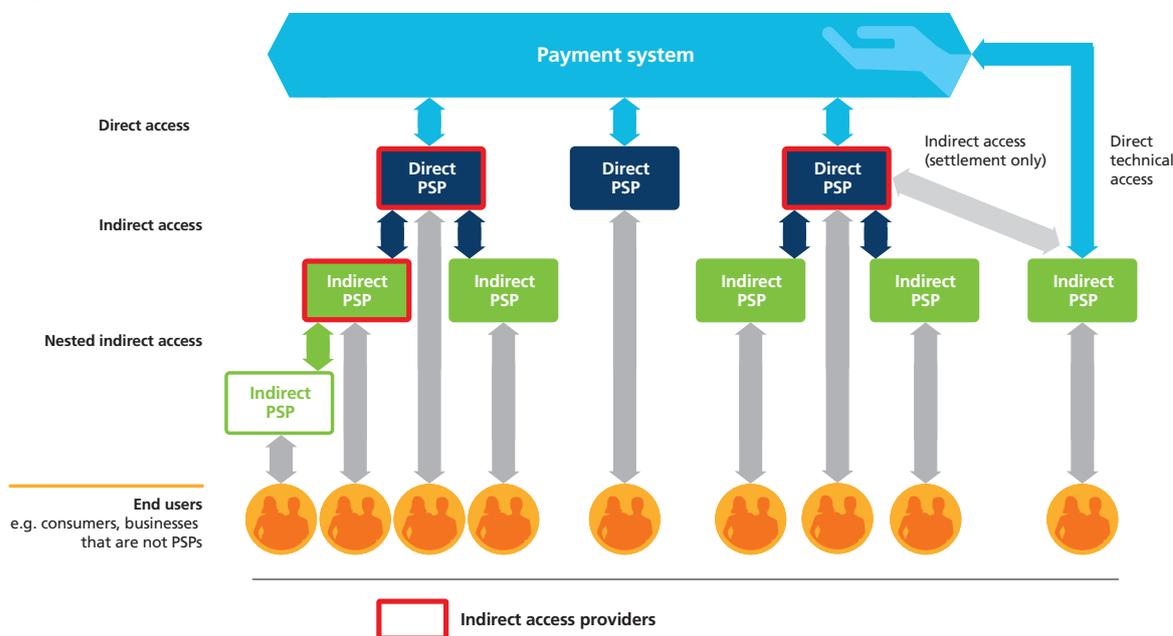
**3.13** A PSP has indirect access to a payment system if it has a contractual arrangement with an indirect access provider (IAP) for the purposes of enabling it to provide services to its own customers that enable the transfer of funds using that payment system. PSPs with indirect access are referred to as

indirect PSPs (IPSPs). IPSPs can also have direct technical access to the payment systems infrastructure, but still rely on IAPs for other indirect access services such as the settlement of their payments.

**3.14** IAPs are themselves also PSPs. They are most commonly DPSPs that are large banks and have direct access to multiple payment systems. IPSPs can also be IAPs, providing access through a process known as ‘nested’ indirect access (see Chapter 5 for further discussion of nesting).

**3.15** The fact that IAPs are themselves PSPs has important implications for this review. It means that IAPs often compete with their IPSPs in the provision of payment services to end users. This vertical integration can potentially create incentives and the ability for IAPs to limit their IPSPs’ ability to effectively compete in the provision of payment services to end users. This could manifest itself, for example, in IPSPs facing disproportionately high prices for indirect access, or a lower quality of access.

**Figure 3: Ways in which PSPs access payment systems**



**3.16** Whether a PSP chooses to access payment systems directly or indirectly will depend on a number of factors:

- **Volume of transactions:** At lower transaction volumes, direct access is more costly than indirect access. This is due to the upfront and ongoing costs of complying with payment system requirements for direct access. These include costs related to technical connectivity, participation in payment system governance, maintaining compliance with payment system requirements, and payment system operator fees.
- **Business model:** The specific services a particular PSP provides, and the complexity and scale of its payment requirements, all have a bearing on what is the most appropriate type of access for them. For example, a payment account provider with a large retail customer base expecting real-time 24/7 payments may find direct access is the right option, but it may not be for a small money remitter that makes infrequent payments as part of facilitating international money transfers.
- **Eligibility:** Payment systems have a range of minimum requirements for PSPs who want direct access, so they can maintain the stability and integrity of their systems. PSPs that cannot meet these requirements must use indirect access. Some systems currently require DPSPs to have a

Bank of England settlement account, so only PSPs with a settlement account can get direct access. This is currently the case for all of the systems in scope of this review (Bacs, CHAPS, C&C and FPS).

## There are two types of IPSPs – agency and non-agency IPSPs

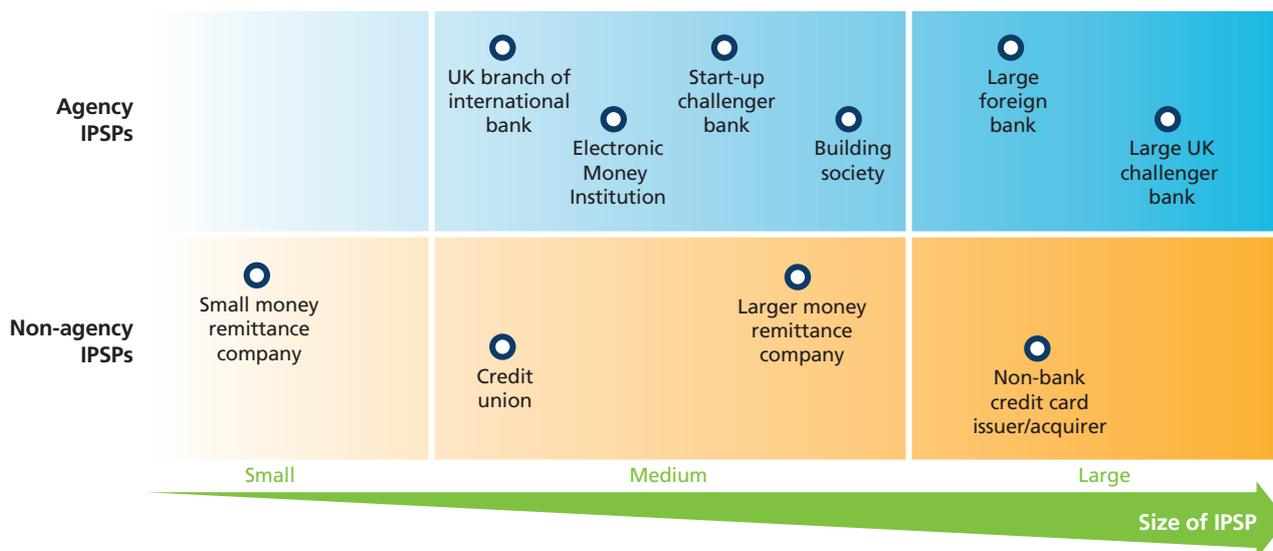
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- 3.17** IPSPs can be categorised into agency IPSPs and non-agency IPSPs.
- 3.18** Agency IPSPs are IPSPs that are provided with one or more unique sort codes by their IAP. The large majority of agency IPSPs are banks and building societies. This reflects their current role as the main providers of payment accounts to end users. However, there are a small number of larger non-bank IPSPs that also have unique sort codes.
- 3.19** Agency IPSPs generally provide payment accounts (for example, personal current accounts) to their customers that are directly addressable for payment using the interbank payment systems which are in the scope of this review. This enables customers to easily make payments to and receive payments from accounts held at other PSPs. By 'directly addressable', we mean that these accounts can be identified by a unique sort code and account number combination. This enables account users to communicate a complete set of associated remittance information when sending and receiving interbank payments (for example, an invoice reference or the reason for the payment).
- 3.20** Some IPSPs without a unique sort code provide payment accounts to end users. However, these accounts are not directly addressable for sending and receiving payments using the in-scope interbank payment systems and, as a result, have less functionality than directly addressable payment accounts. When sending and receiving payments using a payment account that is not directly addressable, less information about the payment can be communicated between the payer and payee (for example, the payment reference field may need to be used to identify the payee rather than to identify the purpose of the payment). This in turn can cause reconciliation issues, leading to increased costs for the payer or payee, or to a lower quality of service.
- 3.21** To be able to provide directly addressable payment accounts, an IPSP needs to have one or more of its own unique sort codes. By having a unique sort code, the IPSP is able to issue account numbers against that sort code for each of its payment account customers. Each of these sort code and account number combinations will create a unique identifier that is usable in the interbank payment systems. To date, most sort codes have been allocated to DPSPs; the way the industry sort code database is designed and built means that only direct members of Bacs and/or FPS have access rights to directly allocate and maintain sort codes in the database. As a result, an IPSP looking to secure a unique sort code must enter into an agreement with a DPSP under which the DPSP will allocate one of its unused sort codes for the exclusive use of that IPSP.
- 3.22** Non-agency IPSPs are IPSPs that are not provided with unique sort codes by their IAP. Non-agency IPSPs generally provide payment services not related to the provision of payment accounts, such as money remittance and card acquiring.
- 3.23** While non-agency IPSPs provide services to their customers that enable the transfer of funds, they do not require a unique sort code to do so. Instead, IAPs provide them with payment accounts that are similar to the ones they provide to businesses that are not PSPs (for example, a utility company). As a result, all existing or new suppliers of payment accounts to businesses that are not PSPs can also potentially supply indirect access to non-agency IPSPs. Only those PSPs that provide payment accounts to large corporates are likely to be suited to supplying the more complex services required by larger non-agency IPSPs. Smaller non-agency IPSPs' banking requirements are more similar to those of smaller businesses that are not PSPs, so they can potentially get indirect access through any provider of payment accounts to small businesses.

**3.24** We estimate that there are approximately 300 agency IPSPs and over 2,000 non-agency IPSPs. While both agency and non-agency IPSPs vary widely in size, on average agency IPSPs are larger, in terms of their payment activities, than non-agency IPSPs. For example, around 60% of the indirect access relationships between the four main IAPs and agency IPSPs that we identified involved more than 10,000 payments a year. In contrast, only around 30% of IAP relationships with non-agency IPSPs involved more than 10,000 payments a year.<sup>12</sup>

**3.25** Figure 4 below presents a stylised segmentation of IPSPs by agency, non-agency, and size (in payment volume terms). Different types of illustrative IPSPs are presented within this segmentation. In this segmentation there are no ‘small’ agency IPSPs. This is because small non-agency IPSPs are typically significantly smaller than agency IPSPs that are considered ‘small’ relative to other agency IPSPs. Small non-agency IPSPs may be, for example, sole traders operating as small payment institutions, whereas (relatively) small agency IPSPs are more likely to be, for example, small UK branches of larger foreign banks. Small non-agency IPSPs will typically process no more than a few thousand transactions per year, while large agency IPSPs will typically process in excess of ten million transactions per year. There is only a small number of large non-agency IPSPs, which are typically non-bank PSPs. Due to current limitations on the ability of non-bank IPSPs to directly participate in interbank payment systems, these large non-agency IPSPs are currently unable to become DPSPs in the in-scope interbank payment systems.<sup>13</sup>

**Figure 4: Stylised segmentation of IPSPs**



<sup>12</sup> Source: PSR analysis of data provided by the four main IAPs.

<sup>13</sup> PSR report, *Access and governance of payment systems: the operators’ progress and areas for ongoing focus* (December 2015): <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

## What specific services enable indirect access?

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- 3.26** To access a payment system indirectly, IPSPs must establish a commercial relationship with an IAP. Fundamentally, this relationship involves the IAP providing services that enable the IPSP to send and receive payments using payment systems. By doing so, the IPSP is able to provide services to its own customers to enable the transfer of funds using those systems.
- 3.27** The specific services that IAPs provide to IPSPs to enable indirect access are:
- An account that the IPSP can use to fund outgoing payments and to which incoming payments can be credited.
  - Channels to send and receive Bacs, CHAPS, C&C and FPS payment instructions. These channels generally include branches, telephone banking, internet banking, host-to-host connections, and SWIFT. Not all channels are used by all IPSPs. For example, smaller IPSPs are more likely to rely upon branch, telephone and internet banking, while larger IPSPs are more likely to use more technically complex channels such as host-to-host connections and SWIFT.
  - Information about payments sent and received by the IPSP. This information is commonly provided through the same channels used to send and receive payment instructions.
  - Customer support services.
  - In the case of agency IPSPs, the provision and related administration of one or more unique sort codes, and certain other services. For example, an IAP may provide services that enable an agency IPSP, or customers of the agency IPSP, to have direct technical access to Bacs.
- 3.28** All providers of indirect access services to agency IPSPs told us that the services they provide to agency IPSPs differ in some ways from the services provided to non-agency IPSPs. A key difference is the provision of unique sort codes to agency IPSPs, but other elements also differ. For example, IAPs may help an agency IPSP process cheques drawn on payment accounts held by the IPSP's customers. They do not do this for non-agency IPSPs. IAPs also told us that the indirect access services they provide to non-agency IPSPs are functionally the same as the payment account services provided to businesses that are not PSPs.
- 3.29** The specific capabilities of the indirect access services provided by IAPs will depend on the size and the complexity of the IPSP and the services they provide to their own customers. Services provided to agency IPSPs are generally bespoke and technically more complex. For example:
- Personal current account holders generally expect to be able to use multiple payment systems (to send and receive Bacs, CHAPS, and FPS payments, and to write and deposit cheques). As a result, IPSPs that provide these accounts need access to all of these payment systems on a frequent, and in some cases real-time, basis. This means that these IPSPs will need:
    - more complex channels to exchange payment instructions through (such as SWIFT or a host-to-host connection)
    - frequent information files of incoming payments to update customer balances
  - A small money remitter may rely primarily on FPS to make and receive payments as part of its service provision, and may only need to make and receive low volumes of infrequent payments. To do so, they may rely mainly on the internet banking service provided by their IAP for their payment needs, similar to businesses that are not PSPs.

- 3.30** IAPs typically provide indirect access services to IPSPs as part of a wider commercial relationship that includes the provision of other, possibly unrelated, banking services. This point is discussed in further detail below.

### Who provides indirect access to IPSPs?

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- 3.31** In this section, we discuss who provides indirect access to agency and non-agency IPSPs respectively.

#### Providers of indirect access to agency IPSPs

- 3.32** Only DPSPs can allocate unique sort codes<sup>14</sup>, so only DPSPs provide indirect access to agency IPSPs. This means that the pool of potential suppliers of indirect access to agency PSPs is limited to DPSPs.
- 3.33** In practice, there are four DPSPs that currently provide indirect access to agency IPSPs: Barclays, HSBC, LBG, and RBS (the 'four main IAPs').
- 3.34** The Co-operative Bank also currently provides indirect access to a small number of agency IPSPs. However, it has announced it intends to stop providing these services [30]. Accordingly, we have not focused on the Co-operative Bank's existing limited role as an IAP, and have instead focused on the four main IAPs.
- 3.35** All four main IAPs offer forms of indirect access to Bacs, C&C, CHAPS and FPS. However in considering the relative technical capabilities of their indirect access propositions, we make the following observations:
- All four main IAPs offer branch, telephone, internet, host-to-host and SWIFT-based channels to exchange payment instructions and related information. However, the specific functionality of these channels differs between IAPs. For example, they use different connectivity protocols (such as web-based or FTPS), message formats (such as Standard 18, MT103, and XML), and make their platforms available at different times.<sup>15</sup> The degree of support for different options for direct technical access to FPS also varies between the four main IAPs (for example, only two IAPs offer a direct agency access model, which allows agency IPSPs to connect directly into the central Faster Payments clearing platform using an approved technical access).
  - Of the four main IAPs, we understand that one IAP has a more limited proposition in terms of overall technical functionality than the others. As an example, these limitations include [30] (this IAP has indicated the intention to undertake significant investment to improve its indirect access offering – see Chapter 5 for further details).

#### Providers of indirect access to non-agency IPSPs

- 3.36** As non-agency IPSPs do not need their IAP to give them a unique sort code, any provider of payment accounts to business customers can potentially provide them with indirect access.
- 3.37** To understand who provides indirect access to non-agency IPSPs, we issued data requests to known providers of business bank accounts in the UK. We also collected information on this topic through our IPSP survey.
- 3.38** The CMA's retail banking market investigation found that in 2014 the four large UK banking groups (Barclays, HSBC, LBG and RBS) together had a market share in the provision of business current

<sup>14</sup> This is discussed in more detail in Chapter 5.

<sup>15</sup> For a description of UK messaging standards, see KPMG, *UK Payments Infrastructure: Exploring Opportunities* (August 2014): <http://www.fca.org.uk/static/documents/psr/kpmg-infrastructure-report-for-psr.pdf>

accounts to SMEs of over 80%.<sup>16</sup> Analysis of responses to our data requests and IPSP survey suggests that the same banks play a similarly important role in providing indirect access to non-agency IPSPs. They collectively provide a significant majority of the non-agency IPSP relationships with IAPs that we were able to identify. For example, over 85% of IAP relationships we identified through our survey are with the four main IAPs.

- 3.39** As well as the four main IAPs, six other respondents to our data request reported providing indirect access to a relatively small number of non-agency IPSPs.<sup>17</sup>
- 3.40** The results of our IPSP survey and other engagement with stakeholders show that at least six additional PSPs also provide some non-agency IPSPs with payment accounts that may enable indirect access. These organisations include [redacted]. Several of these organisations are themselves IPSPs, meaning some IPSPs have ‘nested’ indirect access arrangements.
- 3.41** We consider it likely that other PSPs that we have not identified to date are also offering payment accounts to non-agency IPSPs, including through nested indirect access relationships.
- 3.42** In this chapter we have focused on the supply of indirect access at the overall level of *agency* and *non-agency* IPSPs. We recognise that within the agency and non-agency groupings, there are a large number of different types and sizes of IPSPs and that the number of IAPs providing indirect access to these different sub-groups will vary. We discuss the issue of varying degrees of IAP choice for different types of IPSP in Chapter 4.

## The wider relationship IPSPs have with IAPs

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- 3.43** The four main IAPs all told us that the provision of indirect access is typically only one of a range of banking services they provide to IPSPs. We were also told that indirect access is generally provided to different types of IPSPs by different parts of their organisations.
- 3.44** In this section, we set out a description of where the provision of indirect access sits within the four main IAPs and the types of other services provided to IPSPs by IAPs.
- 3.45** There are two broad customer-facing businesses within the four main IAPs that are responsible for providing indirect access to IPSPs:
- **Business banking:** Provides a range of banking services to small businesses, including small non-agency IPSPs.
  - **Commercial and corporate banking:** Provides a range of banking services to larger businesses, including larger non-agency IPSPs and agency IPSPs.
- 3.46** The specific names and structure of these businesses within each of the four main IAPs varies. The discussion that follows represents a generalisation and is not specific to any one IAP. In its retail banking market investigation the CMA focused on business banking services to small and medium-sized enterprises (defined as businesses with less than £25 million annual turnover). In the two broad customer-facing businesses described above, the CMA definition would capture businesses served by the ‘business banking’ business and some businesses served by the ‘commercial and corporate banking’ business.

<sup>16</sup> CMA, *Retail banking market investigation*, provisional findings report (2015), paragraph 6.11: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf)

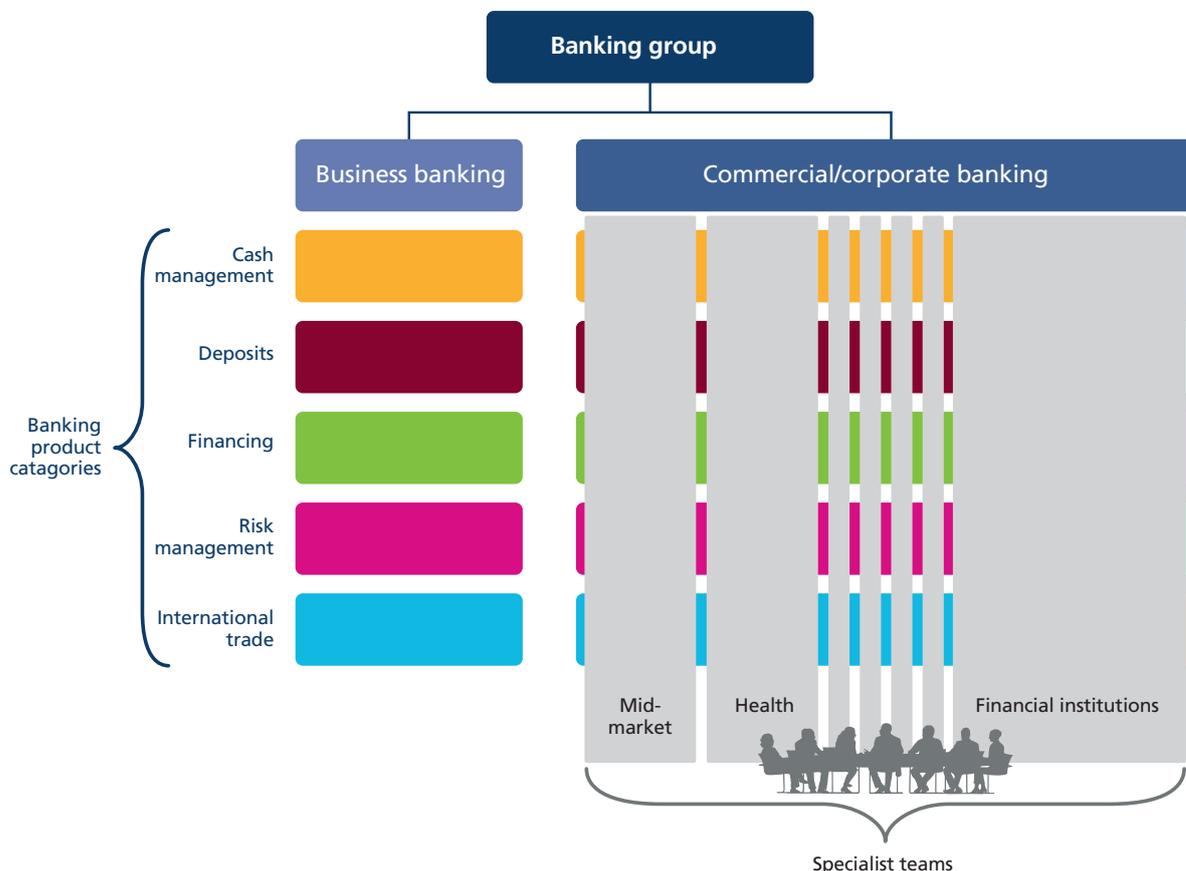
<sup>17</sup> Some respondents to our data request provided data relating to entities that we considered out of scope for this review. This included payments data relating to financial institutions that aren’t PSPs (such as asset managers and insurance companies) and international correspondent banking relationships. Where we have been able to identify data relating to these relationships, we have excluded it from our analysis. However, it’s likely that we have not correctly identified all of these instances.

**3.47** Each of these customer-facing businesses provides a range of banking services under a number of common product categories (see Figure 5). The specific services provided within each category are generally more complex within the commercial and corporate banking business, given that the larger organisations served by this business typically have more complex and specialised banking needs.

**3.48** The main product categories are:

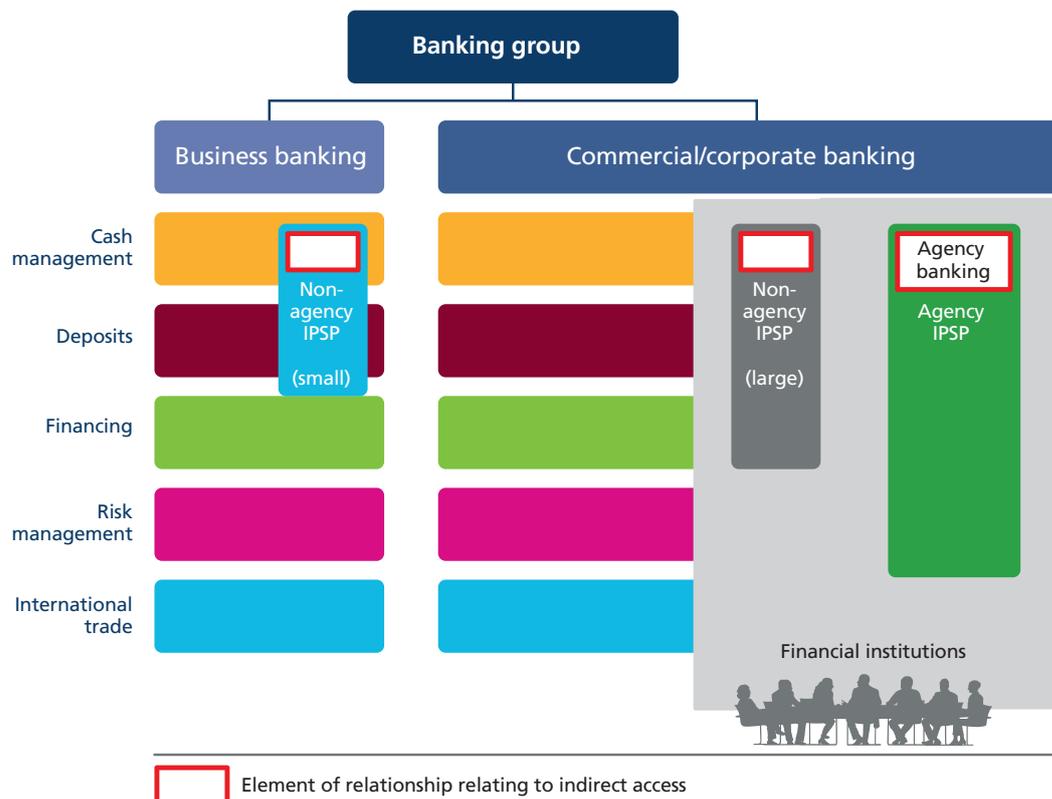
- **Cash management:** The provision of current accounts and payment services. Payment services include domestic interbank payments, international payments, debit and credit cards, bulk cash services, and overdrafts. Within the commercial/corporate banking division, other services may include liquidity and working capital management (for example, cash pooling). (The use of cash here refers to liquid funds (such as balances held in current accounts) rather than physical cash.)
- **Deposits:** The provision of savings accounts and related deposit products, such as term and notice deposit accounts.
- **Financing:** The provision of loans and other debt-related products, such as asset finance and working capital finance.
- **Risk management:** The provision of products to help manage risk. Within the business banking division, this includes insurance products. In the commercial and corporate banking business, it includes foreign exchange and interest rate hedging products.
- **International trade:** The provision of banking products related to international trade, such as trade finance, letters of credit, and foreign exchange services.

**Figure 5: Simplified representation of ‘business banking’ and ‘commercial and corporate banking’ businesses and categories of products they provide**



- 3.49 Within the commercial and corporate banking business, there are dedicated specialist teams. These teams are made up of salespeople, relationship managers and product managers focused on providing banking products to firms in specific industry sectors (e.g. health) or groups (e.g. based on size). One of these specialist teams typically focuses on the provision of banking services to financial institutions, including PSPs (such as banks and larger non-bank PSPs).
- 3.50 Indirect access is enabled by a subset of the services provided within the cash management product category – specifically, the provision of transaction accounts and certain payment services associated with these accounts. Some payment services provided within cash management, however, are unrelated to indirect access to the in-scope interbank payment systems – these services include international payments, card-related payment services, and cash-related services.
- 3.51 Within the cash management product category in the commercial and corporate banking business, there are a set of products that are commonly referred to as ‘agency banking’. These services are generally managed by the financial institutions sector team. These are specialised cash management services that are tailored to banks and other PSPs, such as the provision of unique sort codes. Services within this product sub-category enable indirect access to agency IPSPs.<sup>18</sup>
- 3.52 The four main IAPs told us that they typically provide IPSPs with services across multiple product categories. We understand that indirect access is rarely, if ever, provided as a standalone service. Some IPSPs also have commercial relationships with other businesses within the IAP – for example, an IAP’s investment banking business may provide advice on mergers and acquisitions or capital markets services to an IPSP.
- 3.53 Figure 6 presents several illustrative examples of (i) the multi-product relationships that IPSPs typically have with IAPs, and (ii) the positioning of the provision of indirect access in relation to other banking products provided by the four main IAPs.

**Figure 6: Illustrative IPSP relationships with IAPs across different banking product categories**



<sup>18</sup> However, some elements of the agency banking proposition are not related to indirect access. For example, bulk cash services for banks.

## Summary

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- 3.54** PSPs are made up of a range of firms with varying regulatory permissions to provide payment services to customers. These organisations vary in terms of size – examples include sole traders offering money remittance services, to large challenger banks offering a full suite of retail banking services.
- 3.55** PSPs can either be DPSPs or IPSPs. Where PSPs choose to access payment systems indirectly, they need indirect access services from IAPs to enable them to transfer funds on behalf of their customers. The complexity and capability of these services will depend on the size and the complexity of the IPSP's business activities.
- 3.56** We have categorised IPSPs into agency IPSPs and non-agency IPSPs. Agency IPSPs need sort codes to provide payment services to their customers. They are usually banks providing payment accounts (such as personal current accounts) to customers. Non-agency IPSPs do not require a sort code to provide their payment services to customers.
- 3.57** IAPs are themselves PSPs, and although they are usually DPSPs they can also be IPSPs. IAPs often compete with their IPSP customers in the provision of payment services to end users.
- 3.58** Barclays, HSBC, LBG and RBS are the only providers of indirect access services to agency IPSPs. They are also the main providers of indirect access to non-agency IPSPs. There are, however, a number of additional IAPs that provide indirect access to a relatively small number of non-agency IPSPs. Our review has identified at least another 12 such IAPs.
- 3.59** IAPs typically have a wider commercial relationship with most of their IPSPs beyond the provision of indirect access. The four main IAPs all told us that the provision of indirect access was typically only one of a range of further banking services they provided to IPSPs.

## 4

# Choice, service quality and prices

We have looked at choice, service quality and price outcomes to assess the effectiveness of competition in supplying indirect access.

The four main IAPs (Barclays, HSBC, LBG and RBS) all provide services to agency IPSPs and non-agency IPSPs. A number of other IAPs also provide non-agency indirect access services. However, the choice available to some non-agency IPSPs appears to be limited, particularly for small IPSPs, and those perceived to be higher risk. If these IPSPs are not satisfied with the services they receive from their IAP they will have little or no power to negotiate with their IAP and little or no choice in finding an alternative IAP. Large IPSPs tend to have a wider choice of access options, and many are exercising that choice, including through alternative options such as direct access and aggregators.

Overall, IPSPs appear reasonably satisfied with their indirect access services. Satisfaction is higher among agency IPSPs than non-agency IPSPs. However, we have identified some specific service quality issues. For bank and building society agency IPSPs these include the quality of technical access, particularly the ability to offer 24/7 real-time service for FPS on an equivalent basis to DPSPs. For small non-agency IPSPs, key issues relate to relationship management and termination periods.

Analysis of different pricing indicators shows a wide spread in the prices paid by IPSPs for indirect access to each of the interbank payment systems. Some IPSPs have expressed concern about prices, although the overall feedback we have received to date does not indicate a widespread level of concern with price. Large IPSPs tend to pay relatively lower prices and some do not appear to pay more for indirect access compared to the fees they could expect to pay if they were DPSPs.

Our analysis of IAP revenues suggests that IAPs derive low indirect access revenues from most of their IPSP relationships, and that most of these revenues are derived from a very small number of relationships with large IPSPs. Information we received also suggests that IAPs incur not insignificant compliance monitoring costs in relation to the majority of their IPSP relationships.

### Introduction

- 4.1** In this chapter we focus on the choice, service quality and price outcomes in the supply of indirect access. We set out our assessment of: the choice of indirect access providers (IAPs) for both agency and non-agency indirect payment service providers (IPSPs); the quality of service received by IPSPs; the prices paid by IPSPs; and the revenues earned by the four main IAPs from supplying indirect access and a review of some cost information we received.
- 4.2** We also set out the results of our analysis across these elements, while in Chapters 5 and 6, we examine some of the structural and behavioural factors that contribute to these outcomes.

- 4.3** Chapter 3 identified two types of IPSPs – agency and non-agency. Given the differences in the supply arrangements between the two, the discussion here separates the analysis for each.

## Choice outcomes

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- 4.4** When competition is effective, we would generally expect IPSPs to have a choice of different IAPs. The availability of alternative options in a competitive market is an important factor that provides incentives for IAPs to continually seek to develop offerings that are attractive to their customers and potential customers. We have therefore assessed whether IPSPs consider that there is a sufficient choice.

## Agency IPSPs

- 4.5** As we noted in Chapter 3, there are currently four main IAPs that provide services to agency IPSPs. For large agency IPSPs, direct access to one or more payment systems, rather than indirect access, is also an option. For medium and large agency IPSPs accessing some payment systems (for example, FPS) through aggregators will also be an option in the future.
- 4.6** There is mixed evidence on whether agency IPSPs consider there to be sufficient choice of IAPs. Some agency IPSPs told us that they have a choice of a number of IAPs, and that this puts them in a stronger bargaining position. Large agency IPSPs tend to issue invitations to tender to a number of potential providers. IAPs told us that they compete with one another to supply these agency IPSP customers and actively participate in the tenders. We were also told that large agency IPSPs tend to multi-bank, meaning that they maintain parallel supply relationships with a number of IAPs.
- 4.7** A number of medium and large IPSPs also appear to be planning to exercise the option of becoming DPSPs, as discussed in paragraph 4.35. This reflects the recent focus of the PSR and the payments industry on access issues. For example, our access and governance report identified some of the improvements made which have reduced the costs and time it takes to become a direct PSP (DPSP).<sup>19</sup>
- 4.8** Alternative direct technical access models for interbank payment systems are also emerging, including the development of aggregator arrangements for FPS. Further, both Bacs and FPS are currently undertaking reviews of their access models, and access options for C&C are also set to improve as part of the development of the Image Clearing System. These developments should provide improved technical functionality and choice for IPSPs.
- 4.9** In relation to existing direct technical access options, we note the interim finding of our ‘market review into the ownership and competitiveness of infrastructure provision’ that there generally appears to be effective competition in the provision of gateway solutions.<sup>20</sup>
- 4.10** The choice of IAPs appears to be more limited for agency IPSPs that generate lower revenues, or are perceived to have higher risk business models. As discussed in Chapter 6, some IAPs apply revenue thresholds when considering whether to offer indirect access to an agency IPSP. One IAP for example, applies a minimum revenue threshold of [£<] per annum to agency IPSPs.

<sup>19</sup> <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

<sup>20</sup> PSR MR15/2.2, *Market review into the ownership and competitiveness of infrastructure provision*, interim report (February 2016), Chapter 5: <https://www.psr.org.uk/psr-publications/market-reviews/MR1522-interim-report-infrastructure-provision>

## Non-agency IPSPs

- 4.11** Some IAPs and IPSPs told us that there are more potential IAPs for non-agency IPSPs than for agency IPSPs. In Chapter 3, we noted that all the four main IAPs currently provide non-agency indirect access, and we also identified a number of other providers of indirect access to non-agency IPSPs and other IPSPs that provide services through nested indirect access relationships (i.e. where an IPSP provides non-agency indirect access to another (non-agency) IPSP).
- 4.12** However, a number of non-agency IPSPs have told us that they face a limited choice of IAPs, and in some cases there is only one that is willing to provide them with indirect access. For some small IPSPs, having a bank account is equivalent to having indirect access. A survey conducted by the Association of UK Payment Institutions (AUKPI), which they shared with us for this review, showed that 35 out of 39 applications for bank accounts had been turned down, and 51 out of 71 respondents had had a bank account closed in the past 2½ years.
- 4.13** As discussed in Chapter 6, some IAPs also apply minimum revenue thresholds to non-agency IPSP relationships. Three of the four main IAPs currently apply such a threshold or have a policy of not servicing specific types of non-agency IPSPs. A result of such policies is that some smaller non-agency IPSPs are likely to have only one possible IAP willing to supply indirect access to them from among the four main IAPs.
- 4.14** As discussed in Chapter 5, the extent to which nesting occurs and offers an alternative means by which some non-agency IPSPs can access payment systems is not clear. Some IPSPs told us that nesting has grown in recent years as a result of the changed risk appetites of the four main IAPs, and the need for more providers to service newer and more innovative non-agency IPSPs. 15 respondents to the AUKPI survey had begun receiving indirect access through another IPSP after they had lost their access through a DPSP.
- 4.15** We have also been told that nesting has not fully replaced the supply of indirect access by the four main IAPs and that, in some cases, IAPs have sought to restrict or reduce nesting activity. IAPs told us that the practice of IPSPs providing indirect access increases financial crime risk because they (the IAPs) are one step further away from the underlying originator or beneficiary of a transaction. How financial crime risk may be affecting the offering of indirect access services is considered in more detail in Chapter 6.

## Assessment of the evidence on choice outcomes

- 4.16** Our analysis suggests that the choice of IAPs available to IPSPs differs according to the type and size of IPSP. Generally speaking, large IPSPs tend to have a wider choice of access options and appear to be exercising that choice, including through alternative options such as direct access and aggregators. The existence of these options, and the emergence of new ones, place pressure on existing IAPs to provide an attractive, competitive offering in order to attract and retain IPSP customers.
- 4.17** In contrast, small IPSPs, particularly those perceived to be higher risk or engaged in activities perceived to be higher risk, face a more limited choice. This means some IPSPs may not be able to obtain the services they would like, and have limited ability to negotiate on price and service terms. This may reduce competition and have a negative impact on the interests of service-users in those market segments served by these small IPSPs.

## Service quality

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- 4.18** Another outcome we examined to assess the effectiveness of competition in the supply of indirect access was service quality. When competition is effective, IAPs should have incentives to offer levels of service quality that reflect customer needs and preferences, and to be responsive to the needs and

requirements of their IPSP customers. This section sets out the results of our analysis of the evidence on service quality outcomes. It is based on a survey of IPSPs, as well as meetings with IPSPs and evidence we obtained at an IPSP roundtable.

**4.19** In this section we look at quality of service in the broader sense, not limited to technical quality. We first consider IPSPs' satisfaction with indirect access before assessing the quality of technical access, relationship management, service limitations and termination notice periods for agency and non-agency IPSPs.

### IPSP survey on quality of indirect access

**4.20** All the four main IAPs told us that service quality is an area in which they compete. In our survey we therefore asked IPSPs about the quality of service they receive from their IAP. While the survey results do not provide a perfect proxy for the quality of service,<sup>21</sup> they nevertheless are an indication of overall levels of customer satisfaction.

**4.21** In our survey we asked agency and non-agency IPSPs to rate the quality of service of indirect access provided by IAPs to the different payment systems. Specifically, we asked IPSPs about their levels of satisfaction with the services they receive from IAPs for the four interbank payment systems (Bacs, CHAPS, C&C and FPS).<sup>22</sup> Respondents were asked to rank the services they receive from 1 to 5 (1 being the lowest). This produced a headline satisfaction rating of 3.8 across all IPSP respondents. Agency IPSPs, who are more likely to be large and also more likely to be banks, had a headline satisfaction rating of 4.0, compared with 3.4 for non-agency IPSPs, which are more likely to be small.<sup>23</sup>

**4.22** We explored whether this figure represented a high or low level of satisfaction by benchmarking it against other survey results. We are not aware of any previous surveys that have dealt specifically with IPSPs' satisfaction with indirect access or payment services generally so we have no direct comparative data to assess how satisfaction has changed over time. We have however considered how satisfaction compares with business banking (of which our respondents are themselves a subset) and also with other essential business services.

**4.23** To understand how our survey results compared with satisfaction levels in other surveys of banking and other essential business services such as energy, water and landlines/broadband internet, we converted the score into a 'satisfaction percentage' figure. We did this by calculating how many survey respondents gave a rating of 4 or 5 as a percentage of the total.<sup>24</sup> Our survey gave an overall satisfaction rating of 70%.<sup>25</sup> The satisfaction levels were markedly different between agency IPSPs (77%) and non-agency IPSPs (51%). However, we note that there was a large disparity in the number of observations (171 agency IPSPs and 63 non-agency IPSPs) and the margin for error around the non-agency IPSP figure is quite significant.

<sup>21</sup> Surveys of this kind depend on respondents assessing how the service they receive compares with their expectation of that service, and are inherently subjective. The range of users of indirect access is broad, and expectation levels may also be quite diverse.

<sup>22</sup> We also asked about their satisfaction with LINK.

<sup>23</sup> Bank IPSPs and non-bank IPSPs can be either agency or non-agency customers. We recognise that the ratings given may have been influenced by factors other than the provision of that specific service, such as their broader relationship with their IAP. We also note that the sample size for our survey was relatively small at 68, and within this sample not all respondents provided a rating for each system (as in many instances they would not receive indirect access to all systems). A reasonable margin of error should therefore be allowed around the headline figure, and because of the small sample size we have not provided percentages for any subsets of data below the level of IAP or payment system, but rather treated these results qualitatively.

<sup>24</sup> We considered a rating of 4 or 5 to be broadly equivalent to a qualitative rating of 'satisfied' or 'very satisfied' used in the surveys we have benchmarked against. In our survey we asked respondents to provide a comment supporting their rating. We reviewed the comments and are content that this is a fair comparison, with most respondents providing a rating of 4 or 5 supporting this with a largely or wholly positive comment about the service received.

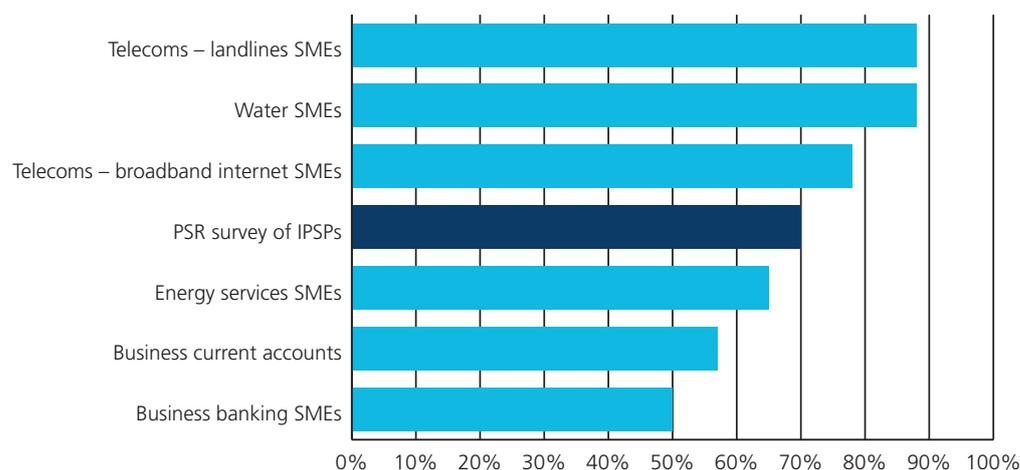
<sup>25</sup> The overall satisfaction score of 70% is based on 234 ratings given across the payment systems, with each respondent individually ranking each payment system to which it received indirect access.

4.24 The comparators we considered were:

- the Business Banking Insight survey of BCA customers<sup>26</sup>
- the Charterhouse Business Banking Survey presented by the CMA as part of its investigation into retail banking<sup>27</sup>
- an Ofgem<sup>28</sup> survey of satisfaction levels with energy services amongst SMEs
- a Consumer Council for Water<sup>29</sup> survey of SME satisfaction levels with water and waste water
- an Ofcom<sup>30</sup> survey of SMEs satisfaction levels for landlines and broadband internet

4.25 Figure 7 shows these various satisfaction levels. We note that the quality of service satisfaction level for indirect access to payment systems seems to be higher than for business banking but lower than for non-banking sectors.

**Figure 7: Satisfaction level for indirect access to interbank payment systems compared with various other banking and non-banking surveys**



Source: PSR survey of IPSPs, various surveys (see paragraph 4.24)

### **Respondent satisfaction by payment system**

4.26 Our IPSP survey data enabled us to consider trends beneath the headline satisfaction figures, including looking at variations across payment systems and IAPs and, when possible, at whether there are significant differences between the experiences of agency and non-agency IPSPs. Because of the limitations of the sample size, in particular with the smaller subset of non-agency IPSPs within the sample, we are treating these findings as indicative.

26 <http://www.businessbankinginsight.co.uk>. While this survey is not a perfect benchmark, it provides a guide for how users who receive similar services to IPSPs rate the four main IAPs.

27 CMA Retail banking market investigation, provisional findings report (2015), page 177: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf)  
Also see Appendix 6.5: [https://assets.digital.cabinet-office.gov.uk/media/5630c4eee5274a59dc000004/Appendix\\_6.pdf](https://assets.digital.cabinet-office.gov.uk/media/5630c4eee5274a59dc000004/Appendix_6.pdf)

28 Ofgem, *Micro and Small Business Engagement in Energy Markets* (March 2015): [https://www.ofgem.gov.uk/sites/default/files/docs/2015/03/non\\_dom\\_quant\\_final\\_v4\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/03/non_dom_quant_final_v4_0.pdf)

29 Consumer Council for Water, *Testing the Waters: SME customers' views on water & sewerage services 2014* (July 2014): <http://www.ccwater.org.uk/wp-content/uploads/2014/07/Testing-the-Waters-SME-customers-views-on-water-sewerage-services-2014.pdf>

30 Ofcom, *SME experience of communications services* (October 2014): [http://stakeholders.ofcom.org.uk/binaries/research/telecoms-research/sme/sme\\_research\\_report.pdf](http://stakeholders.ofcom.org.uk/binaries/research/telecoms-research/sme/sme_research_report.pdf)

- 4.27** A key finding to emerge from the IPSP survey was that overall satisfaction levels for indirect access to FPS were lower than for other payment systems. This appeared to be consistent across all types of IPSPs. These satisfaction levels by payment system are shown in Table 3.

**Table 3: Satisfaction level per payment system across all IPSP respondents**

Payment System	Satisfaction Rating
Bacs	78%
CHAPS	74%
C&C	70%
FPS	58%
Average (mean)	69%

Source: PSR survey of IPSPs

- 4.28** Higher satisfaction levels with Bacs may in part relate to the fact that more PSPs have direct technical access to the payment system through existing bureaux and other third party providers. This means that most DPSPs and IPSPs receive an equivalent level of service through this payment system.
- 4.29** FPS was launched in May 2008 as a result of work conducted by the Office of Fair Trading (OFT) Payment Systems Task Force. At present, only ten large PSPs have direct access to FPS. Other PSPs access FPS indirectly and typically are not able to process payments on a 24/7 near real-time basis like DPSPs. Because of this, the quality of the services they receive is not equivalent to that received by DPSPs. This was supported by a number of respondents to our IPSP survey, who raised specific concerns about the lack of 24/7 near real-time access to FPS through their IAP. These respondents were all banks and building societies.
- 4.30** IAPs have primarily supplied FPS services to IPSPs based on the SWIFT messaging service, since they considered it to be the most cost-effective and convenient option for IPSPs at the time of launch. However, the growth in demand for real-time services has brought into question whether these technical solutions provided to IPSPs still meet customer needs. This has prompted FPS to develop plans to widen the reach of 24/7 real-time access to more PSPs. FPS is currently working with IT vendors to develop alternative direct technical access solutions to improve the quality of services.
- 4.31** The lower satisfaction rating for FPS may partly reflect a higher level of IPSP and end-user expectation of the payment system's functionality (in terms of 24/7 near real-time payments) compared with expectations of Bacs, CHAPS and C&C. IPSPs may face further potential restrictions on competing in retail markets where they are less able to offer overlay services such as Paym, which rely on this capability.
- 4.32** A number of IPSPs told us that indirect access to FPS is not as good as indirect access to other payment systems. One agency IPSP told us that its ability to compete and attract business in retail markets was restricted because it was unable to access real-time payments, and it was also subject to a service that had regular weekend outages. One said that indirect access to FPS is more technically complex when compared to indirect access to other payment systems.
- 4.33** Some of these quality issues relating to FPS could be due to the availability of services from VocaLink. However, as set out in our interim report for our market review into the ownership and competitiveness of infrastructure provision, there have only been two occasions where VocaLink has not met the SLAs for the availability of a communication channel interface used by indirect PSPs.<sup>31</sup> One agency IPSP told us that it tends to lose at least one day a month through scheduled outages, which originate either from its IAP or from VocaLink. The IPSP did not see this as a deliberate strategy

<sup>31</sup> PSR MR15/2.2, *Market review into the ownership and competitiveness of infrastructure provision*, interim report (February 2016): <https://www.psr.org.uk/psr-publications/market-reviews/MR1522-interim-report-infrastructure-provision>

on the part of the operator, central infrastructure provider or its IAP to damage smaller competitors, but thought it reflected a failure to consider the consequences of such outages on IPSPs.

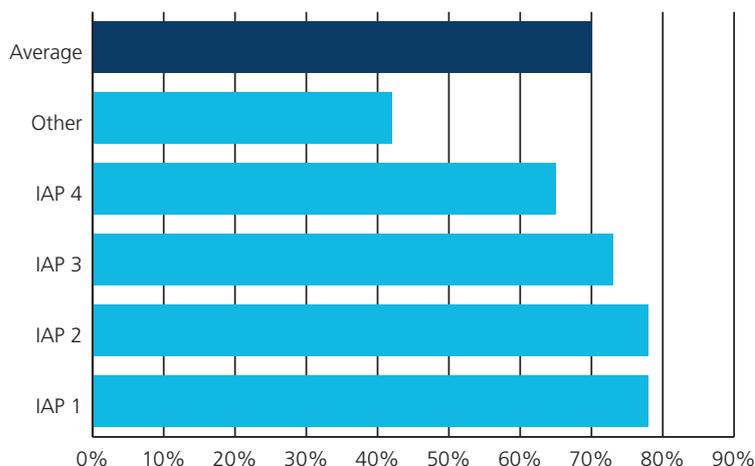
**4.34** Other FPS concerns relate more directly to IAP capabilities. Another agency IPSP told us that during much of 2015 they experienced some form of service interruption on their FPS access. It said that this happened during half of the weekends in 2015.

**4.35** A number of IPSPs appear to be planning to address the quality of service issues through becoming a direct member of FPS or using aggregator services: in our survey 15 IPSPs told us that they planned to become a direct member of FPS within the next three years, and the most common reason given for this was 'improved service offering to customers'. In addition 35 of 66 respondents told us that they were either 'very likely' or 'quite likely' to use aggregator services in the next three years (if they became available), and 67% thought that this offering would improve the quality of their offering to customers.

### **Respondent satisfaction by IAP**

**4.36** There does not appear to be significant variation in levels of satisfaction with the four main IAPs (Figure 8). Satisfaction ratings range from 65% to 79%. IAPs told us that they compete on quality of service and one plans to invest in its indirect access offering. It believes this will give it the ability to deliver some of the latest in modern transaction banking technologies.

**Figure 8: Satisfaction level per IAP**



Source: PSR survey of IPSPs

## **Quality of service for agency IPSPs**

### **Quality of technical access**

**4.37** IPSPs can connect to their IAP through a variety of channels. These include: their IAP's online banking service; SWIFT, which is an internationally used financial messaging service; and/or host-to-host connections, which are direct connections between the IPSP's and IAP's IT systems. For Bacs and FPS, some IPSPs have a direct connection to the payment system itself.<sup>32</sup> IPSPs may also use telephone banking and counter services at bank branches (for depositing cheques, for example).

**4.38** One of the trends we identified from our survey is that the channel through which IPSPs connect to their IAP appears to influence their satisfaction levels and the quality of service they receive.

<sup>32</sup> Direct connection is most common with Bacs, where more than half of respondents submit directly using either Bacstel-IP or an approved bureau (see <http://www.bacs.co.uk/Bacs/Bureaux/Pages/WhatsABacsBureau.aspx>). The connection is sponsored by the IAP and the IPSP obtains settlement through its IAP.

The percentage of respondents rating their indirect access service 4 or 5 (out of 5) was 64% among those that banked online, compared with 74% among those using SWIFT and 78% among those using a host-to-host connection. Several IPSPs noted their inability to offer their customers a 24/7 real-time service for FPS.

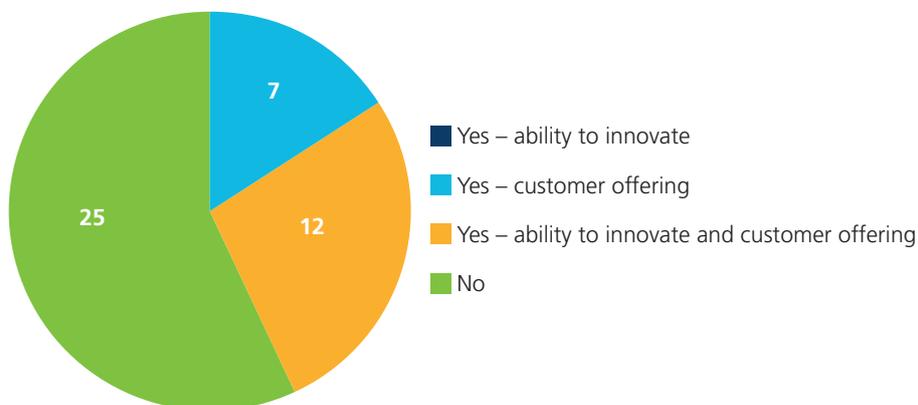
### **Relationship management**

- 4.39** One IAP said that all agency IPSPs, and most non-agency IPSPs above a certain size threshold, have the services of a relationship manager. Another IAP said that, as a result of their specialised status and services, agency IPSPs were more likely to have a specialist relationship manager. While large non-agency IPSPs may also receive this service, small customers would be more likely to be part of a mixed customer portfolio for a generalist relationship manager.
- 4.40** Some agency IPSPs also told us that the quality of services provided by the account or relationship manager at IAPs can vary, and that sometimes the quality of service received can depend on whether or not you are 'plugged into the right people'. However, there was a difference of opinion on this point. While some agency IPSPs noted that IAP relationship managers make the effort to ensure that you connect with the right people if issues arise, others noted that:
- the quality of information exchange was at times only 'adequate'
  - their IAP was responsive when contacted, but not necessarily proactive in providing them with relevant information
- 4.41** There also appear to be differences across agency IPSPs in terms of whether or not they consider that an adequate service level agreement is in place. Some agency IPSPs at our roundtable noted that they do not have any such agreement in place.

### **Service limitations**

- 4.42** We assessed whether agency IPSPs consider that they obtain the services they need to enable them to offer their customers innovative and competitive services. Limitations in the services IPSPs receive can limit an IPSP's ability to compete at the retail level.
- 4.43** As shown in Figure 9, over 40% of the agency IPSP respondents to our survey told us that their indirect access arrangements did hinder their customer offering and/or ability to innovate.

**Figure 9: Response from agency IPSPs – Does the way you access payment systems through your provider hinder your customer offering and/or your ability to innovate?**



Source: PSR survey of IPSPs

- 4.44** Some respondents suggested that the limitations in the services offered by their IAP restricted the functionality and services they could offer, particularly, as noted earlier, their ability to offer a 24/7 real-time service for FPS.

#### ***Termination notice periods and contracts***

- 4.45** We have received limited feedback from agency IPSPs about the termination notice periods that they have, although we have been told anecdotally that there are instances where there are no formal written contracts in place between IAPs and agency IPSPs. We note that, under the IAP Code of Conduct, an IPSP is entitled to have a written agreement which will include a number of key components, one of which is the termination notice period.<sup>33</sup> One agency IPSP told us that its IAP was seeking to impose a written contract on it with a notice period of six months, which the IPSP considers unacceptably short.
- 4.46** IAPs told us that termination notice periods range from a minimum of three months to a maximum of 12 months. One agency IPSP told us that at least 12 months is required to switch IAPs in instances when they want, or need, to find alternative access arrangements. One IAP suggested that, where an agency IPSP has chosen to switch to an alternative provider, it would normally keep a contract rolling until the IPSP had been able to switch.
- 4.47** Based on the evidence we have seen on switching, three months' notice is likely to be too short to enable some IPSPs to put a proper transition plan in place and migrate to a new IAP. However, in other situations, if IAPs are supportive of their IPSP customers who want to transition away (and they want to comply with the industry IAP Code of Conduct<sup>34</sup>) then three months' notice, as a starting point, might not be short. We recognise that IAPs have certain legal obligations under the Money Laundering Regulations 2007 in which very short-notice terminations may be required.

### **Quality of service to non-agency IPSPs**

#### ***Quality of technical access***

- 4.48** Non-agency IPSPs also connect to IAPs using a variety of channels, as discussed in paragraph 4.37. However there was less variation in the use of different channels by the non-agency IPSP respondents to our survey, and a significant number only use their IAP's online banking channel.
- 4.49** Our survey showed a correlation between lower levels of satisfaction and IPSPs that connected to their IAP exclusively through the IAP's online services (see paragraph 4.38 above). These were all small non-agency IPSPs who processed lower payments volumes.
- 4.50** Large non-agency IPSPs that responded to our survey had more in common with agency IPSPs in the way in which they connected to IAPs. They also have higher satisfaction levels than small non-agency IPSPs – although satisfaction levels were still lower than agency IPSPs on average.

#### ***Relationship management***

- 4.51** Non-agency IPSPs told us that they typically did not have access to the services of an account or relationship manager – only to general customer services support. They suggested that this caused particular difficulties because the issues they encountered could be quite specialised (such as misdirected payments and IT issues), and general customer services staff were often unfamiliar with payment systems and IT and therefore could not provide the support required. One non-agency IPSP told us that it took their IAP over a month to respond to a basic request for a letter confirming the status of their account.

<sup>33</sup> Payments UK Code of Conduct for Indirect Access Providers, s. 2.1: <http://www.accesstopaymentssystem.co.uk/code-of-conduct>

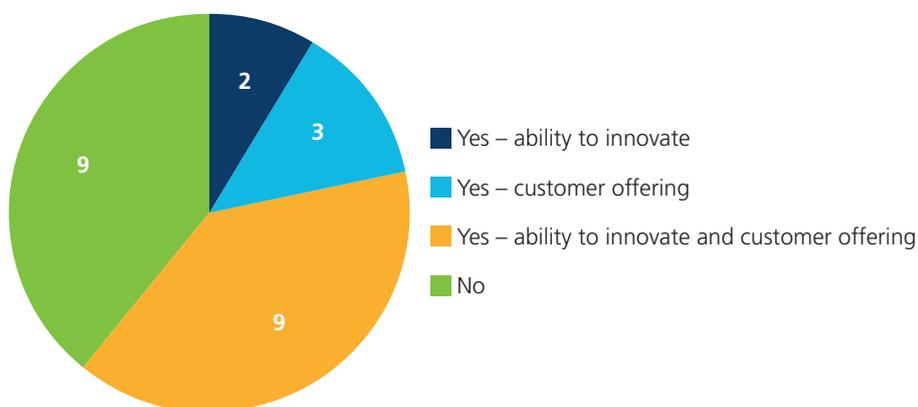
<sup>34</sup> Payments UK Code of Conduct for Indirect Access Providers, s. 2.3: <http://www.accesstopaymentssystem.co.uk/code-of-conduct>

- 4.52** Like agency IPSPs, non-agency IPSPs told us that some IAPs were not proactive in providing relevant information about system changes and scheduled outages.

### ***Service limitations***

- 4.53** We noted that there was a significantly lower level of satisfaction from non-agency IPSPs when asked whether the way they accessed payment systems hindered their customer offering and/or ability to innovate; just over 60% considered it hindered them (see Figure 10). Some respondents cited a lack of flexibility and functionality within the services they receive.

**Figure 10: Response from non-agency IPSPs – Does the way you access payment systems through your indirect access provider hinder your customer offering and/or your ability to innovate?**



Source: PSR survey of IPSPs

### ***Termination notice periods***

- 4.54** A specific quality of service issue relates to the termination notice period that an IAP sets when notifying a non-agency IPSP that it intends to cease supplying indirect access. This is a particular concern for non-agency IPSPs, because significant numbers have had services terminated over recent years as a result of banks' de-risking policies (see Chapter 6).
- 4.55** Termination notice periods for non-agency IPSPs vary across IAPs. We have been told by some non-agency IPSPs that the termination periods can range between one and three months. Some IPSPs told us that the termination notice periods they have are too short to enable them to find an alternative supplier. Our comments on agency termination notice periods in paragraph 4.47 also apply to non-agency IPSPs.

## **Our assessment of the evidence on quality of service**

- 4.56** Our analysis of the evidence suggests that overall IPSPs appear to be reasonably satisfied with the level of service that they receive in accessing payment systems. Levels of satisfaction appear to be higher than general levels of satisfaction with business banking, although they are towards the lower end of satisfaction when compared with other essential business services. We also note that there appear to be differences in satisfaction levels between different IPSPs. Small IPSPs that access payment systems through IAPs' online banking services tend to be less satisfied.
- 4.57** While the IPSP survey responses provide an aggregated picture of average overall satisfaction with service quality, some IPSPs have specific concerns with certain aspects of the quality of services provided by IAPs. For banks and building societies, the main issues identified concern quality of technical access and, in particular, the ability to offer a 24/7, near real-time service for FPS on an

equivalent basis to DPSPs. For small non-agency IPSPs, key issues concern relationship management (including timely flow of relevant information) and termination periods.

- 4.58** The quality of service issues we have identified affect the ability of some IPSPs to compete effectively and deliver better outcomes for service-users, for example in the retail banking market.

### What do IPSPs pay for indirect access?

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- 4.59** As we noted in our terms of reference, some IPSPs have previously expressed concern about the prices they were charged for indirect access. We therefore assessed what they paid, looking for evidence to suggest that prices levied by the four main IAPs were similar to one another, and whether they had been stable over a sustained period. In concentrated supply structures, stable and similar prices over a sustained period of time can sometimes indicate a lack of effective competition.
- 4.60** There are a wide variety of tariff structures and price points for indirect access. IAPs tend to charge different prices for inbound (received) and outbound (sent) transactions within each payment system, with inbound transactions typically being cheaper than outbound. Although most tariffs tend to be volume dependent, some are not: for example, some users pay a fixed fee for unlimited payments. Other more complex tariff structures exist: for example, one IAP agreed to an IPSP's request for a lower interest rate on their credit balances in return for lower (or no) charges on payment transactions. Reciprocal arrangements also exist: for example, when an IAP offers cheaper or free payments in the UK to a foreign bank that clears its payments in a non-UK jurisdiction.
- 4.61** We obtained evidence about the prices that IPSPs pay for indirect access from three sources. Our starting point was the pricing information the IAPs gave us as part of our information requests. Because some IPSPs can negotiate prices, we also considered the average prices paid by the IPSPs that responded to our survey. Finally, we examined estimates of the revenue per transaction based on the information we received from IAPs through our data requests (see Box A). In Box B (page 44) we also consider indirect access compared to direct access fees in one payment system, FPS. We now consider each in turn.

## Box A: IAP data request

The IAPs said they do not systematically measure the revenues and costs of servicing agency and non-agency IPSPs, because these activities are either sub-business units (that are part of a larger unit where costs and revenues are measured), or not recognised as a separate business unit at all (particularly in the case of non-agency IPSPs). For more details see Chapter 3. The IAPs focus on measuring the revenues generated by an entire client relationship, rather than the individual elements and services within that relationship, such as the provision of indirect access.

We asked the four main IAPs for information about their indirect access revenues and transaction volumes and values for each payment system on a per-IPSP basis. We requested indirect access revenue including:

- any volume-based fees levied on a per-transaction or per-file basis, split between inbound and outbound transactions
- any payment system-specific fixed fees, such as fees which are not volume dependent but which are linked to participation in a given payment system)
- any other fees which relate to indirect access but which are not volume-related or linked to participating in a given payment system (for example, charges for information files of payments activity)

All of the four main IAPs were able to provide this information for their agency IPSPs, and three of the four for their non-agency PSPs. One IAP was unable to split fees and volumes between inbound and outbound transactions. Some also noted data reliability issues, particularly when data had been sourced from multiple internal information systems.

We have used this information in both our assessment of prices (where we consider the revenue per transaction generated by the four main IAPs), and in our assessment of revenues. We note:

- differences in revenue per transaction cannot be wholly ascribed to differences in **prices**: they could be influenced by a number of other factors (see paragraph 4.74 for more details). While this limits the reliance we can place on this element of our pricing analysis, we nevertheless considered it useful, particularly in comparing the results to the other elements of our pricing assessment
- the data reflects the prices actually charged (including any negotiated discounts) for indirect access and we can place more reliance on it in our assessment of **revenues**. However, it is also important to recognise that the prices charged for indirect access form only one part of a wider commercial relationship which a PSP negotiates with an IAP

We also considered whether we should require the IAPs to conduct a more comprehensive exercise to estimate the revenues and costs of supplying indirect access to agency and non-agency IPSPs. We decided not to, because there was no established approach for allocating costs, a significant proportion of which were likely to be shared with other business lines. Therefore, the exercise would risk inaccuracies, result in variability (and therefore lack of comparability) between approaches and would have been disproportionate and overly onerous given the evidence and information IAPs were already giving us for this market review.

## Pricing information provided by IAPs

### Agency IPSPs

- 4.62** As part of our information requests the four main IAPs gave us pricing information for indirect access. This included a combination of price lists and pricing proposals. Table 4 shows the range of indicative prices for outbound (sent) transactions to the different payment systems. Prices can vary depending on transaction volumes, channel used and an IPSP's ability to negotiate. The pricing information sometimes states 'negotiable' for very high volumes in certain systems. For example, one IAP stated that the price was 'negotiable' for FPS volumes greater than 500,000.

**Table 4: Indicative prices for agency IPSPs (in £/transaction)**

Payment type	Range across the four main IAPs	
	Low	High
Bacs	0.03	0.20
CHAPS	1.25	15.00
C&C	0.10	0.25
FPS	0.23	3.00

*Source: PSR analysis of agency pricing information (price lists and pricing proposals made by IAPs to agency IPSPs)*

- 4.63** We see from Table 4 that different IAPs offer agency IPSPs a wide range of prices within most payment systems. For example, one IAP could offer 3p per Bacs transaction to agency IPSPs and another IAP could offer up to 20p for a transaction in the same system.

### Non-agency IPSPs

- 4.64** Each of the main IAPs told us that their offering for non-agency IPSPs was the same as the service they provided to businesses that are not PSPs through business current accounts (BCAs). We therefore looked at the indirect access prices for BCA customers on the Better Business Finance website.<sup>35</sup> We also reviewed the BCA pricing information that was publicly available on the four main IAPs' websites, and some pricing proposals given to us as part of our information request.
- 4.65** Our analysis showed that indirect access prices varied significantly between accounts and IAPs.<sup>36</sup> For example, debit cheque charges ranged from nil to £1.50 per transaction, direct debit charges from nil to £0.65 per transaction, CHAPS charges from £15 to £40 per transaction, and account fees from nil to £55 per month.
- 4.66** We note that the total price a non-agency IPSP pays for a BCA will have several different elements. These will vary according to how the BCA is used. They may include transaction fees for indirect access, monthly account fees, overdraft fees, overdraft interest paid and credit interest received. Our analysis suggested that higher monthly account fees were sometimes associated with IAPs offering lower transaction charges for indirect access.
- 4.67** We also note that in the CMA's provisional findings in its retail banking market investigation it found a significant variation in the total monthly BCA charges paid by small and medium-sized enterprises

<sup>35</sup> <http://bba.moneyfacts.co.uk/Default.aspx>

<sup>36</sup> Each IAP offers several different BCA accounts with a range of pricing structures.

(SMEs) with a turnover of less than £2 million.<sup>37</sup> These charges cover a wider range of services than just the provision of indirect access.

### Average price paid by survey respondents

**4.68** Our second source of evidence on prices was our IPSP survey.

**4.69** IPSPs responding to the survey told us that some agency IPSPs and some larger non-agency IPSPs negotiated prices for indirect access. The CMA also found that SMEs with a turnover of more than £2 million tended to negotiate on pricing.<sup>38</sup> This can involve adjusting prices in response to volumes or other potential revenue streams. Therefore, while the prices set out earlier are a useful starting point in assessing those paid for indirect access services, the prices actually paid may differ because some IPSPs will negotiate prices directly with IAPs.

### Average price paid by agency IPSPs

**4.70** Table 5 shows our analysis of the prices paid by the agency IPSPs that responded to our survey; the results are broken down by payment system.

**4.71** This analysis again shows a significant spread of prices paid across all the payment systems. For example, there was a significant difference in the prices paid by the 25<sup>th</sup> and 75<sup>th</sup> percentiles.

**Table 5: Prices paid by agency IPSPs in different payment systems (in £/transaction)**

	Mean	P25	Median	P75	Max	N
Bacs	0.13	0.01	0.04	0.10	1.50	30
CHAPS	3.00	0.12	1.50	3.00	20.00	29
C&C	0.23	0.08	0.15	0.25	1.50	29
FPS	0.37	0.16	0.27	0.43	1.25	26

Source: PSR analysis of survey data

Notes: A number of data points we considered to be outliers or possible errors were excluded from the sample. Mean is the average of the numbers in the sample; P25 and P75 are percentiles – 25% and 75% of prices in the sample fall at or below this level; Median is the middle value in the sample; Max is the highest price in the sample; N is the number of data points in the sample.

### Average price paid by non-agency IPSPs

**4.72** Table 6 shows our analysis of the prices paid by the non-agency IPSPs that responded to our survey. This also shows a significant spread in the prices paid by non-agency IPSPs for accessing payment systems, although these should be treated as indicative only because of the small sample size.

<sup>37</sup> CMA, *Retail banking market investigation*, provisional findings report (2015), paragraph 6.82: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf). The CMA used customer profiles submitted by four banks in its assessment.

<sup>38</sup> CMA, *Retail banking market investigation*, provisional findings report (2015), paragraph 6.78: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf)

**Table 6: Prices paid by non-agency IPSPs in different payment systems (in £/transaction)**

	Mean	P25	Median	P75	Max	N
Bacs	0.14	0.03	0.13	0.20	0.48	12
CHAPS	6.50	0.10	2.40	8.13	30.00	12
C&C	0.37	0.07	0.23	0.68	0.80	5
FPS	0.60	0.15	0.21	0.35	5.00	13

Source: PSR analysis of survey data

Note: A number of data points we considered to be outliers or possible errors were excluded from the sample.

### Revenue per transaction

**4.73** Our third source of evidence was the revenue and volume data we collected as part of our IAP data requests. This enabled us to estimate the revenue per transaction (RPT) across all the payment systems. The data covers the four main IAPs in relation to agency IPSPs, and three of the four main IAPs in relation to non-agency IPSPs.<sup>39</sup>

**4.74** In interpreting the results of this analysis, it should be noted that a range of IAP tariff structures exist (as discussed in paragraph 4.60). Therefore, differences in RPT cannot be wholly ascribed to differences in prices: they could be influenced by a number of other factors, such as:

- Within a given payment system, IAPs process both inbound transactions, which involve receiving a payment instruction relating to an IPSP (for which an IAP will generally charge less), and outbound ones, which involve initiating a payment instruction on behalf of an IPSP (for which an IAP will generally charge more). Overall, an IAP processing more inbound transactions tends to have a lower RPT, even if it does not have lower per transaction prices.
- The more complex tariff structures described in paragraph 4.60, including some which may not be based (or not solely based) on payment volumes, will also have an impact on RPT.
- Allocating revenues as being related to (i) indirect access and (ii) a specific system required a degree of judgement by each IAP. It is unlikely that a wholly consistent approach was taken by each IAP, which limits data comparability between providers.
- Some IAPs also told us about data reliability issues, particularly when data had been sourced from multiple internal information systems.

### Revenue per transaction for agency IPSPs

**4.75** Our analysis of the revenue data supplied by the four main IAPs indicates a wide spread in the RPT for the agency IPSPs across all payment systems in 2014. In particular, it shows a significant difference between the RPT for the 25th and 75th percentiles, with the RPT of the 75th percentile being between six and ten times that for the 25th. For example for Bacs, 25% of the IPSPs served by these IAPs generated revenue of less than 3p per transaction and 25% generated revenue of greater than 29p per transaction. However, as indicated in paragraph 4.74, the wide spread in RPT could also reflect other factors.

**4.76** Our analysis also shows that there is considerable variation in the median RPT being earned by each IAP for each of the main payment systems, implying that different prices are being charged by the IAPs for accessing a given payment system.<sup>40</sup>

<sup>39</sup> One IAP was unable to provide non-agency transaction volume data by system so RPT calculations could not be made for it.

<sup>40</sup> As described in paragraph 4.74, this variation in RPT could reflect other factors.

**4.77** Finally, we examined the extent to which the RPTs of the four main IAPs have been constant over the past four years for each of the payment systems. As noted earlier, circumstances in which they charge similar prices over a sustained period may indicate a lack of competition. Our analysis of the data shows that this was not the case and that RPT was variable by IAP and by system over time.<sup>41</sup>

**4.78** For a number of agency IPSPs, where RPT was particularly high (or low), we requested additional tariff information from the IAPs. A very high RPT was sometimes caused by an agency IPSP submitting a high percentage of Bacs or FPS files. A file containing relatively few transactions will inflate the per-transaction charge an IPSP pays. A high RPT was also sometimes associated with an agency IPSP incurring multiple charges – for example, Bacs overlimit charges (where a pre-agreed Bacs settlement limit is breached). A very low RPT was sometimes associated with fixed fees or bespoke pricing arrangements, such as an agency IPSP paying low or no indirect access fees in return or agreeing to hold a minimum deposit balance at an IAP.

### ***Revenue per transaction for non-agency IPSPs***

**4.79** We have also examined the RPT for three of the four main IAPs<sup>42</sup> in supplying non-agency IPSPs. This analysis showed the same wide spread in RPT as for agency IPSPs.<sup>43</sup> It showed:

- A significant difference in RPT across all payment systems. The RPT of the 75<sup>th</sup> percentile was between three and ten times the 25<sup>th</sup> percentile in different payment systems.
- Considerable variation in the median RPT for each IAP for each payment system.
- RPT was variable by IAP and by system over time.<sup>44</sup>

**4.80** Our comments on particularly high (and low) RPT described above also apply to non-agency IPSPs.

### **Qualitative evidence on prices**

**4.81** We collected qualitative evidence on prices through our IPSP survey and various meetings and workshops with IPSPs. We also collected evidence on the price of indirect access as part of earlier consultations, and took account of submissions made to the CMA in its recent retail banking market investigation.<sup>45</sup>

### ***Agency IPSPs***

**4.82** The qualitative evidence on prices for agency indirect access is mixed. Some agency IPSPs, including some challenger banks, have said that the price of indirect access is too high, or reflects the concentrated nature of the supply of indirect access and the high cost of switching. However, other agency IPSPs indicated that they are reasonably satisfied with the price they pay. For example, Virgin Money told the CMA that in practice it did not have any major concerns regarding the prices it paid for indirect access.<sup>46</sup>

**4.83** Some agency IPSPs have said that the prices IAPs charge for providing indirect access are higher than those paid by participants accessing the payment system directly. One PSP told us the processing charge it paid for CHAPS was much lower once it became a DPSP compared to the charge it paid as an IPSP (although it noted that this does not factor in other costs of being a DPSP such as a Bank of England reserve account). These IPSPs claim that because IPSPs pay more for access than the four

<sup>41</sup> As described in paragraph 4.74, this variation in RPT could reflect other factors.

<sup>42</sup> One IAP was unable to provide transaction volume data by payment system for non-agency IPSPs.

<sup>43</sup> The variation in RPT described could also reflect factors other than price, as indicated in paragraph 4.74.

<sup>44</sup> The data for this analysis was restricted to two IAPs because the data provided by one of the three IAPs for which we had non-agency IPSP data did not enable us to accurately perform this analysis.

<sup>45</sup> <https://www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk>

<sup>46</sup> CMA Retail banking market investigation, Appendix 10.2-84 paragraph 335. [https://assets.digital.cabinet-office.gov.uk/media/5630c58840f0b674d300000e/Appendix\\_10.pdf](https://assets.digital.cabinet-office.gov.uk/media/5630c58840f0b674d300000e/Appendix_10.pdf)

main IAPs, it's harder for them to compete in retail markets against those DPSPs and so competition is distorted. For example, Metro Bank and Tesco Bank told the CMA that they were paying a premium for accessing certain payment systems through IAPs as compared to direct access. [X] told us that the prices charged for accessing payment systems were 'disproportionate' for challenger banks using indirect access.

## Box B: FPS direct access vs. indirect access fees

We compared the total per transaction fees paid by DPSPs for access to FPS with the information we have available on the indirect access fees paid by some large IPSPs.

DPSPs access FPS (and other payment systems) through the system operator. The operator of each payment system is a not-for-profit organisation which passes on its costs to DPSPs. FPS notes that the operator fees for DPSPs have two elements: a per transaction fee of 3.51p, and a fixed monthly connectivity fee of £9,270.<sup>45</sup>

Because it has fixed and variable elements, the total fees paid to FPS by a DPSP tends towards 3.5p as number of transactions rise. For a DPSP making ten million transactions a year the fee per transaction is 4.6p; for 100 million it is 3.6p per transaction.

In addition to operator fees, DPSPs will incur internal costs relating to FPS. These are capital investment costs<sup>46</sup>, which are particularly relevant when becoming a new DPSP in a payment system, and internal operating costs which ensure the DPSP's effective day to day provision of payment services to its customers. A DPSP which provides indirect access will also incur internal costs relating to the provision of that service. Due to the limitations outlined in Box A we have not made an assessment of these internal costs.

The majority of current DPSPs in FPS process greater than [X] million transactions per year. In a recently published white paper, FPS's own assessment indicated that PSPs with transaction volumes greater than 13 million should consider direct access an economically viable option.<sup>47</sup>

Information we saw in our review showed that a number of large IPSPs, with annual transaction volumes in FPS of between 1 and 10 million, including some banks, pay between 7p and 21p per transaction to their IAP for indirect access to FPS. If those IPSPs chose to get direct access to FPS the fees they would pay to the operator would be between 5p and 15p per transaction.

Based on this assessment, some large IPSPs do not appear to pay significantly more for indirect access compared to the fees they could expect to pay to the operator for direct access to FPS. We also observe that there are economies of scale present in payment systems, which reduces unit costs for larger participants.

The per transaction fees for direct access compared to indirect access includes a number of cost items which we have been unable to assess, and the fees involved are not always directly comparable. We may in due course request additional information from PSPs to further this analysis either as part of this review or our ongoing work on direct access, and would welcome any evidence from both DPSPs and IPSPs to help inform this analysis.

<sup>47</sup> <http://www.fasterpayments.org.uk/membership/access-options/direct-membership/fees-structure>

<sup>48</sup> In our Access and Governance report, we noted that this initial investment can be between £2.5 million and £4 million. This appears to be significantly less for new potential DPSPs compared to the initial investment the incumbent DPSPs had to make when they established FPS in 2008, which has been estimated to be up to £70 million per PSP (see <http://www.bostonfed.org/economic/current-policy-perspectives/2014/cpp1405.pdf>). These costs would typically be amortised over a number of years.

<sup>49</sup> <http://www.fasterpayments.org.uk/sites/default/files/Faster%20Payments%20Access%20Programme%20Economics%20Report%20-%20Online%20Version.pdf>

- 4.84** We would not generally expect the price paid by an IPSP to its IAP for indirect access to be the same as, or cheaper than, the price of direct access. The costs of indirect access reflect that the services a DPSP receives through a payment system operator are not directly comparable to the indirect access services provided by IAPs to IPSPs.
- 4.85** As we discussed in Chapter 3, the characteristics and business models of IPSPs vary substantially, which has an impact on the services they receive. Payment message transformation, relationship management, and reporting services may be included in the price paid by an IPSP and are costs beyond the direct ones of running a payment system. Furthermore, because supplying indirect access to IPSPs introduces additional risks for IAPs, which are associated with additional monitoring and compliance costs<sup>50</sup>, this could also be expected to be reflected in the price of indirect access. We discuss the price of direct access and the price of indirect access further in Box B above.

### ***Non-agency IPSPs***

- 4.86** The qualitative evidence we have collected suggests that there is generally a higher level of dissatisfaction with prices among non-agency IPSPs. For example, some small non-agency IPSPs told us that they had no scope to negotiate, and were locked in to high prices, which made it more difficult for them to compete.

### **Assessment of pricing evidence**

- 4.87** Overall our evidence was inconclusive on the impact of pricing on competition, innovation and service-users. We also recognise that the quality of some of the information to inform the analysis was limited in some respects due to the inability to be confident that information was directly comparable or prepared on the same basis.
- 4.88** Each of the elements of evidence we collected indicates a wide spread in actual prices paid for indirect access by both agency and non-agency IPSPs. They do not suggest that the prices levied by the four main IAPs are similar.
- 4.89** Our analysis is consistent with qualitative statements made during our market review, when some IPSPs told us that they were satisfied with the price they were paying for indirect access while others expressed dissatisfaction. This evidence implies that some IPSPs may be paying significantly less (or more) than others for accessing the same payment systems, depending on their IAP and their particular circumstances.
- 4.90** We have sought to understand the factors that may explain the observed spread in actual prices. We examined whether the observed differences in prices reported by our IPSP survey respondents are correlated with total transaction volumes. Our analysis of this data suggests that large IPSPs (in terms of transaction volumes) tend to pay relatively lower average prices across all the payment systems. Some large IPSPs do not appear to pay more for indirect access compared to the fees they would expect to pay if they were DPSPs. However, for small IPSPs with lower transaction volumes, there is no strong relationship between the average price per transaction and volume levels.
- 4.91** This appears to reflect the fact that the price of indirect access services is not determined in isolation, but involves a range of other considerations. Some of the factors that might explain the wide spread in indirect access prices observed include:
- Bespoke or more complex tariff structures, as described in paragraph 4.60, where the price of payment transactions may be part of a wider commercial negotiation.

<sup>50</sup> See paragraphs 4.102 and 4.103.

- Differences in how transactions are processed. For example, pricing for batch processing will be cheaper than that for individual transactions, and a manual CHAPS payment<sup>51</sup> will be significantly more expensive than a CHAPS payment initiated through a SWIFT channel.
- IAPs' tendency to focus on the wider customer relationship, and not on the marginal prices for individual transactions. Prices for indirect access form only part of the revenues that IAPs receive from IPSPs. As we discussed in Chapter 3, indirect access is not provided as a standalone service to IPSPs and the pricing may reflect this.
- The prices actually levied, which may, in part, reflect the perceived riskiness of an IPSP, or category of IPSPs. There are various sources of risk for IAPs, for example financial crime risk. We consider the issue of risk in more detail in Chapter 6.
- The ability to negotiate, which is partly a function of the choice of available IAPs. We consider the negotiating power of IPSPs in Chapter 6.

## Revenue and costs of supplying indirect access

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**4.92** Some IPSPs have expressed concern in the past about the prices they were charged for indirect access. Two IPSPs suggested that, because of the relatively concentrated supply structure, some IAPs may be earning excessive returns. As discussed in Box A, we examined the revenues of the four main IAPs to help us understand the features of indirect access and provide insights into the effectiveness of competition. We also received some limited information on costs from the four main IAPs in response to our RFI.

### IAP revenues

**4.93** The four main IAPs told us that they assess client revenues on a 'whole relationship' basis and not just on individual elements and services within that relationship, such as the provision of indirect access (see Box A on page 39).

**4.94** The IAP revenues from IPSP clients, which are not specific to indirect access supply and were therefore excluded from our data request, include:

- **Net interest income:** earned by lending money to customers and charging interest on the amount lent. A bank earns interest income by lending money to customers at higher rates of interest than it costs the bank to pay interest on credit balances held in IPSPs' accounts (and/or wholesale markets). Funds held by a customer on account are a valuable source of funding for loans, and a bank will therefore assign a value to these balances (often referred to as 'net value of funds').<sup>52</sup> However, the net value of funds for an IPSP will tend to be lower compared to other corporate and retail customers, because these funds are more likely to be withdrawn by the IPSP.
- **Payment-related revenue that does not relate to indirect access:** for example, revenue from international payments and cash-handling.
- **Income from other banking products:** banks earn revenue from other banking services that are not related to payments: for example, fees relating to loans and commissions for foreign exchange transactions.

<sup>51</sup> A manual CHAPS payment is initiated in a non-electronic format (for example, by paper or fax).

<sup>52</sup> CMA, *Retail banking market investigation*, provisional findings report (2015), page 164, Table 6.8: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf)

- 4.95** The CMA analysed the composition of net revenues for BCAs in its provisional findings. This is only likely to be relevant for smaller IPSPs. The CMA found that transaction charges (which would include fees for payment transactions) represented around 15% of total BCA net revenue.<sup>53</sup> While the composition of revenues varies according to the characteristics of the client, we consider that this suggests that for many IPSP relationships (both agency and non-agency), the revenues from indirect access may be a small part of the overall revenues derived from the overall wider client relationship.
- 4.96** One IAP originally submitted its IPSP revenue data to us inclusive of revenue from international payments and cash handling, which it later excluded at our request. Including these two additional revenue streams materially increased the revenues it reported, also suggesting that IPSP revenues from indirect access represent a small part of the revenues from the overall client relationship. When we looked at revenue data for one non-agency IPSP, we found that these two revenue streams represented around 86% of the total revenues paid to the IAP, with indirect access only representing 14%.

### **Agency IPSPs' revenues**

- 4.97** All the IAPs we spoke to told us that indirect access on its own does not generate significant revenues compared with other business lines, customer segments or overall corporate banking revenues.
- 4.98** Our analysis of the financial information provided by the four main IAPs corroborates these statements. The total indirect access revenue that each IAP earned was between £[>] million and £[<] million in 2014. The variation in revenues may in part reflect the interpretation of the definition of indirect access revenues applied by the IAPs (see paragraph 4.74, and Box A on page 39). The average indirect access revenue earned by the four IAPs for servicing agency IPSPs was estimated at £101,500 in 2014. However, these averages are skewed by a small number of agency IPSPs which generate significant revenues: in 2014 the median agency IPSP only generated £8,800 in indirect access, while the bottom quarter of agency IPSPs generated indirect access revenue of less than £800 each.
- 4.99** Indirect access revenue is therefore highly concentrated in a small number of relationships with large IPSPs. The ten largest agency IPSPs for each IAP on average accounted for 83% of total indirect access revenues for the four main IAPs (see Table 7).

**Table 7: Percentage of total indirect agency access revenue attributable to the ten largest agency IPSPs (2014) (%)**

IAP	% indirect access revenue generated by the top ten agency IPSPs
IAP 4	91.8
IAP 2	89.8
IAP 1	79.3
IAP 3	72.8

Source: PSR analysis of IAP data

### **Non-agency IPSPs' revenues**

- 4.100** The supply of indirect access to non-agency IPSPs is also typically part of a wider commercial arrangement. Revenue earned from non-agency IPSPs is substantially less than that from agency IPSPs – this would be expected as non-agency IPSPs are generally smaller in terms of their indirect access

<sup>53</sup> CMA, *Retail banking market investigation*, provisional findings report (2015), paragraph 6.49: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf)

activities and volumes than agency IPSPs. Our analysis shows that the average revenue generated by non-agency IPSPs was estimated at £15,200 in 2014 across the four main IAPs. As with agency IPSPs, the average estimates are skewed by a small number of non-agency IPSPs that generate significant revenues. The median non-agency IPSP generated only £800 in 2014, and a quarter of non-agency IPSPs across the four main IAPs generated less than £200 per year in indirect access revenue.

**4.101** As with agency IPSPs, non-agency IPSPs' indirect access revenue is highly concentrated in a small number of relationships with large IPSPs. The ten largest non-agency IPSPs for each IAP on average accounted for 70% of the indirect access revenue of the four main IAPs (see Table 8).

**Table 8: Percentage of total indirect non-agency access revenue attributable to ten largest non-agency IPSPs for the four main IAPs (2014) (%)**

	% indirect access revenue generated by the top ten non-agency IPSPs
IAP 4	88.1
IAP 1	76.8
IAP 3	70.8
IAP 2	45.3

Source: PSR analysis of IAP data

## Costs information

**4.102** The information we received indicates that the main cost elements involved in providing indirect access are:

- **Evaluating and onboarding<sup>54</sup> clients:** IAPs generally consider PSPs to be higher risk customers (compared with non-PSPs), needing additional onboarding due diligence. This is because the IAP is processing transactions for the IPSP's customers, with whom they have no direct relationship.
- **Managing ongoing customer and compliance risk:** This includes ongoing monitoring of client transactions, particularly for anti-money laundering (AML) and financial crime risk, as well as annual reviews. We were told that these costs had increased significantly in the last five years. They vary by IPSP client type, with some categories – for example, money transfer businesses – being more likely to be considered higher risk and subject to enhanced risk management procedures (which will increase the cost for an IAP to provide services to such IPSPs).
- **Facilitating clients making and receiving payments:** This includes the cost of being a direct participant of interbank payment systems, as well as internal channels to facilitate payments: for example, internet banking platforms. IAPs usually enable IPSPs to send messages in multiple formats and may also agree bespoke arrangements.
- **Product management:** This includes help desk, customer support, product specialists, and credit specialists.
- **Other shared costs:** For example, legal, HR, general regulatory and compliance, and IT. These are general costs incurred in running a bank and would be attributed across all its businesses (including the provision of indirect access services) with each making a contribution.

<sup>54</sup> The processes undertaken before taking on a new client.

- 4.103** Each cost element is shared by a number of different businesses within an IAP; the costs are not solely attributable to the provision of indirect access. For example, all corporate clients, not just IPSPs, need to be onboarded and would tend to make payments.
- 4.104** Two IAPs have recently conducted an internal review of the costs of serving certain segments of the non-agency IPSP market. They indicate that the whole relationship costs associated with serving these types of IPSPs are significant, and principally include labour costs associated with ongoing compliance and monitoring as well as central shared costs, such as the cost of investments needed to support products across various business lines (including agency and non-agency).
- 4.105** These two reviews are a valuable source of evidence because they were produced for internal IAP purposes rather than specifically for a regulator. However, in our view they only capture the costs of supplying IPSPs and do not consider any risk exposure associated with servicing these clients. They therefore do not assess the full costs of providing indirect access to non-agency IPSPs.

### Assessment of revenues and costs

- 4.106** Our analysis of the revenue information we requested from the four main IAPs indicates that the indirect access revenues generated by most agency and non-agency IPSPs are relatively low, both in absolute value and relative to other business lines. This is consistent with statements made by the IAPs in meetings and in their responses to our requests. Most revenues come from a small number of relationships with large IPSPs. Also, the surveys and information we have seen indicate that the costs associated with supplying indirect access to some types of non-agency IPSPs are significant (although these costs will be shared across a number of different business units and not solely attributable to indirect access).
- 4.107** As set out above, IPSPs receive indirect access services alongside other banking services as part of a wider commercial relationship. The combination of low revenues and significant ongoing monitoring and compliance costs suggests that IAPs may not have the financial incentives to provide indirect access on a standalone basis to some small IPSPs.

### Summary

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- 4.108** Choice, service quality and price are important areas where we would expect IAPs to compete with one another to supply indirect access. Outcomes in each area are important indicators of the effectiveness of competition.
- 4.109** Our interim findings on choice, quality and price are:
- The four main IAPs (Barclays, HSBC, LBG and RBS) all provide services to agency IPSPs and non-agency IPSPs. A number of other IAPs also provide non-agency indirect access services. However, the choice available to some non-agency IPSPs appears to be limited, particularly for small IPSPs, and those perceived to be higher risk (**Finding 1**). If these IPSPs are not satisfied with the services they receive from their IAP they will have little or no power to negotiate with their IAP, and little or no choice in finding an alternative IAP. Large IPSPs tend to have a wider choice of access options, and many are exercising that choice, including through alternative options such as direct access and aggregators. Work to date by the PSR has helped to make these alternative options available to a wider number of IPSPs.
  - Overall there is a reasonable level of satisfaction with the quality of indirect access. However, we have identified various specific service quality issues for some agency and non-agency IPSPs (**Finding 2**). These include:

- the quality of technical access to FPS, which is a particular issue for banks and building societies given their customers' increased demand for real time payments
- the short duration of some notice periods for the termination of agreements, which is a particular concern for non-agency IPSPs
- issues around relationship management provided by IAPs, which is an issue raised mostly by small non-agency IPSPs
- The overall evidence on pricing is inconclusive in part because there are difficulties with comparing some of the information. Analysis of different pricing indicators shows a wide spread in the prices paid by IPSPs for indirect access to each of the interbank payment systems. Some IPSPs have expressed concern about prices, although the overall feedback we have received to date does not indicate a widespread level of concern with price. Large IPSPs tend to pay relatively lower prices and some do not appear to pay significantly more for indirect access compared to the fees they could expect to pay if they were DPSPs (**Finding 3**).
- Various factors appear to be driving differences in pricing outcomes, including:
  - IPSPs' ability to negotiate and influence prices
  - tariff structures
  - volume levels
  - revenues generated for an IAP from supplying other banking services to an IPSP
  - transaction mix (e.g. batch processing versus single transactions)
  - the direction of payment transmitted (inbound versus outbound)
- IPSPs receive indirect access services alongside other banking services as part of a wider commercial relationship. The provision of indirect access services does not appear to generate significant revenues for IAPs on a standalone basis (**Finding 4**). In addition, the majority of IAP revenues from indirect access are derived from a small number of relationships with large IPSPs. The combination of low revenues and significant ongoing monitoring and compliance costs suggests that the commercial incentives for some IAPs to provide indirect access on a standalone basis to some IPSPs are limited.

## 5 Factors affecting the number of indirect access providers

To supply indirect access to agency IPSPs, an IAP must be a DPSP. There are also some advantages to being a DPSP for an IAP supplying non-agency IPSPs.

Non-agency indirect access can also be supplied as part of a 'nested' supply arrangement, where an IPSP itself also acts as an IAP. An IPSP's decision to do this is also influenced by a range of factors, particularly the risk appetite of its own IAP and the quality of its technical access.

Historically these factors have limited the entry of new IAPs, but we are aware of at least four PSPs that are now planning to become IAPs and two existing IAPs expanding their provision of indirect access. We consider this entry and expansion to be likely, swift enough and sufficient in scale to address many of the concerns we have raised. These developments suggest that any barriers to becoming an IAP are not insurmountable, at least for some organisations.

These PSPs are responding to a number of commercial, technological, market and regulatory changes, including actions taken by the PSR. The specific motivation for entry and expansion varies. All want to provide a range of banking services (including indirect access to payment systems). At least one potential entrant wants to serve specific customer segments, including smaller non-agency IPSPs that have had their access through one of the four main IAPs terminated.

### Introduction

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- 5.1** In Chapter 3 we identified the number of indirect access providers (IAPs) in the market, and Chapter 4 reported on the evidence about the service quality and prices indirect payment service providers (IPSPs) receive from these IAPs and the choice of IAPs they have. Those outcomes are, in part, affected by the number of IAPs competing to supply indirect access, and the opportunities for new IAPs to start supplying indirect access. In this chapter we examine the incentives for PSPs to become IAPs, or for existing IAPs to expand their service offerings. In Chapter 6 we will consider the appetites of existing IAPs to supply certain IPSPs, or types of IPSP.
- 5.2** A PSP's decision to become an IAP is affected by various regulatory, commercial, technical and operational factors. As we set out in Chapter 3, IAPs provide different indirect access services to agency and non-agency IPSPs. This means a PSP deciding whether to become an IAP to agency IPSPs may consider different factors to one looking to supply non-agency IPSPs. We examine all these factors, as well as those that may affect an IPSP's incentive to offer nested access to other IPSPs.
- 5.3** We first consider the factors raised during this review that may affect any PSP's decisions to become an IAP. These include:
- regulatory and compliance requirements

- the current and future demand for indirect access
- consistency with that PSP's business focus and strategy
- switching levels
- the ability to leave a supply relationship
- other revenue streams from the wider commercial relationship
- pre-funding in Bacs and FPS

**5.4** We then look at the additional factors that could affect a PSP's decision to become an IAP to **agency** IPSPs. These include:

- the ability to get direct access to payment systems
- the ability to get sort codes
- the need to invest in relevant IT systems, staff and expertise

**5.5** We then look at the additional factors which could affect an **IPSP's** decision to become an IAP through a nested supply arrangement. These include:

- the risk appetite of the IPSP's own IAP
- the quality of technical access between the IPSP and its IAP

**5.6** The factors which influence decisions about becoming an IAP collectively affect the likely number of current and future IAPs. Barriers to entry and expansion can insulate existing IAPs from potential competition, and reduce the incentives they have to respond to IPSPs' requirements and to innovate.

## Factors affecting a decision to provide indirect access

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**5.7** The following factors may affect the decision of any IAP to provide any form of indirect access, whether to agency or non-agency IPSPs (or both).

## Regulatory and compliance requirements

**5.8** IAPs must comply with various regulatory requirements, including regulations aimed at preventing certain types of financial crime (see Chapter 6 for more details).

**5.9** Many direct PSPs (DPSPs) operate in multiple jurisdictions and must comply with requirements in all of them. Some IAPs told us that because of regulatory requirements, particularly those relating to customer due diligence and ongoing monitoring associated with anti-money laundering (AML) regulations, they adopt a conservative approach to providing indirect access. Given the size and nature of the sanctions for breaches of these regulatory requirements – which can include the loss of a banking licence and significant financial penalties – some IAPs do not feel these risks can be appropriately factored into the price they charge for indirect access. This may also lead some PSPs to decide not to become, or not to continue to be, IAPs for some categories of IPSPs (or even all IPSPs).

**5.10** Chapter 6 contains a detailed discussion of regulatory obligations, IAPs' responses to those obligations and the implications for indirect access.

## Current and future demand for indirect access

- 5.11** Some PSPs have told us that one reason they are not providing or expanding the supply of indirect access, including to other payment systems, is that they do not see a significant unmet demand from their customers. However, some other PSPs said they've received numerous requests for indirect access.
- 5.12** There are also mixed views on whether demand for indirect access is contracting or expanding. Some PSPs expect that there will be more demand for indirect access in the future as more retail banks and new businesses such as financial technology firms require access to payment systems. Others consider there is a possibility that demand for indirect access may decline due to some of the larger IPSPs deciding to become DPSPs, the development of direct technical access products, and other developments such as the Image Clearing System in cheques. One of those PSPs noted that the market remains attractive, despite the possible decline in demand.

## Switching levels

- 5.13** IPSPs' willingness to switch suppliers is an important consideration in a PSP's decision to become an IAP. New entrants are more likely to be attracted to a market which has high levels of switching because it indicates they will have an opportunity to acquire customers from their competitors.
- 5.14** However, at the moment there is little historic evidence of switching between IAPs. This may reflect the fact that, as discussed in Chapter 4, some IPSPs have a limited number of IAPs to choose from. If this is the case then the entry of new IAPs may itself encourage more switching.
- 5.15** We discuss switching in more detail in Chapter 6.

## IAP's ability to terminate a supply relationship

- 5.16** The potential difficulties involved in terminating an indirect access relationship can influence an IAP's decision to expand its indirect access services, or to become an IAP in the first place. Some IAPs told us that the decision to end a relationship is never taken lightly; not least because managing the exit takes up resources, and there is a risk of challenge (including court proceedings). One IAP has [redacted].
- 5.17** As a result, given the costs associated with terminating an indirect access relationship, a PSP will carefully weigh up whether they want to begin providing indirect access and becoming an IAP.
- 5.18** More generally, one IAP told us that [redacted]. Similarly, another IAP told us it seeks to provide indirect access to customers with whom it can develop a long-term relationship which meets acceptable risk criteria.

## Other revenue streams

- 5.19** As discussed in Chapter 3, indirect access is part of a wider commercial arrangement between IAPs and their IPSP customers, as IAPs typically provide other services to IPSPs alongside indirect access. As set out in Chapter 4, the revenues from indirect access provision alone are, in relative terms, very low for the majority of IPSP customers. It follows that the commercial appeal of providing indirect access is enhanced by the extent to which an IAP can generate other revenue streams from the relationship.
- 5.20** The potential revenue streams from any individual IPSP depend principally on its size and the services it wants to provide to its customers. One IAP told us that, in its experience, non-agency IPSPs usually present fewer opportunities to generate cross-business revenues.

- 5.21** None of the current potential IAP entrants that we are aware of are proposing to base their business model on only providing indirect access services. The provision of indirect access is only one reason for the investments they are making. We discuss this further below.

### **Pre-funding in Bacs and FPS**

- 5.22** Bacs and FPS recently implemented pre-funding arrangements that require DPSPs to set aside a portion of their cash reserves held at the Bank of England that is equal to the maximum net exposure they may accumulate in each system. This cash replaces the collateral that was required under the previous arrangements. This eliminates settlement risk if a DPSP defaults and the potential for mutualised losses.
- 5.23** Providing an IPSP with indirect access to Bacs or FPS may either increase or decrease a DPSP's maximum net exposure in those payment systems – and therefore the amount of cash to be held – depending on the IPSP's payment flows. Therefore, the direction of an IPSP's payment flows may affect the decision to provide indirect access to that individual IPSP. This could theoretically mean that certain IPSPs are more attractive to some IAPs than to others.

### **Additional factors affecting the decision to become an IAP to agency IPSPs**

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- 5.24** There are more costs and other factors involved in becoming an IAP to agency IPSPs than to non-agency IPSPs. The following additional factors only or principally apply to supplying indirect access to agency IPSPs.

### **Ability to become a DPSP**

- 5.25** We have not seen evidence of any PSPs becoming DPSPs purely because they want to provide indirect access. However, many PSPs have told us that a key factor in deciding to become an IAP is assessing whether it's in their interests to become a DPSP.
- 5.26** As discussed in Chapter 3, to provide agency indirect access, an IAP must be a DPSP. There are also some advantages for an IAP to being a DPSP if it provides indirect access to non-agency IPSPs. These are discussed in paragraphs 5.50 to 5.59 below, where we set out the factors affecting an IPSP's decision to be an IAP.
- 5.27** A number of stakeholders have expressed concern over the difficulties associated with becoming a DPSP. Some PSPs see the process as too onerous, complex and costly, given the scale of their operations.
- 5.28** In terms of cost, evidence we have gathered from PSPs suggests that the upfront costs of gaining direct membership can be significant. We understand that it could cost in the order of £2.5 million to £4 million, depending on the payment system.<sup>55</sup> While this may deter PSPs without sufficient resources from becoming DPSPs, the costs reflect the fact that DPSPs are expected to invest adequately in their systems, expertise and capital to ensure the security and resilience of the payment systems. This means that becoming a DPSP is only likely to be a viable option for larger PSPs, who can spread those costs over a large volume of transactions. The payback of such investment could be expected to be around three to five years, although the payback time will be driven by both the cost of joining (which will depend on the status of the PSP) and the volume of transactions that PSP processes through the payment system.<sup>56</sup>

<sup>55</sup> PSR report, *Access and governance of payment systems: the operators' progress and areas for ongoing focus* (December 2015): <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

<sup>56</sup> See footnote 55

**5.29** Agency IPSPs that provide payment accounts to customers may need access to all payment systems on a frequent, and in some cases real-time, basis. This is supported by several PSPs who noted that direct access to all the interbank systems is necessary to operate as a 'full-service' IAP (which can provide indirect access services to all systems to both agency and non-agency IPSP customers). This involves considerable investment, and only seven PSPs are currently direct participants in all interbank systems.<sup>57</sup> Similarly, one PSP has cited its status as an indirect member of all but one of the payment systems as one reason that it is not an IAP.

**5.30** Among other issues identified with becoming a DPSP are:

- An important requirement for PSPs to get direct access to some payment systems is a Bank of England settlement account. Currently banks and building societies are the only types of PSP that are eligible for a settlement account. However, the Bank of England is reviewing its settlement account policy as one strand of its strategic review into the sterling wholesale settlement services it provides. The review, which will take place during 2016, will consider the demand for access to settlement accounts from different types of institutions as well as the risks involved in extending access.<sup>58</sup>
- The eligibility criteria for some interbank payment systems limit participation to banks.<sup>59</sup>
- The process for getting direct access can be complicated, technical and time consuming.
- Becoming a DPSP for one payment system might affect a PSP's relationship with their IAP for other payment systems, which in extreme cases might lead those IAPs to terminate their indirect access to other payment systems. Two IPSPs told us that they were concerned that transitioning to direct access for one or more payment systems may have a negative effect on their wider commercial relationship with their IAP. One IAP told us that if an IPSP moves a significant proportion of its transactions to direct access (for example, transactions for one payment system), the IAP may reassess the price it charges for the remaining transactions (for example, through other payment systems). However, it would continue to look at that IPSP within the context of the commercial relationship as a whole. One large agency IPSP told us that its IAP is aware of its intention to become a direct participant of FPS and had been helpful and supportive, and willing to shepherd them through the process. Some IPSPs have also expressed concern about the extent to which their IAP would be willing to continue to support them during their transition to direct membership.

**5.31** We discussed the issues with getting direct access in detail in our November 2014 consultation paper and March 2015 policy statement, and in our December 2015 report on access and governance.<sup>60</sup>

**5.32** Although a number of PSPs cite having direct access as a major factor in deciding whether to become an IAP, a number of existing DPSPs choose not to be IAPs.

### ***Why are all DPSPs not also IAPs?***

**5.33** The UK payment systems each currently have between 10 and 22 DPSPs, with seven of them being direct participants in all interbank payment systems. So, in principle, there could be at least seven IAPs who could provide indirect access to all interbank payment systems, and 25 IAPs who could supply indirect access to at least one individual interbank payment system (because 22 PSPs are direct participants in CHAPS and three PSPs are direct participants in one or more payment systems, but not in CHAPS).<sup>61</sup>

<sup>57</sup> The seven PSPs are Barclays, Co-operative Bank, Clydesdale, HSBC, LBG, RBS and Santander.

<sup>58</sup> For further information on the Bank of England's strategic review of its RTGS infrastructure see <http://www.bankofengland.co.uk/markets/Pages/paymentsystem/strategy.aspx>

<sup>59</sup> PSR report, *Access and governance of payment systems: the operators' progress and areas for ongoing focus* (December 2015): <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

<sup>60</sup> <https://www.psr.org.uk/psr-publications/consultations/consultation-paper-141>, <https://www.psr.org.uk/psr-publications/policy-statements/policy-statement-151>, <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

<sup>61</sup> These numbers exclude LINK. All PSPs who use LINK are direct participants in the LINK payment system. Some of them use other LINK members for settlement purposes. We explain this further in Chapter 2.

**Table 9: Number of direct participants in interbank payment systems**

Payment system	Number of direct participants
Bacs	16
CHAPS	22 <sup>62</sup>
Cheque and Credit	11
Faster Payments	10

Source: PSR report: Access and governance of payment systems: the operators' progress and areas for ongoing focus (December 2015)<sup>63</sup>

- 5.34** All DPSPs have already incurred significant costs in becoming a DPSP in an interbank payment system, and most should have the capacity to supply indirect access. A number of DPSPs told us that they could increase their transaction volumes through the system(s) in which they are DPSPs by 10% to 50% without incurring significant additional expenditure or capital investment.
- 5.35** However, a number of DPSPs (and potential DPSPs) said their reasons for getting direct access are unrelated to a plan to become IAPs. Some DPSPs in CHAPS told us they mainly became DPSPs as a result of 'de-tiering' work by the Bank of England and others. This showed that risks to financial stability would be materially reduced if six IPSPs which were systemically important agreed to become DPSPs in CHAPS.<sup>64</sup> Another DPSP told us that it became a DPSP because their IAP terminated their service. Others considering becoming DPSPs told us the principal reason is that they have concerns with their security of supply through an IAP relationship.
- 5.36** Some international banks with direct access have not actively pursued supplying indirect access to IPSPs and principally focused on serving clients who have commercial relationships across their wider banking group. However, some of those banks have said that their approach is changing or may change as the market evolves.
- 5.37** One DPSP said that, as a wholesale bank, it is focused on providing international payment and clearing services to multinational corporates and financial institutions, and so is not involved in delivering indirect access to UK IPSPs. Another DPSP only provides indirect access to IPSPs within its corporate group (such as other subsidiaries and affiliates), which it does on a cost pass-through basis. One DPSP offers UK indirect access services as part of a larger global and cross-border payments proposition to its customers. One DPSP told us that historically it has not targeted indirect access clients for new business. However, as part of a new strategy it intends to offer indirect access to clients who have an existing commercial relationship across the wider banking group. It will retain a global focus and does not plan to serve any IPSPs with exclusively UK payment services.

### Ability to obtain sort codes and update sort code information

- 5.38** Agency IPSPs have unique sort codes. An IAP looking to provide indirect access to agency IPSPs therefore needs the ability to allocate one or more unique sort codes to each agency IPSP to which it provides services (unless the agency PSP already had one or more sort codes allocated to it during a previous indirect access arrangement with another IAP).
- 5.39** However, the way the industry sort code database is designed and built means that only direct members of Bacs or FPS have access rights to directly allocate and maintain sort codes in the database (this is achieved through Public Key Infrastructure (PKI) which is required to connect to the payment systems). This means that any PSP who wants to become an IAP to agency IPSPs would

<sup>62</sup> Since the publication of the PSR's report, Societe Generale joined CHAPS Co as a direct participant (on 15 February 2016).

<sup>63</sup> <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

<sup>64</sup> <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130408.pdf>

need to be a Bacs and/or FPS direct member or to have an existing Bacs and/or FPS direct member to allocate and maintain sort codes directly in the database on its behalf. For other DPSPs that are not direct members in Bacs and/or FPS, updates to sort code information can be requested manually by submitting a paper form to the database administrators (VocaLink).

- 5.40** A new IAP could take on an existing agency IPSP (for example if the agency IPSP switched from an existing IAP) because the IPSP will already have its own sort code.<sup>65</sup> The new IAP would be able to change the sponsorship of the relevant sort codes to indicate themselves as the IAP.
- 5.41** However a new IAP (that was not a Bacs and/or FPS DPSP) may not automatically be able to supply indirect access to an IPSP that wants to become an agency IPSP because it might not have access to any unique sort codes that it could allocate to the new agency IPSP. Historically, sort code ranges have been allocated on the basis of lead pairs (the first two digits of a sort code) to members of C&C. Even if it did have sort codes to allocate, it would only have the access to the industry sort code database to undertake sort code registration and maintenance if it was a direct member of Bacs and/or FPS. Otherwise updates would need to be requested by submitting a paper form to the database administrators.<sup>66</sup>
- 5.42** The rules around allocation and updating of sort codes are very opaque. This can in itself make it difficult for new or existing IAPs to provide services to agency IPSPs. Bacs is conducting a review of these processes to consider how to address ongoing concerns. We are monitoring the progress of this work through our direct access work programme.

### Investment in systems, staff and expertise

- 5.43** All the IAPs we spoke to told us that significant investment in IT systems, staff and expertise is required to segregate activity associated with agency IPSPs and their customers from the activities of the IAP and its own customers.
- 5.44** These investment requirements are much more substantial when providing agency indirect access compared to non-agency access.
- 5.45** One IAP said that 'the key requirement is the ability to deliver data relating to the IAP's clients in a timely manner and in a way that allows the IAP to apply the funds to the accounts of the clients in their books'. Other necessary extra technical capabilities include the ability to receive multiple message standards and reformat them, and contingency and back-up arrangements.
- 5.46** A number of PSPs told us that specific skills and expertise are required to manage an agency IPSP relationship. One IAP said 'there are a limited number of individuals in the industry with experience of supporting agency banking products due to the specialist nature of agency banking'. One IAP said that for certain positions it can take up to 18 to 24 months to train a new member of staff, even if they have experience of working in another part of the bank.
- 5.47** Similarly, some IPSPs have told us that they would need to invest time and money in developing some internal expertise and operational capability before they would be able to process payments on behalf of other PSPs.
- 5.48** In principle, the costs of these additional investments could be passed on to IPSPs. However, IAPs told us this is not always possible in practice, as IAPs usually consider indirect access as part of a wider commercial relationship they have with IPSPs, not on a standalone basis. This can mean that it might not always be possible to recover the additional costs of providing indirect access through higher indirect access prices, and any increase in prices may be constrained by wider relationship

<sup>65</sup> This is not currently the case for C&C, but this is being addressed through the introduction of the new image clearing system.

<sup>66</sup> FPS members are able to access the sort code database for certain purposes. However, currently all FPS members are also Bacs members.

considerations. However the commercial attractiveness of the wider commercial relationship with IPSPs may justify making such additional investments in indirect access internal capabilities.

- 5.49** Another commercial reason identified by one IAP for not previously actively expanding its indirect access provision was the need to prioritise other necessary investments, for example relating to strengthened processing controls, resilience and security, and the investments required as a result of other internal priorities. Similarly one IAP told us one factor restricting the ability to expand indirect access provision is the opportunity cost involved: given the relatively low levels of revenue indirect access generates, it makes commercial sense to focus resources on other more profitable activities. One IPSP said that the investment that would be required to provide indirect access to other IPSPs would divert investment funding and management resource from their customer growth aspirations. We note however that providing indirect access may be key to developing wider overall commercial relationships with IPSPs.

### **Additional factors affecting an IPSP's decision to become an IAP to non-agency IPSPs**

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- 5.50** IPSPs can potentially provide non-agency indirect access to other IPSPs, also known as nesting. An example of this supply arrangement is shown in Figure 3 in Chapter 3.
- 5.51** Nested supply arrangements represent another potential supply of indirect access for non-agency IPSPs. One IPSP told us that there was a need for nested IAPs to service newer and more innovative PSPs – particularly those in direct competition with the four main IAPs at the retail level, but which have not yet reached a scale to justify the costs of direct access. Some of the four main IAPs told us that nesting is one reason there is a much broader range of suppliers of non-agency indirect access than agency indirect access.
- 5.52** In order to supply nested indirect access, the IPSP needs a payment account it can use to make and receive payments. In principle, any PSP who offers SME or corporate customers bank accounts could offer at least a basic indirect access service to non-agency IPSPs.
- 5.53** Although the other factors discussed in this chapter are likely to influence an IPSP's decision to supply nested indirect access, there are also some specific, additional factors which it may consider.

### **The risk appetite of an IPSP's own IAP**

- 5.54** An IPSP's risk appetite is conditioned by its own IAP's risk profile. This means that even if an IPSP is prepared to offer indirect access services to some IPSPs, it may have to consider its own IAP's processes and risk appetite when assessing potential customers.
- 5.55** IAPs have told us that nesting arrangements increase the risks associated with providing indirect access (in particular the risk of certain types of financial crime), because the IAP is one step further away from the originator or beneficiary of a transaction. We understand that at least one IAP has asked an IPSP customer to stop offering nested access. One IPSP told us it is aware that many nested supply arrangements have been terminated due to pressure from the relevant IAPs.
- 5.56** In other cases, IAPs have prevented their IPSPs from carrying out some types of transactions. Some IAPs have told us that in some high-risk cases, their own compliance and sanction screening resulted in them overriding an IPSP's decision to process an individual transaction. Similarly, one IPSP told us that even once it had secured an arrangement with an agency IPSP, that agency IPSP still had some difficulty in finding an IAP that was willing to allow the nesting arrangement.

- 5.57** One IAP said that it does not tell its IPSP customers who they may serve, but will evaluate the IPSP's target customers and risk management controls. It said if an IPSP is onboarding customers that bring significant risk to it as the IAP, it may review the adequacy of the IPSP's controls to address that risk.
- 5.58** There could also be other reasons for IAPs restricting who their IPSPs supply. For example, one agency IPSP told us that its IAP had sometimes restricted which customers the IPSP supplied because the IAP did not want to take on the additional credit risk from those customers.

### The quality of technical access between the IPSP and its IAP

- 5.59** Any payments flowing to or from an IPSP's nested customers would have to use the IPSP's own technical access connection with its IAP. Any limitations on these services that the IPSP is subject to, such as frequent outages or real time processing, will also affect the quality of the technical access their own IPSP customers receive. We discussed IPSPs' concerns regarding technical access from their IAP in Chapter 4.

### Market developments

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- 5.60** The factors outlined above influence a PSP's decision to become an IAP. Although historically these factors have limited the entry of new IAPs, there is evidence that a number of PSPs are considering becoming new IAPs or expanding their provision of indirect access.
- 5.61** At least fifteen IPSPs who responded to our survey said they are planning to become DPSPs in interbank payment systems within the next three years. [3<] IPSPs are expected to get direct access within the next year, having had their letters of intent accepted by one or more interbank payment systems. A larger number of DPSPs will increase the potential number of new IAPs, especially those which may be interested in providing services to agency IPSPs.
- 5.62** The greater direct participation in payment systems is enabled by factors including:
- PSR initiatives aimed at ensuring that access requirements do not unnecessarily restrict direct participation in payment systems, or act as a barrier to entry and expansion for new and emerging PSPs.
  - New types of access arrangements and services, such as aggregator services, which are emerging for some payment systems. These developments potentially provide some PSPs with more ways to get direct access.
- 5.63** A number of other market and regulatory developments also appear to be making it more attractive for some DPSPs and IPSPs to become IAPs, or for existing IAPs to expand their services to a wider group of IPSPs. [3<] of the four main IAPs are looking to expand their indirect access activities, and another (HSBC) has recently started offering an improved indirect access option for agency IPSPs. We are also aware of [3<] potential new IAPs. One of them initially plans to offer indirect access only to agency IPSPs who have direct technical access to FPS. One initially plans to offer indirect access only to non-agency IPSPs. However, all of them plan to offer indirect access to both agency and non-agency IPSPs eventually.

**5.64** None of these potential entrants are looking to provide indirect access services as a single standalone service. They are all investing in a wider service offering which includes indirect access. However, the factors which particularly appear to be motivating the new entry and expansion in indirect access provision include:

- Some potential entrants consider that there is unmet demand for indirect access, and sometimes a limited choice of IAPs.
- Some IPSPs are becoming IAPs in order to target specific customer groups or types of IPSPs. These potential IAPs are looking to take advantage of their knowledge of these customer groups' business areas and their own capabilities to provide specialised services.
- One DPSP told us it is considering becoming an IAP to agency IPSPs partly as a response to wider regulatory and policy changes, including ring-fencing. PSPs are restructuring and investing in their capabilities in response to these wider regulatory and policy changes, and one consequence of this is that becoming an IAP is becoming more viable and attractive.
- One existing IAP told us it wants to invest in its commercial banking capabilities (including indirect access) in part as a response to the increase in the number of retail banks which has, in its view, increased demand for indirect access to some extent. It expects that continued growth of this type of demand may be supported by consumer demand for banking choice.

**5.65** In judging whether the prospect of new entry or expansion may address the concerns we have identified elsewhere in this report about how effective competition is, we have considered whether the entry or expansion is likely, of sufficient scale and swift enough. We consider the prospective entry and expansion under these criteria below.

#### *Is entry and expansion likely?*

**5.66** Each of the potential IAPs we identified is at a different stage of entry. Two of the potential IAPs are currently undergoing the authorisation process to become credit institutions. We are not in a position to comment on the likelihood of those applications being successful. However, the evidence we have gathered indicates that three potential new entrants ([REDACTED] and Raphaels) have already taken concrete steps and made significant investments towards becoming IAPs:

- Raphaels is an existing credit institution. On 12 January 2016 it publically confirmed its intention to become a DPSP in FPS.<sup>67</sup> Raphaels intends to use its participation in FPS to become an IAP, by offering settlement and payment authorisation services to PSPs who have direct technical access to FPS.
- [REDACTED] is currently going through the authorisation process to become a credit institution. It has also agreed a project plan with FPS to become a DPSP, with a target go live date of [REDACTED] 2016.
- [REDACTED] aims to become a retail bank. As part of its proposition, it aims to offer indirect access services to agency and non-agency IPSPs. It has secured the initial funding for its business plan. It is currently going through the authorisation process to become a credit institution, and expects to submit a final application in [REDACTED] 2016. If its authorisation application is successful, it plans to become a direct participant in all the regulated interbank schemes and [REDACTED].
- [REDACTED] is an existing credit institution. It is planning to [REDACTED].
- [REDACTED] recognises that its current indirect access offering has some important limitations relative to the other main IAPs. For example, for some payment types, [REDACTED]. [REDACTED] believes its planned investments should make its indirect access offering more attractive, particularly for agency IPSPs, so it intends to be a stronger competitor in this area.

<sup>67</sup> <https://www.raphaelsbank.com/raphaels-bank-to-join-faster-payments-scheme/>

- HSBC has recently made its improved indirect access option available to IPSPs. This option allows agency IPSPs to connect directly into the central Faster Payments clearing platform using an approved technical access solution (this is known as the direct agency clearing model).<sup>68</sup>

### ***Will entry and expansion be swift enough?***

**5.67** Three of the four potential entrants plan to start offering indirect access this year or early next year. One of the existing IAPs' improved FPS indirect access offering is already available. The other is investing over the next [X]. More specifically:

- Raphaels plans to start offering settlement and authorisation services to agency IPSPs who have direct technical access to FPS from Q1 2017. It plans to offer indirect access (including settlement and technical access) to all IPSPs from [X]. It is in discussions with FPS about ways to enable it to offer this service sooner.
- [X] plans to start offering indirect access services to non-agency IPSPs from [X] 2016. Within a year of becoming a DPSP in FPS, it plans to offer settlement to non-bank agency DPSPs who have direct technical access to FPS.
- [X] aims to start offering indirect access services to agency and non-agency IPSPs in [X] 2017.
- [X].
- HSBC's improved indirect access option is now available to IPSPs.
- [X]'s planned investment in its commercial banking capabilities, including its ability to deliver enhanced indirect access services is taking place over the next [X].

### ***Is entry and expansion of sufficient scale?***

**5.68** It appears that, in combination with other market developments we set out in this report, the proposed entry and expansion, if successful, is likely to be sufficient to address many of our concerns. It will provide a significant increase in the choice of IAPs currently available to many IPSPs (both agency and non-agency). The potential entrants (combined) plan to supply indirect access to more than 50 agency IPSPs, and to several hundred non-agency IPSPs. These developments also suggest that any barriers to becoming an IAP are not insurmountable, at least for some organisations. Specific entry and expansion plans include:

- One of the banking services [X] plans to offer is indirect access to other non-agency IPSPs, including money remittance companies. It also plans to offer settlement services to non-bank agency DPSPs who have direct technical access to FPS. [X] made it clear to us that all indirect access will be provided subject to satisfactory onboarding, including review of each IPSP's AML policies. [X]. [X] is looking to serve many of the non-agency IPSPs who have had their indirect access services terminated by the four main IAPs. These forecasts would account for a significant proportion of those IPSPs.
- [X] plans to build its PSP customers from around [X] agency and [X] non-agency IPSPs in its first year to around [X] agency and [X] non-agency IPSPs within five years of its launch [X] next year.
- Raphaels initially plans to supply settlement access to agency IPSPs who have direct technical access to FPS. It plans to supply to up to [X] IPSPs in its first year, and up to [X] by year 3. It is currently unable to offer technical access to FPS because [X]. It plans to offer indirect access to both agency and non-agency IPSPs in the future.

<sup>68</sup> <http://www.business.hsbc.uk/en-gb/gb/generic/indirect-access-services>

- [X] is investing in its retail commercial banking capabilities, including its ability to provide competitive indirect access services. [X] intends to provide agency IPSPs with the ability to both send and receive payments via a 24/7, real-time service, accessible via a wider range of channels, and to support the full range of transactions required by agency IPSPs.
- HSBC's direct agency proposition is generally available to all agency IPSPs.

**Table 10: How entry and expansion helps address our concerns**

IPSP type	Access options	Main concerns	How entry or expansion will help
<b>Large agency</b> e.g. Challenger bank, Building society	<ul style="list-style-type: none"> <li>• Direct access</li> <li>• Direct technical access (e.g. via an aggregator)</li> <li>• Indirect access</li> </ul>	<p><b>Quality:</b> 24/7 access to FPS (if indirect)</p> <p><b>Switching:</b> Costly, complex, time-consuming</p> <p><b>Switching:</b> Business continuity</p>	<ul style="list-style-type: none"> <li>• Existing IAPs' investments in their indirect access service will provide an improved quality of technical access to FPS for agency IPSPs (including 24/7 availability).</li> <li>• Three new entrants ([X], Raphaels) plan to offer indirect access to agency IPSPs.</li> </ul>
<b>Medium agency or non-agency</b> e.g. Smaller building society, large money transfer company	<ul style="list-style-type: none"> <li>• Direct technical access (e.g. via an aggregator)</li> <li>• Indirect access</li> </ul>	<p><b>Quality:</b> 24/7 access to FPS (if indirect)</p> <p><b>Switching:</b> Business continuity</p> <p><b>Choice:</b> May be limited for some</p>	<ul style="list-style-type: none"> <li>• Existing IAPs' investments in their indirect access service will provide an improved quality of technical access to FPS for agency IPSPs (including 24/7 availability).</li> <li>• [X]'s investment will improve its indirect access offering for all IPSPs, and [X]. It will become a more attractive option for many IPSPs.</li> <li>• Three new entrants ([X], Raphaels, [X]) plan to offer indirect access to agency IPSPs.</li> <li>• Three new entrants ([X], Raphaels, [X]) plan to offer indirect access to non-agency IPSPs.</li> </ul>
<b>Small non-agency</b> e.g. EMI, APIs, remittance companies	<ul style="list-style-type: none"> <li>• Indirect access</li> </ul>	<p><b>Choice</b></p> <p><b>Price:</b> Little bargaining power</p> <p><b>Quality:</b> Relationship management</p> <p><b>Switching:</b> Short notice periods</p> <p><b>Switching:</b> Business continuity</p>	<ul style="list-style-type: none"> <li>• Three new entrants ([X], Raphaels, [X]) plan to offer indirect access to non-agency IPSPs, including IPSPs who have had their access terminated by the four main IAPs.</li> <li>• [X]'s investment will improve its indirect access offering for all IPSPs, and [X]. It will become a more attractive option for many IPSPs.</li> </ul>

## Assessment of factors affecting the number of IAPs

- 5.69** Low barriers to entry can be expected to improve choice, quality and price outcomes. New competitors may offer new options, or lower prices, and may force existing providers to improve their own offering in order to retain customers. Even the threat of new entry can have an impact on existing providers' behaviour.

- 5.70** Many PSPs may not consider becoming an IAP an attractive option because:
- regulatory and compliance requirements may impose costs and risks on IAPs
  - there are mixed views about the level of future demand for indirect access
  - switching levels are low so it may be difficult to attract customers from an existing provider
  - the revenues earned from providing indirect access appear to be very low (as we explain in Chapter 4), which may deter some potential IAPs from beginning to provide indirect access services unless they can offer a range of other banking services alongside indirect access
- 5.71** In addition, a prospective IAP which wants to provide indirect access to agency IPSPs needs to invest in complex systems and recruit or train specialist staff. It also needs to consider its ability to obtain and issue sort codes.
- 5.72** As we have described in this chapter, all DPSPs do not provide indirect access. However, becoming a DPSP is one of the most significant steps a prospective IAP needs to take if it wants to provide indirect access to agency IPSPs. Being a DPSP also has advantages for an IAP providing indirect access to non-agency IPSPs. An increase in the number of DPSPs therefore creates a greater prospect of an increase in the number of IAPs.
- 5.73** Historically there has been a limited number of PSPs becoming direct participants in payment systems, but this is likely to change. We have introduced measures to help open up direct access to more PSPs, and will continue to focus on this area. We are closely monitoring the effect of these measures, and will periodically assess their impact on the number of new IAPs.<sup>69</sup>
- 5.74** Changes in technical access, and the associated emergence of ‘aggregators,’ are also likely to change the way PSPs access payment systems in the future.
- 5.75** [3<] IPSPs are expected to become DPSPs in at least one interbank payment system in 2016 (including some through aggregators). We are aware of [3<] of those PSPs who are planning to become IAPs if they are successful in becoming DPSPs this year ([3<] and Raphaels). One existing DPSP also plans to start offering indirect access to agency IPSPs.
- 5.76** The existence of IPSPs who provide nested services can potentially promote competition in the supply of indirect access. Nesting can also provide an option for segments of the market that are seen as commercially less attractive to the four main IAPs, such as smaller non-agency IPSPs, or innovative PSPs who want to compete directly with the four main IAPs at a retail level.
- 5.77** However, the scope for growth in nesting to act as a strong competitive constraint on IAPs is limited by a number of factors, including the risk appetites of IAPs and any constraint from the quality of technical access between the IPSP and its IAP.
- 5.78** Although there are several factors that may affect a PSP’s incentives to provide indirect access services, the emergence of four potential new IAPs suggests some PSPs consider entry is both possible and attractive. Potential entrants have not become IAPs at this stage and we will monitor their progress. However, we consider this new entry and expansion to be likely, swift enough and of sufficient scale to address many of the concerns we have raised.
- 5.79** Some existing IAPs are also currently making investments in their banking offerings, including indirect access, which may be in part in response to a threat of new entry.

<sup>69</sup> PSR report, *Access and governance of payment systems: the operators’ progress and areas for ongoing focus* (December 2015): <https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report>

## Summary

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**5.80** Our interim findings on factors which affect the number of indirect access providers are:

- There are a number of factors which appear to have detracted from the incentives to become an IAP in the past. While levels of entry and expansion into the supply of indirect access have historically been low, this appears to be changing. We are aware of four potential entrants planning to become IAPs (**Finding 5**).
- New IAP entrants are looking to provide a range of banking services (or improve their existing services), including indirect access to payment systems, in response to various commercial, technological, market and regulatory changes.
- Two existing IAPs are looking to expand and improve their indirect access offering.
- We consider this new entry and expansion to be likely, swift enough and of sufficient scale to address many of the concerns we have raised.

**5.81** In Chapter 8 we consider whether any measures are required to address the factors affecting the number of IAPs.

## 6

# Behavioural factors that influence competition in indirect access provision

Even though we can see potential new entrants planning to become IAPs, a range of supply and demand-side factors may still affect the intensity of competition in the provision of indirect access.

On the supply side, particular financial crime risks (including perceived regulatory risks) are an important influence on IAP behaviour. Some IAPs apply minimum revenue thresholds for new IPSP customers and have introduced de-risking policies for existing IPSP customers, resulting in some cases in the termination of indirect access provision. These policies could collectively be limiting the provision of indirect access to some IPSPs.

More generally, IAPs have different commercial appetites for attracting new and maintaining existing IPSP business. Some IAPs want to expand their activities, while others are more selective about which IPSPs they serve.

On the demand side, we find that switching rates are low. This can be attributed to the cost, time and resources required to switch IAP. Many IPSPs who have switched have done so as a result of their IAP terminating their access. Only a few appear to have switched IAP because of price or quality concerns with their existing provider or in response to a more attractive offer from an alternative supplier.

IPSPs' ability to negotiate, and therefore exert competitive pressure on IAPs, appears to differ according to the IPSP's size and the wider potential revenue opportunities for the IAP. Larger agency IPSPs appear more able to negotiate than smaller non-agency IPSPs. Some IAPs do not negotiate on terms at all.

### Introduction

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- 6.1** In Chapter 5 we considered various structural factors which influence a payment service provider's (PSP's) incentives to become an indirect access provider (IAP) and, in turn, affect the number of IAPs. In this chapter we build on this analysis to assess various behavioural aspects which could affect the nature and intensity of competition in indirect access provision. We examine supply-side behavioural factors that shape how, and the extent to which, existing IAPs compete with each other, and some demand-side behavioural factors which appear to determine how much buyer power and influence IPSPs have and are able to exercise. The interaction between the structural and behavioural aspects, on both the supply and demand side, leads to the choice, quality and price outcomes we described in Chapter 4.

## Supply-side behavioural factors which may affect competition

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**6.2** This section considers some of the supply-side behavioural features we have identified which appear to affect the supply of indirect access. Specifically, we consider:

- the financial crime risks involved in supplying indirect access
- minimum revenue thresholds
- de-risking and the termination of existing access arrangements
- the intensity of competition to attract and maintain business

### The financial crime risks involved in supplying indirect access

**6.3** An important part of our analysis has been to consider how the financial crime risks associated with providing indirect access affect IAPs' incentives to supply certain types of indirect PSPs (IPSPs), and how this in turn affects competition.

**6.4** Financial crime risks can impact all IPSPs. However, two of the four main IAPs told us they consider the magnitude of risk to be higher for smaller IPSPs, as they generally have fewer resources and capabilities to monitor transactions. Smaller IPSPs tend to be non-agency IPSPs. IAPs also consider that some IPSPs (agency or non-agency) may pose a higher risk depending on their business activities and the services they provide.<sup>70</sup> For example, [3<] told us that they classified non-agency IPSPs as high risk.

**6.5** There is also some evidence of IAPs applying 'blanket' restrictions on providing access to certain categories of new (or existing) business because they consider some types of IPSPs to be too risky. However, most of the four main IAPs are now considering, or intend to consider, each individual IPSP on a case-by-case basis.

**6.6** These risks can lead to various costs including the costs of assessing and monitoring risk, and the potential for fines and other penalties should a compliance incident occur.

### *The cost of assessing and monitoring risks*

**6.7** All of the IAPs told us that, by its very nature, providing indirect access leads to specific commercial, operational, regulatory and financial crime risks. IAPs undertake specific processes and procedures to mitigate these risks.

**6.8** [3<] told us that for each potential customer it assesses:

- the financial crime risk (this has the highest potential impact and is regarded as a priority)
- its own risk appetite (whether the IPSP falls with the acceptable parameters of risk)
- the economic rationale (whether the expected return will cover the costs of managing the relationship)

**6.9** If the initial review is positive, further customer due diligence (and sometimes enhanced due diligence) is required (certain IPSPs must also be taken to client selection committees).

<sup>70</sup> A large proportion of non-agency IPSPs fall under the definition of Money Service Business (as defined in the Money Laundering Regulations 2007 (Regulation 2)). The Government's risk assessment of money laundering and terrorist financing (October 2015) classifies money service businesses as having a high structural risk and overall medium risk (Table 1A): [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/468210/UK\\_NRA\\_October\\_2015\\_final\\_web.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468210/UK_NRA_October_2015_final_web.pdf)

- 6.10** [X] applies an ‘enhanced due diligence’ procedure depending on the client sector and services. It makes a comprehensive risk assessment of all non-agency IPSPs, particularly those involved in foreign exchange and remittance services, on the basis that [X] characterises them as ‘high risk’. Following a risk-based review of IPSP relationships in 2013, which commenced a continual review process with clients assessed at least annually, [X] exited a number of its arrangements with IPSPs that did not meet its risk appetite.
- 6.11** [X] says regulatory and legal risk is a critical risk category for all customers, but particularly for IPSPs. This is because of the critical importance of complying with regulatory obligations and the additional risks of serving some IPSPs under anti-money laundering (AML), sanctions and other financial crime regulation. [X] applies enhanced risk management to certain customer sectors, such as those providing money remittance services, due to the higher risks it considers they present.
- 6.12** [X] told us that certain types of IPSPs, such as money remittance businesses, potentially expose it to greater operational, reputational and regulatory risk. It assesses these IPSPs on a case-by-case basis. It assesses risk (including country risk) from an AML, counter-terrorist financing (CTF) and financial sanctions perspective, which incorporates customer due diligence, operational (governance and compliance), and reputational risk. Where an organisation’s activities fall within a ‘high risk’ category, it applies an enhanced due diligence procedure on the entity, its ownership, and individuals.
- 6.13** IAPs say that the processes they implement to mitigate these financial crime risks increase the initial and ongoing costs of supplying indirect access to IPSPs. IAPs have submitted evidence to support their argument that there is a material cost to assessing and monitoring risk. They told us these costs can deter them from taking on certain types of new customers – for example those that fall into a category that they deem too risky.

### *The risk of penalties*

- 6.14** EU and UK legislation places a range of obligations on firms and professionals carrying out certain businesses, including financial services, in order to detect and prevent financial crime – particularly money laundering, terrorist financing and breaching various sanctions.<sup>71</sup> These include requirements under AML legislation, such as customer due diligence requirements, sanctions-related regulations, and other financial crime related regulations such as CTF regulations.<sup>72</sup>
- 6.15** The regulations which are designed to detect and prevent financial crime in relation to money laundering, sanctions and terrorist financing follow internationally agreed standards, in particular those established by the Financial Action Task Force (FATF).
- 6.16** Civil penalties can be imposed following infringements under the Money Laundering Regulations 2007<sup>73</sup> and under other powers in the Financial Services and Markets Act 2000, where systems and processes to detect and prevent financial crime are inadequate or have not been followed. These penalties can be imposed even if no crime has actually been committed, including where a business fails to terminate a business relationship when the law requires it to do so.<sup>74</sup>
- 6.17** To comply with these regulations, IAPs must conduct due diligence on their customers to be sure of their identity and matters such as beneficial ownership. In practice, this means that IAPs must be confident that all their clients operate appropriate and effective AML and CTF measures.<sup>75</sup> IAPs are not required to conduct due diligence on their customers’ customers (also known as ‘know your

71 The term ‘sanctions’ encompasses a variety of restrictions under a number of different UK and international laws. A non-exhaustive list of examples includes regulations under Article 215 Treaty on the Functioning of the European Union; the Anti-terrorism, Crime and Security Act 2001; and the Counter-Terrorism Act 2008. The restrictions include, in particular, prohibitions on dealing with the funds or economic resources belonging to, held or controlled by designated persons and on making funds or such resources available to or for the benefit of a designated persons. Certain sanctions also include prohibitions on the provision or performance of other financial services.

72 In particular the Third EU Money Laundering Directive 2005/60/EC, transposed into UK law by the Money Laundering Regulations 2007 (SI 2007/2157), and what are commonly known as the Wire Transfer Regulations – Regulation (EC) 1781/2006.

73 Regulation 42(1), Money Laundering Regulations 2007 (SI 2007/2157).

74 For example, under Regulation 11(1) of the Money Laundering Regulations 2007 (SI 2007/2157).

75 For example, see [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/372271/mlr8\\_tcsp.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/372271/mlr8_tcsp.pdf)

customer's customer', or KYCC). In fact, FATF has explicitly clarified that its standards do not require this approach to due diligence.<sup>76</sup> The Treasury and the Home Office have also specifically clarified there is no blanket KYCC requirement for UK banks, noting that *'there are concerns from banks that they are expected to know their customer's customer – something which is not required to comply with AML/CFT requirements'*.<sup>77</sup>

- 6.18** Failure to comply with certain financial crime regulation can also constitute a criminal offence leading to various potential penalties.<sup>78</sup> These can include an unlimited fine and a prison term for the responsible officer of up to two years.<sup>79</sup> There is also the risk of public censure and reputational damage, which may be particularly significant for larger banks with high public profiles.
- 6.19** The scale of potential civil and criminal penalties is a major concern for IAPs considering supplying indirect access to specific types of IPSP. Where they remain liable for any compliance failures, IAPs argue that they need to be confident that clients have adequate processes in place and apply them diligently. IAPs told us they have a zero risk appetite for regulatory breaches.
- 6.20** Larger IAPs are also subject to financial crime regulation in other jurisdictions. However, we are not aware of any foreign authorities penalising a financial institution solely for the actions of parties with indirect access to payment systems. The same applies in the UK.<sup>80</sup> So far, penalties have been imposed on those immediately responsible (rather than on the IAP for the behaviour of their IPSP's customers). However, IAPs in the UK have told us their conduct is influenced by the scale of the penalties that foreign authorities have imposed for financial crime, particularly in the US. For example, in 2012 HSBC paid a fine of US\$1.9 billion to US authorities for deficient AML controls, including failing to carry out due diligence on some of its customers.<sup>81</sup> Other examples include BNP Paribas agreeing to a \$9 billion settlement with US authorities over allegations of sanctions violations and Commerzbank paying \$1.45 billion to settle charges from US authorities over US sanctions.<sup>82,83</sup>
- 6.21** IAPs are also mindful of other potential consequences such as reputational harm, restrictions on certain activities (for example, US dollar trading) or even the loss of a banking licence. These exposures have led IAPs to reduce their exposure to categories of IPSP which they perceive as engaging in higher-risk activities. We discuss this in paragraphs 6.29 to 6.37 below.

## Minimum revenue thresholds

- 6.22** As a result of increased compliance activity, some IAPs have introduced minimum revenue thresholds that a potential IPSP would be expected to achieve before they will supply it. Thresholds may also be applied to existing customers, possibly at different levels. IAPs say these thresholds reflect the relative perceived risks of supplying different types of IPSPs, and the higher costs associated with compliance and monitoring for some of them. Thresholds for new customers may be higher because of the additional costs of initial due diligence.
- 6.23** [§<] IAPs told us they apply minimum revenue thresholds for IPSP clients. One IAP has a threshold of £[§<] per annum for new agency IPSPs. For non-agency IPSPs its thresholds differ according to their business activity. For money remitters its threshold is £[§<], while its threshold for bureaux de

<sup>76</sup> <http://www.fatf-gafi.org/documents/news/private-sector-forum-march-2015.html>.

<sup>77</sup> UK national risk assessment of money laundering and terrorist financing, page 36, paragraph 6.33: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/468210/UK\\_NRA\\_October\\_2015\\_final\\_web.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468210/UK_NRA_October_2015_final_web.pdf)

<sup>78</sup> Regulation 45(1), Money Laundering Regulations 2007.

<sup>79</sup> For the purposes of AML legislation, officer means: 'a director, manager, secretary, chief executive, member of the committee of management, or a person purporting to act in such a capacity.' (Regulation 47(9) Money Laundering Regulations 2007 (SI 2007/2157)).

<sup>80</sup> Information published by the FCA on its website about recent enforcement cases relating to money laundering shows that the six cases taken since February 2012 have all been directed at bank users of indirect access services for their own failings, rather than at their IAPs. See <http://www.fca.org.uk/firms/being-regulated/enforcement/fines>

<sup>81</sup> <http://www.reuters.com/article/us-hsbc-probe-idUSBRE8BA05M20121211>

<sup>82</sup> <http://www.bbc.co.uk/news/business-28099694>

<sup>83</sup> <http://www.bbc.co.uk/news/business-31861368>

change, foreign exchange brokers, third party cheque cashers and e-money firms is £[redacted]. One IAP told us that it has a guideline threshold of £[redacted] for both new agency and new non-agency IPSPs, based on the total revenue generated by the relationship. The IAP told us that the thresholds are not applied retrospectively and it has not sought to exit relationships purely on the basis of below-threshold revenue.

- 6.24** As we discussed in Chapter 3, IAPs consider the wider commercial relationship with an IPSP when deciding to supply indirect access. Thresholds apply to revenues generated by the total relationship with an IPSP, not just those associated with the supply of indirect access. According to [redacted] the minimum revenue thresholds reflect the costs of evaluating and onboarding IPSPs, and the ongoing monitoring of the different types of IPSP. It said the revenue thresholds are in place to ensure that ‘acceptable returns are achieved’. [redacted] told us that the revenue thresholds reflect the relative risk of providing services to IPSPs and are used as a proxy for the ability of the IPSP to commit resources to AML compliance.
- 6.25** [redacted] IAPs told us that their thresholds are not based on a granular build-up of costs – which they do not calculate at that level of detail – but on a wider assessment of the revenues that could be generated from a supply relationship. These IAPs have reviewed the overall costs of serving certain categories of non-agency IPSP. These reviews showed that the minimum revenue threshold for this particular type of non-agency IPSP was higher than their estimated average cost of supplying those IPSPs with indirect access. However, the IAPs emphasised that the estimated costs are approximates, and do not take full account of the regulatory, financial crime and reputational risks associated with supplying specific types of IPSP. The thresholds also cover other products and services, which are likely to generate their own additional costs.
- 6.26** While [redacted] does not apply revenue thresholds, in 2012 it introduced a policy of not supplying indirect access to certain new firms (including some non-agency IPSPs) such as all bureaux de change, money remittance agents, cheque encashment businesses and similar businesses. It has now altered its approach to assess applications on a case-by-case basis and only takes on new IPSP clients where there is a ‘strong business case’. [redacted] also told us that when considering a new agency IPSP it assesses the potential revenue from the whole relationship. For each IPSP customer, the relationship revenue must be sufficient to cover, [redacted], the cost of servicing the relationship (including due diligence and transaction monitoring). For potential agency IPSPs it assesses volumes and other service requirements to work out the expected revenue. Other revenue sources (such as loans) will feed into the overall assessment.
- 6.27** [redacted] told us that while it does not apply [redacted], it does assess the risks of supplying services to customers. [redacted] told us that relationship managers are responsible for ensuring customers (including IPSPs) generate an acceptable overall return [redacted], although a long term relationship view of expected returns is taken.
- 6.28** One consequence of revenue thresholds is that IAPs may not offer access to a new IPSP, or may terminate an existing IPSP’s access, even if the IPSP does not pose an imminent financial crime risk. The IAPs may consider that the IPSP may simply be too small to generate enough revenues to cover the costs associated with providing indirect access.

## De-risking and the termination of existing access arrangements

- 6.29** Some IAPs have responded to financial crime regulation, both in the UK and internationally, by introducing ‘de-risking’ policies. These aim to reduce the IAP’s perceived risks by withdrawing services from customers (including IPSPs) associated with a higher risk of non-compliance with financial crime regulations. In practice, some IAPs have terminated access for entire segments of IPSP customers, or categories of IPSPs – for example, money remitters or businesses operating in jurisdictions perceived to be at higher risk of financial crime. The information the IAPs have given us suggests that hundreds of IPSPs may have been affected by this de-risking exercise in the UK.

- 6.30** Both agency IPSPs and non-agency IPSPs have been subject to de-risking policies. We have seen evidence that suggests IAPs have terminated around 6 to 12 agency IPSP relationships in recent years. [X] told us that since November 2013 it had ended [X] agency IPSP relationships and that it was currently in the process of ending another [X]. [X] told us that it had ended [X] agency IPSP relationships in the last five years.
- 6.31** Small non-agency IPSPs, particularly those involved in money remittance services, have been the most affected by these policies, especially those providing services to particular countries such as Somalia, and smaller Caribbean countries.
- 6.32** Our evidence suggests at least 450 access arrangements for non-agency IPSPs have been terminated in recent years. All of the four main IAPs have terminated relationships with non-agency IPSPs:
- [X] told us that in the last five years it has reduced the number of non-agency IPSPs it supplies from [X] to [X], and that a further [X] have been given notice to close. This is a total reduction of 65%. However, [X] noted that the overall volume of payments and foreign exchange activity for the retained clients has doubled over the same period.
  - [X] told us that since August 2012 it has stopped supplying around [X] non-agency IPSPs. It also has around [X] non-agency IPSPs which are currently under review. [X] current policy defines certain categories of non-agency IPSP as 'prohibited',<sup>84</sup> although this is expected to change to 'restricted' (subject to management sign-off) – which means it will assess these IPSPs on a case-by-case basis.
  - Primarily on the basis of risk assessment, [X] has terminated relationships with [X] non-agency IPSPs over the last five years.
  - [X] told us that it has terminated its supply relationship with around [X] to [X] non-agency IPSPs, although the net change in the number of its non-agency IPSP customers may not be negative.
- 6.33** De-risking is not only a UK phenomenon, but is recognised as part of an international trend by major financial institutions to reduce their exposure to money laundering and terrorist financing risk. In the US a number of financial institutions also have a policy of de-risking. For example, the Merchant Bank of California was the last US bank to facilitate transfers to Somalia, but suspended these services in February 2015.<sup>85</sup> Kenyan banks also stopped transferring money to Somalia in April 2015, because of concerns about terrorist funding.<sup>86</sup> The number of financial institutions servicing the Caribbean region has also reduced significantly according to the World Bank.<sup>87</sup> De-risking policies have also affected virtual currency providers, such as bitcoin exchange operators, in some jurisdictions such as Australia.<sup>88</sup>
- 6.34** De-risking on a wide scale has a number of consequences for the supply of indirect access. Perhaps most obviously, de-risking has resulted in a large number of IPSPs having their indirect access arrangements terminated by their IAP. However, our analysis suggests that most of those IPSPs have found an alternative supplier so they can continue providing services to their customers, although not necessarily on the same terms as their initial access arrangements.

84 This includes what [X] classifies as money service businesses, such as bureaux de change, money transmission agents, cheque encashment business and similar businesses.

85 See Wall Street Journal: <http://www.wsj.com/articles/account-closed-how-bank-de-risking-hurts-legitimate-customers-1439419093>

86 See Wall Street Journal: <http://www.wsj.com/articles/kenyan-money-transfer-ban-puts-strain-on-somalis-1429053973>

87 [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/11/24/090224b08339501/3\\_0/Rendered/PDF/Withdraw0from000what0to0do0about0it.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/11/24/090224b08339501/3_0/Rendered/PDF/Withdraw0from000what0to0do0about0it.pdf)

88 See Australian Financial Review: <http://www.afr.com/technology/accc-investigating-why-banks-are-closing-bitcoin-companies-accounts-20151018-gkc5iv>

- 6.35** We analysed a sample of 173 customers that had had their access arrangements terminated, representing around a quarter of the exits or planned exits that IAPs told us about (see Box C for more detail). As of December 2015:
- 124 of these companies were actively filing accounts and/or appeared to be a going concern (although we do not know to what extent their activities may have changed).
  - 31 companies had ceased trading or were due to be struck off the Companies House register.
  - The company's fate was unclear in 18 cases.
- 6.36** This analysis is supported by research commissioned by the Association of UK Payment Institutions (AUKPI) which found that 51 out of 71 respondents (composed of payment institutions and electronic money institutions) had had a bank account closed in the past 2.5 years, but only three of those had gone out of business.
- 6.37** However, the AUKPI survey noted that over half of respondents felt that the service quality from their bank had decreased over the past 2.5 years, suggesting that those who had found alternative access were less satisfied after switching. The survey noted that some respondents had found alternative bank accounts elsewhere in the EU and some had become an agent of another payment institution or electronic money institution. These types of access arrangements may be seen as sub-optimal by IPSPs.

## Box C: Customer exit analysis

Two IAPs gave us lists of business customers whose access they had terminated for various reasons since 2010.<sup>86</sup> They included a mixture of IPSPs and other firms involved in the financial sector, and in a few cases, a named individual rather than a company. We then matched these names against the Financial Services Register (FSR).<sup>87</sup> From this we identified, where possible, which customers were PSPs and which undertook other activities. We then sought to establish how many appeared still to be in business by checking the name of each company (or individual person) against the Companies House register.<sup>88</sup> We then looked for corroborating evidence that the company was still trading, such as an active and recently updated company website, or any media reports.

In total, we looked at 173 companies, representing around a quarter of the terminations or planned terminations the IAPs told us about. From the FSR we established that 72 were IPSPs, 11 had authorisations in relation to payments (frequently as an agent of an authorised IPSP) and 40 undertook some other form of authorised financial services activity (for example providing loans) but were not authorised to undertake payments activity.

In 50 cases we did not have enough information to positively identify the companies against the FSR. There are a variety of possible reasons for this, such as only being provided with a surname of a director, making it impossible to positively identify the company they were associated with, or because the company carried out an activity which did not require authorisation.

<sup>89</sup> IAPs provided us with lists of their customers who had their access terminated. IAPs made clear that they were not certain that all such customers would meet our definition of an IPSP. As such, the analysis may include some non IPSPs.

<sup>90</sup> <https://register.fca.org.uk>

<sup>91</sup> <https://beta.companieshouse.gov.uk/>

## Box C: Customer exit analysis *(continued)*

We established that 124 of the companies (including 61 of the 72 positively identified IPSPs) were either actively filing accounts or that the business appeared to be a going concern. This does not necessarily mean that their business activities were always the same as when their IAP terminated their accounts. It also does not necessarily mean that the company managed to get another UK bank account – this information was not generally available, although we did manage to positively establish a few instances where companies had obtained an account with another UK IAP.

We have been told by IPSPs that in some cases the companies needed to use more than one provider to supply the necessary range of services. In at least one case this has involved a provider elsewhere in the EU. Some IPSPs told us that a number of IPSPs have started nested supply arrangements with medium-sized agency IPSPs after their original IAP terminated their access. We have also been told that de-risking has driven some payment activities 'underground', where IPSPs have stopped providing those services.<sup>92</sup> This implies that one effect of the de-risking policy has not necessarily been to eliminate the risks of money laundering or terrorist financing, but to change the mechanisms used to transfer those funds.

We found that 31 companies (including 11 PSPs) had ceased trading or were due to be struck off the Companies House register. From the information available it was not possible to attribute the cause of the company ceasing trading to the withdrawal of banking services by their IAP. In a few cases we established that the company had been wound up as a result of criminal activity.

In 18 cases, the company's fate was unclear. In almost all of these we didn't have enough information to establish the nature of the company's business. In most cases this was because the only information available to us was a named individual, who we could not match to a company. In some cases there was evidence that the company may have been registered overseas.

**Table 11: Companies subject to de-risking**

FSR categorisation	Number affected	Still active	Closed	Status unclear
Authorised payment institution	38	35	3	0
Small payment institution	31	23	8	0
Authorised electronic money institution	3	3	0	0
Passported PSP	3	1	0	2
Agent of PSP	8	7	1	0
Non PSP <sup>93</sup>	40	36	4	0
Unknown	50	19	15	16
<b>Total</b>	<b>173</b>	<b>124 (72%)</b>	<b>31 (18%)</b>	<b>18 (10%)</b>

<sup>92</sup> Companies which are not authorised to undertake payments activity, but which are traceable on the FSR as being authorised to undertake some other form of activity (for example, to extend credit or advise on investments).

<sup>93</sup> Companies or individuals who do not appear on the FSR at all, or where the FSR has multiple possible matches and we have not been able to positively make a link with the names provided by IAPs. In a number of cases an exact match was possible on the Companies House register, however, hence we have been able to identify whether the company is still trading.

## The intensity of competition to attract and maintain business

- 6.38** We have examined evidence on IAPs' appetite for finding new IPSPs and business, including the extent to which they actively try to take IPSP business from their competitors. This is an important component of our assessment of the state of competition in the market, given the high proportion of IPSPs supplied by the four main IAPs, and the historically limited entry of new providers. We have also considered whether IAPs limit IPSPs' access to payment systems in order to restrict downstream competition.
- 6.39** The four main IAPs told us they competed with other IAPs on the basis of the following factors:
- technical capabilities of their indirect access propositions
  - price
  - quality of customer service and relationship management
  - specialist industry knowledge and a strong track-record of service provision
  - their ability to offer a wide range of other banking products to meet customer needs
- 6.40** Specific aspects of the technical capabilities of indirect access offerings that IAPs compete on include:
- the speed, reliability, integrity and availability of the indirect access offering
  - the communication of payment messages and related reporting information through a range of different channels and in different messaging standards
  - for agency IPSPs with one or more existing sort codes, offering the ability to provide services using the IPSP's existing sort codes
- 6.41** The incentive to attract new business, and the intensity of competition among IAPs, differs depending on the size and agency status of potential IPSPs. All the four main IAPs told us that they aim to establish long-term supply relationships with IPSPs. For some IAPs this partly reflects the potential costs (such as resource costs) of service, including the costs of ending indirect access relationships. However, it also appears to reflect a view that competition centres on long-term relationships – where IPSPs do not change IAPs frequently – rather than on a shorter-term transaction basis. As we discuss in the next section, the relatively long tenure of supply relationships was confirmed by respondents to our IPSP survey and by IAPs.
- 6.42** In this context we have also considered whether IAPs have the incentive and ability to restrict access to payment systems to IPSPs in order to restrict downstream competition. In the provisional findings report of its Retail Banking Market Investigation, the CMA identified a number of issues in relation to payment systems which suggested that indirect participants (mostly new and smaller banks) may be at a competitive disadvantage compared with DPSPs.<sup>94</sup> However, the CMA did not draw any conclusions on this topic. We had considered similar concerns in our March 2015 policy statement. We have not received any substantive evidence as part of this market review to support the hypothesis that IAPs are restricting access in order to restrict or influence downstream competition.
- 6.43** The appetite for attracting new business among the four main IAPs differs according to their overall commercial strategy:
- [X] told us that indirect access is not particularly attractive compared to other commercial opportunities that it could pursue, particularly as it has limited staff with the relevant expertise to manage these relationships. Historically it wanted to be the preferred supplier of indirect access

<sup>94</sup> CMA *Retail banking market investigation*, provisional findings report (2015), paragraph 110: [https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail\\_banking\\_market\\_investigation\\_-\\_PFs\\_V2.pdf](https://assets.digital.cabinet-office.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf)

services for agency IPSPs. However, it told us that it is more selective now due to regulatory changes, the increased pressures of AML and financial crime risks and associated enhanced due diligence requirements, and the investment constraints of developing new services. It now adopts a more selective approach and only enters into commercial relationships that it believes are consistent with its strategy and are likely to be long term. For agency IPSPs, [X] is generally keen to grow its existing relationships, subject to its risk appetite. It will also consider new supply relationships with non-agency IPSPs, providing they meet its risk appetite and it can provide the full range of products and services the IPSPs require.

- [X] told us that it will continue to offer a strong and competitive agency banking proposition, and looks to enhance its service to meet evolving market needs. It said it puts considerable effort into its agency relationships, and has a breadth of proposition [X] which can appeal to some agency IPSPs. However, it said it will continue to adopt a highly cautious approach for IPSPs because of the associated risks.
- [X] told us it does not consider indirect access to be an area where there are major commercial opportunities. Its risk appetite has tightened, including around AML concerns. It has not terminated all its IPSP relationships, but [X] has reviewed its approach in line with its risk appetite. [X] gets most of its new IPSP customers on a referral basis i.e. rather than active sales and marketing. [X] told us that recruiting smaller non-agency IPSPs, which only generate small revenues to cover onboarding and ongoing costs (e.g. relating to compliance), is not commercially attractive to it.
- In contrast, [X] told us that it sees indirect access provision as commercially attractive. It is actively pursuing new agency and non-agency IPSP business and wants to expand its indirect access provision. It has invested in its core payments infrastructure and plans to make future investments to improve its client proposition. [X] expects that this will enhance its product and service offerings, and support its aim to build market share.

**6.44** All the main four IAPs told us that they have regularly responded to tenders for new agency IPSP business over the previous five years, each responding to two or three a year on average. They have all taken on new agency IPSP business. However, the evidence from our IPSP survey suggests that the majority of agency IPSPs who have sought tenders for new indirect access services did not ultimately switch provider.

**6.45** The appetite for non-agency IPSP business is less clear. IAPs consider non-agency IPSPs to generally present a higher risk and lower reward, which does not make them particularly attractive commercially to IAPs. In our survey, four of the eight non-agency IPSP respondents who had issued tenders to multiple IAPs received fewer responses than tenders issued, while a number of non-agency IPSPs at our roundtable told us that the main IAPs did not respond to tenders they had issued.

**6.46** As discussed in Chapter 5, the commercial strategies of other IAPs (outside the four main IAPs – such as [X], [X], [X] and [X]), have tended to have a different focus. We were told that they have generally not been particularly interested in attracting or competing for new IPSPs, particularly smaller, UK based non-agency IPSPs.

## Our assessment of supply-side behavioural factors

**6.47** Our analysis indicates that there are two important supply-side behavioural factors which affect the intensity of competition for indirect access. These are:

- the risks associated with supplying indirect access, particularly to certain categories of IPSPs
- the measures IAPs have adopted to mitigate the perceived risks (such as de-risking policies and revenue thresholds), which limit their appetite to attract new IPSP business

- 6.48** Although these policies have been applied across agency and non-agency IPSPs, non-agency IPSPs have been particularly affected.

#### ***The financial crime risks involved in supplying indirect access***

- 6.49** All of the four main IAPs told us that the risk of compliance failures under regulations aimed at preventing financial crime (such as under AML/CTF legislation) is a significant influence on the provision of indirect access. In some circumstances, IAPs are required to terminate supply arrangements with IPSPs if they are unable to conduct customer due diligence in accordance with the Money Laundering Regulations 2007.<sup>95</sup> In other instances, IAPs chose to terminate arrangements, in particular with smaller IPSPs, because they felt the increased costs of mitigating the risks made the relationship uneconomic.
- 6.50** We are not a supervisory authority for the purposes of the Money Laundering Regulations 2007 and there are limitations on supervisory authorities' powers to disclose information under these regulations. This restricts our ability to assess whether the main IAPs' risk perceptions and consequent actions are reasonable given their potential exposures in the UK and other jurisdictions. As we explain in Chapter 8, we have powers under sections 56 and 57 of FSBRA to grant new access to payment systems and to vary existing agreements in relation to payment systems (respectively). We will develop a framework for how we will exercise these powers, which we intend to consult on either as part of or alongside our final report for this market review.
- 6.51** In the discussion below we consider the potential impact the IAPs' actions have on competition in indirect access provision.

#### ***Minimum revenue thresholds***

- 6.52** The use of revenue thresholds by some IAPs is potentially a significant competition concern because it can directly affect the choice of IAPs available to IPSPs. Consequently, IPSPs who generate revenues below all of the relevant thresholds applied by the main IAPs may have very limited supply options for indirect access. For example, a non-agency IPSP that would generate less than [£<] in revenue for an IAP may only be offered indirect access by one of the four main IAPs, although it might be able to get an offer from an alternative provider (for example, through a nesting arrangement).
- 6.53** Non-agency IPSPs are generally more affected by minimum revenue thresholds than agency IPSPs. For products such as indirect access, thresholds can affect competition in related services by limiting the number of competitors at the retail level. They can also potentially harm innovation by restricting smaller, more innovative IPSPs in their choice of IAP.
- 6.54** However, minimum revenue thresholds are generally not harmful to competition when they are used as a proxy for the average costs associated with servicing particular types or categories of customer. It would not be economically efficient for IAPs to service customers where they do not recover their underlying costs. And as we set out above for existing IAPs, where IAPs' level and use of thresholds varies, some IPSPs may have a choice of more than one IAP.
- 6.55** The revenue data we asked the IAPs to give us was limited to payments revenues only, rather than the revenues associated with the whole relationship. This means it has not been possible to calculate the impact the minimum revenue thresholds have had, either in terms of the number of IPSPs that would fall outside them, or how they relate to the underlying costs of providing indirect access.
- 6.56** As we discussed in Chapter 5, some PSPs are considering becoming IAPs in order to service specific IPSPs who have a more limited choice. One of the potential new entrants has told us it will employ a minimum revenue threshold for new customers, although this may be lower than existing IAPs' thresholds.

<sup>95</sup> Regulation 11(1)(c) of the Money Laundering Regulations 2007.

- 6.57** The question of whether minimum revenue thresholds limit competition and innovation in the provision of indirect access will depend on a number of specific considerations. These include:
- the underlying costs of supplying different types of IPSPs
  - the risks of supplying certain types of IPSPs
  - the impact of the wider commercial relationship
- 6.58** Given the scope of this review and the limited data available to us (which does not include revenues relating to wider commercial relationships, nor a granular set of costs) we cannot form a firm view about how minimum revenue thresholds may affect competition in indirect access provision alone.

### ***De-risking and the termination of existing access arrangements***

- 6.59** While de-risking policies clearly have an immediate impact on an IPSP whose indirect access supply arrangements have been terminated, they can also ultimately affect that IPSP's customers. If all IPSPs who transmit money to specific jurisdictions have their access to payment systems removed, this could have a big impact on service-users – people, businesses and charities – who want to transmit money to these jurisdictions.
- 6.60** Another consequence of de-risking, and one which is likely to become more important in the future, is the impact that it might have on more innovative, and potentially higher risk, payment services. Some IAPs we spoke to said in their response to our request for information that they do not service PSPs who supply indirect access to virtual currency or blockchain operators because of concerns around the potential financial crime risk. However, they highlighted that this is an area of rapid change and one that they are constantly monitoring and evaluating.
- 6.61** IPSPs who have had their indirect access supply arrangement terminated have told us that the information their IAP gave them at the time of termination did not explain the reasons fully. This is a major concern for them. A number of IPSPs have told us that the termination process involved the IAP issuing them with a letter with little or no explanation. Some IPSPs told us that when they asked their IAP for an explanation, it told them it was not required to give them a reason for the termination. The practice of providing limited reasons as part of a de-risking exercise is not limited to the UK – similar complaints are made in other jurisdictions.<sup>96</sup>
- 6.62** In normal competitive market conditions we would expect that, for reputational reasons, IAPs would naturally have an incentive to provide an adequate explanation for terminating a supply arrangement. IAPs who gained a reputation for poor customer communications or who terminated supply arrangements without adequate reasons would lose custom to IAPs with a higher level of relationship management and greater security of supply.
- 6.63** However, the arrangements for the termination of services and de-risking are complicated by the restrictions that all IAPs face under AML and CTF regulations. Specifically, an IAP who discloses concerns about a particular IPSP contravening AML or CTF requirements is potentially at risk of committing the offence of 'tipping off' under relevant legislation.<sup>97</sup> We have been told that IAPs may as a result be reluctant to tell customers why they are terminating their arrangements in case this amounts to tipping off.
- 6.64** The potential consequences of de-risking are recognised at the UK and international level. In the UK, the FCA has responded to de-risking by clarifying the requirements for banks to manage financial

<sup>96</sup> For example, see points raised by the Executive Director of the IMF: [http://www.huffingtonpost.com/otaviano-canuto/de-risking-is-de-linking\\_b\\_8357342.html](http://www.huffingtonpost.com/otaviano-canuto/de-risking-is-de-linking_b_8357342.html)

<sup>97</sup> The offence of tipping off is contained in s.333A of the Proceeds of Crime Act 2002: There are also [tipping off offences for terrorist property](#) in the Terrorism Act 2000.

crime risks.<sup>98</sup> It has also commissioned research to gather evidence about the nature, scale and drivers of the issue, and plans to publish a report shortly.

- 6.65** Other UK government initiatives include the Action Group on Cross Border Remittances, which brings together government, supervisors and representatives of the banking and money service business sectors,<sup>99</sup> and work by the Department for International Development on the Somalia Safer Corridor Initiative, in response to fears of a crisis for remittance flows to that country.<sup>100</sup>
- 6.66** In August 2015, the Better Regulation Executive (BRE) of the Department for Business, Innovation and Skills (BIS) issued a call for information for a review of the impact the current AML and CTF regime has on business.<sup>101</sup> The review looked at the implementation of legislation and activity carried out by national supervisors – including the FCA and HMRC – under The Money Laundering Regulations 2007. As well as identifying where more clarity is needed for businesses, it looked for evidence of where the activity of these regulators could be made more efficient and effective. The outcome has yet to be published, but will feed into the UK’s AML action plan, due to be published by the government in the next few months.<sup>102</sup>
- 6.67** The UK must also implement the fourth EU Money Laundering Directive by June 2017. The Treasury will be consulting on the UK’s implementation during the course of 2016.
- 6.68** At the international level, the World Bank issued a report on de-risking activities in the remittance market in October 2015 and a report on the decline in correspondent banking and its consequences in November 2015.<sup>103</sup> In 2018, the Financial Action Task Force (FATF) will be evaluating the UK’s AML and CTF framework.

### *The intensity of competition to attract new business*

- 6.69** The other major supply-side behavioural factor which appears to affect competition is the different appetites that IAPs have for attracting new IPSP business and the potential revenue opportunities associated with the supply of indirect access.
- 6.70** Our analysis shows that while some IAPs want to maintain or expand their activities in this area, others are more selective about which IPSPs they supply. The intensity of competition for new IPSPs tends to vary according to the type of IPSP (agency or non-agency), its size, and the potential for additional revenue opportunities.
- 6.71** The four main IAPs are all interested in attracting large agency IPSPs. However, IAPs’ appetite for supplying non-agency IPSPs is more limited, particularly for smaller IPSPs and those in higher risk categories. Smaller IPSPs process low volumes of payments, bring in low revenues, can have high onboarding costs and may present higher risks for the IAPs. As discussed above, in some cases an IPSP may have little or no choice in securing indirect access through the main IAPs and instead be forced to secure access through a different IAP (for example, through a nested supply arrangement). It follows that, in these circumstances, the intensity of competition amongst the four main IAPs for these IPSP customer categories is low.
- 6.72** However as discussed in Chapter 5, this may be changing as a result of potential entry by some new IAPs who are targeting categories of IPSP with limited supply options. This may positively affect the intensity of competition in the future, particularly for non-agency IPSPs. Changes such as the emergence of aggregators and other new access options may also result in new forms of supply arrangements which could change the competitive landscape.

98 <https://www.fca.org.uk/about/what/enforcing/money-laundering/derisking>

99 <https://www.gov.uk/government/groups/action-group-on-cross-border-remittances>

100 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/471064/UK-Somalia\\_Safer\\_Corridor\\_Initiative.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/471064/UK-Somalia_Safer_Corridor_Initiative.pdf)

101 <https://cutting-red-tape.cabinetoffice.gov.uk/anti-money-laundering/>

102 <https://www.gov.uk/government/news/government-publishes-anti-money-laundering-assessment-and-commits-to-action-plan>

103 <http://documents.worldbank.org/curated/en/2015/11/25481335/withdraw-correspondent-banking> and <http://documents.worldbank.org/curated/en/2014/05/19628431/making-remittances-work-balancing-financial-integrity-inclusion>

## Demand-side behavioural factors which may affect competition

**6.73** In this section we consider the factors relating to IPSPs' behaviours and capabilities which may contribute to the outcomes in Chapter 4. The three main factors we've identified are:

- IPSPs' propensity to switch IAPs
- IPSPs' negotiation capabilities
- IPSPs' internal capabilities

### IPSPs' propensity to switch IAPs

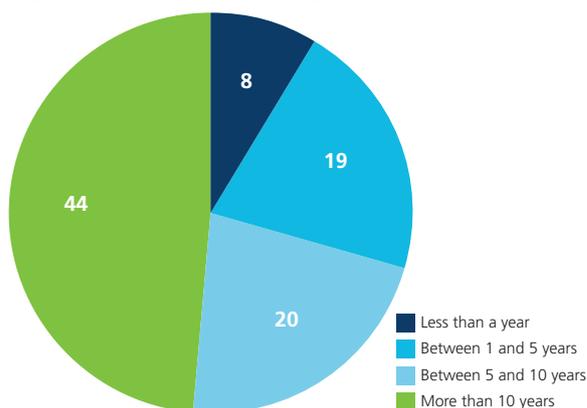
**6.74** Switching, or the plausible threat of switching, is important in well-functioning competitive markets. It can create a virtuous circle of competition by motivating suppliers to innovate, provide good quality relationship management, and keep prices competitive, in order to retain and attract customers. An active demand side can therefore constrain suppliers' behaviour.

**6.75** As discussed in Chapter 5, IPSPs' willingness to switch suppliers is one factor which may influence an IPSP's decision to become an IAP and build market share.

**6.76** Our IPSP survey provides insight into the levels of switching for indirect access. In our survey 70% of survey respondents had been with their current IAP for at least five years, with just under half the relationships (48%) lasting over 10 years. There was little significant variation between agency and non-agency IPSPs in this regard. If we take account of the fact that some respondents to the survey are likely to be new entrants without a prior IAP relationship, this suggests that switching rates overall are low.

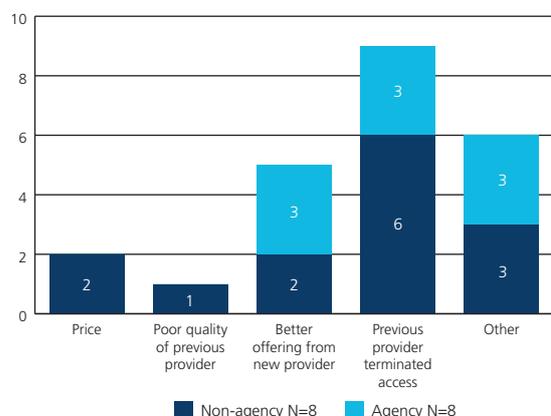
**6.77** The results of the survey broadly correspond to information provided by IAPs. In our survey the most commonly reported length of relationship between IAP and IPSP was in excess of 10 years.

**Figure 11: Reported length of relationship between IPSP and IAP**



Source: IPSP survey

**6.78** The motivation for switching varies across agency and non-agency IPSPs. However, in the majority of cases switching came as a result of an IAP terminating indirect access. The few IPSPs who switched of their own initiative cited reasons such as price, quality and more attractive offerings.

**Figure 12: Reported reasons for switching IAP**

Source: IPSP survey. Respondents could report multiple reasons.

### Agency IPSPs

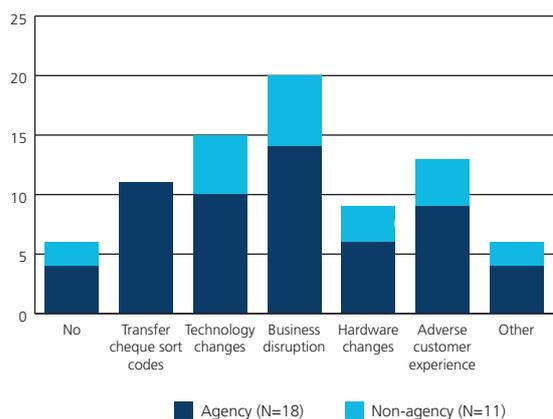
- 6.79** As we discussed in Chapter 4, agency IPSPs tend to have a wider choice of access options than many non-agency IPSPs, and IAPs appear to compete more actively to provide services to them – particularly larger agency IPSPs requiring more extensive banking services. This choice can be exercised both when an IPSP first enters the market and when they consider switching supplier.
- 6.80** Despite the wider choice of access options, we have found that agency IPSPs appear to have a low incentive to switch supplier and a high incentive to remain with their existing provider. This is reflected in the low levels of switching that we have seen. Our survey shows that only 14% of agency IPSPs had switched IAP over the past 15 years, an annual average of around 1%.<sup>104</sup>
- 6.81** We have looked at the reasons why agency IPSPs do not appear to switch, despite possibly having the opportunity to do so. We have found that the costs of searching for and assessing alternatives and then switching can be high, and for many agency IPSPs these costs may outweigh the potential price and quality benefits. To switch supplier, an agency IPSP may first carry out a tender exercise to identify a new supplier, negotiate new terms of service and undergo rigorous due diligence checks. It must then develop new technical and IT connections with the new IAP, carry out testing and potentially change back office processes. At present, if an IPSP is changing IAP for access to C&C, the agency IPSP will need to change its sort code, which requires a customer communication exercise, destroying old cheque stationery, issuing replacements and dealing with misdirected payments. However, Cheque and Credit Clearing Company Limited told us that under the new Image Clearing System, sort codes used for cheque processing will be portable in the same manner as for the electronic payment systems.<sup>105</sup>
- 6.82** The search, assessment and switching process can be lengthy. A number of agency IPSP respondents to our survey said it took them more than 12 months to switch. Some IAPs cited similar timescales while another said it could take up to 18 months, primarily to ensure that the transition is as seamless as possible for the agency's own customers. While these longer switching periods exceed typical termination notice periods (which range from three to 12 months), some IAPs expressed a willingness to extend contracts, in certain circumstances, to allow the switch.
- 6.83** As part of our survey we asked agency IPSPs whether they perceived any barriers to switching their IAP, and for those who had switched, whether they had experienced any issues when switching.

<sup>104</sup> The survey showed that only three agency banks (from a sample of 45) switched supplier between 2000 and 2013, while four had switched since 2014, of which two were former customers of Co-operative Bank. The withdrawal of Co-operative Bank from providing indirect access services has led to 28 agency IPSPs across the whole market switching supplier since 2013. This is an atypically high level of switching activity for agency banks.

<sup>105</sup> [http://www.chequeandcredit.co.uk/files/candc/c&ccc/consultation\\_response/2015/13\\_psr\\_mr15\\_1.1\\_supply\\_of\\_indirect\\_access\\_to\\_payment\\_systems.pdf](http://www.chequeandcredit.co.uk/files/candc/c&ccc/consultation_response/2015/13_psr_mr15_1.1_supply_of_indirect_access_to_payment_systems.pdf)

We found that for those agency IPSPs that have not switched, around 80% perceive that there are barriers to switching. Among the smaller group of agency IPSPs that had switched, just over half had experienced business disruption and continuity issues. A few had experienced other issues such as changes to their internal business processes or issues with sort codes. Just one IPSP said that it had experienced no issues. However, our survey also suggested that all of the agency IPSPs that had switched were either more satisfied or as satisfied with their service after switching.

**Figure 13: Perceived barriers to switching IAP reported by IPSPs**



Source: IPSP survey. Respondents report multiple responses.

- 6.84** As we noted in Chapter 4, agency IPSPs generally consider the quality of service to be good, so we would not expect this to be a significant motivation for switching.
- 6.85** However, the service quality associated with indirect access to FPS might be an exception. As outlined in Chapter 4, the evidence we have gathered suggests agency IPSPs are less content with the indirect access service they receive for FPS compared to other payment systems. This might be expected to lead to higher levels of switching for FPS.
- 6.86** We consider that there may be several reasons why significant numbers of agency IPSPs have not switched their FPS IAP. These reasons can be grouped into two broad categories. The first category is that the costs may still outweigh the potential benefits. In particular:
- If an IPSP switches IAP for only one payment system (such as FPS), its original IAP could charge more for access to the other payment systems. This concern was raised by one agency IPSP.
  - Although we have seen evidence that agency IPSPs multi-bank, many still prefer to consolidate all their services with one IAP.
  - In common with other payment systems, the costs of switching indirect access to FPS only can still be high and outweigh the benefits of switching, particularly if the new provider does not offer a better service quality.
- 6.87** The second set of reasons why switching IAP for FPS may be low is that some agency IPSPs may be waiting to see how supply arrangements to FPS develop in the short term. In particular:
- While there is evidence that IAPs are developing improved platforms for IPSPs to access FPS, these are either not yet operational or not fully functional. IPSPs might consider they are likely to receive a better service if they wait until these platforms are fully implemented before switching.
  - As we discussed in Chapter 5, new IAPs may emerge, thereby offering a greater choice for IPSPs and better quality services.

- FPS is developing a new access model, which might make becoming a DPSP a more attractive proposition for some IPSPs.

### **Non-agency IPSPs**

- 6.88** Our analysis suggests that switching rates for non-agency IPSPs who have switched of their own initiative are also low. Only 30% of the non-agency IPSPs that responded to our survey have switched IAP over the past 15 years (an annual average of about 2%). These switching rates (allowing for a margin for error) are similar to those in the SME business current account market.<sup>106</sup>
- 6.89** The non-agency IPSP switching rates have been high in recent years and reflect the high number of terminations leading to involuntary switches. As we discussed earlier, a significant number of non-agency IPSPs have had their access terminated since 2010. In our survey we observed lower than average switching rates (compared with SME business current account customers) until 2012 and higher than average rates since then.<sup>107</sup>
- 6.90** One of the main barriers to switching for non-agency IPSPs appears to be a perceived lack of choice of alternative IAPs. Our survey also suggested a similar pattern to agency IPSPs, with non-agency IPSPs perceiving a wide range of issues around the switching process. The experiences of those who had switched suggested that these concerns may be justified, with all eight having experienced some form of difficulty during the transition – most commonly with disruption to business. However, our survey results suggest that where switches do take place, customers are at least as satisfied, if not more satisfied, with their new IAP.
- 6.91** Evidence from both IAPs and IPSPs suggests that switching times are much shorter for non-agency IPSPs than for agency IPSPs. However, termination notice periods can be very short, sometimes as short as one month. Some IPSPs at our roundtable told us that termination notice periods can be too short to find a new supplier when their IAP terminates their access. They did not comment on whether it was sufficient when they initiated the notice period themselves. Some non-agency respondents to our survey, who had their indirect access terminated, said it had taken them more than three months to switch supplier. This suggests that a standard termination notice period of one to three months would not be enough time to switch.
- 6.92** Evidence from our survey suggests that some alternative options to switching supplier, such as getting direct technical access to FPS or becoming a DPSP, are not feasible for most smaller non-agency IPSPs. They lack the resources and volumes to make this viable or economic and most cannot meet the eligibility criteria to become DPSPs. However, direct technical access to FPS via an aggregator may soon be a more attractive option for medium and larger non-agency IPSPs.

### **IPSPs' negotiating ability and bargaining power**

- 6.93** In competitive contexts, purchasers of a product or service can influence outcomes in terms of price and quality through applying pressure on suppliers during negotiations using their countervailing bargaining power. We have examined the extent to which IPSPs are able to influence price and non-price outcomes in negotiations with IAPs.
- 6.94** All the main IAPs told us that they are prepared to negotiate over terms and conditions. However, the extent to which this actually occurs appears to vary by IAP and the type and size of IPSP. One IAP told us that it was only prepared to negotiate with non-agency IPSPs on certain aspects, such as notice

<sup>106</sup> The most recently available figure is 4% in the CMA's *Retail banking market investigation*, Summary of provisional findings report (October 2015), page 23, paragraph 84 (c): [https://assets.digital.cabinet-office.gov.uk/media/5627b571e5274a1329000003/Banking\\_summary\\_of\\_PFs.pdf](https://assets.digital.cabinet-office.gov.uk/media/5627b571e5274a1329000003/Banking_summary_of_PFs.pdf). This is roughly in line with previous surveys which put switching rates between 2% and 4.6% – see OFT review of SME banking undertakings (August 2007), page 33, Table 4.6: [http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared\\_offt/reports/financial\\_products/oft937.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared_offt/reports/financial_products/oft937.pdf)

<sup>107</sup> Survey Q50: In our survey only four non-agency IPSPs switched supplier (all voluntarily) between 2000 and 2012, while four switched between 2013 and 2015 (all involuntarily – their access had been terminated).

periods. However, two other IAPs told us that they were open to negotiating more broadly, and across all types of IPSP.

- 6.95** We have heard mixed views from IPSPs on their experiences of negotiating with IAPs. One IPSP, which is a challenger bank, told us that its negotiations with its IAP were reasonable, including on price and non-price terms (such as notice periods and liabilities). However, another IPSP, also a challenger bank, told us that while it had been able to negotiate with its IAP, it had experienced difficulties in reaching a resolution, with liabilities and termination clauses causing particular problems. Further evidence from IPSPs confirmed that experiences were varied.<sup>108</sup> Some IPSPs told us that they have very little bargaining power, while others said they had been able to negotiate substantial reductions in price and other terms of access.
- 6.96** As we set out in Chapter 4, some agency IPSPs and larger non-agency IPSPs negotiate prices for indirect access. In part this reflects the fact that these IPSPs have greater bargaining power as they are typically larger, generate greater volumes, and are often associated with other potential revenue streams. IAPs told us that some agency IPSPs and larger non-agency IPSPs may also engage procurement professionals or external advisors to support them in the process, suggesting that these IPSPs do have a reasonable ability to negotiate better terms. However, this is not universally the case and one larger non-agency IPSP told us that its IAP was unwilling to negotiate on price, even after its volumes increased significantly.
- 6.97** We have only limited evidence around the ability of smaller non-agency IPSPs to negotiate. It was clear at our roundtable that a number of non-agency and smaller agency IPSPs had not attempted to negotiate around service quality or notice periods, and had been unsuccessful in attempts to negotiate over price. Where non-agency IPSPs are generating relatively small revenues and have few alternative supply options, they are likely to have more limited bargaining power.

### IPSP capability

- 6.98** In Chapter 4 we concluded that while overall satisfaction levels for indirect access were generally reasonable, it was low for FPS. A number of IPSPs said this limited their ability to offer the service that they wanted to their own customers.
- 6.99** However, IPSPs' technical and operational capability can in itself affect the services that they are able to offer customers. For example, while most might like to have 24/7 access, they may not have the capability to do so.
- 6.100** As part of our survey we asked IPSPs to tell us if they themselves lacked any capabilities – technological, resources or knowledge – which might limit their customer service offering. Around a third of respondents (22 out of 67) told us that they did lack some of these capabilities. For agency IPSPs, a lack of resources was cited as the main missing factor. Non-agency IPSPs cited technology as their biggest gap. Around 70% of respondents said that they did not currently have the capability to offer near real-time payments 24/7.
- 6.101** Taken together these factors suggest that the reason that some IPSPs feel they are less able to compete may only be partly attributed to the service offered by their IAP. In some cases the IPSP's own capabilities may be a contributory factor. Even if a superior quality of service (such as 24/7 access to FPS) were offered through aggregators or IAPs, a number of IPSPs would not have the capability to support this at this time and so would not be able to benefit from these developments.

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<sup>108</sup> IPSP roundtable.

## Our assessment of demand-side behavioural factors

- 6.102** Our analysis suggests that IPSPs in all categories face certain barriers to switching IAPs, which can reduce the competitive pressure on IAPs and prevent IPSPs from securing the best possible price and quality outcomes.
- 6.103** Barriers to switching limit IAPs' incentives to compete because the threat of their customers switching away is low, and the likelihood of winning new customers is also low. The difficulties in switching may also be a deterrent for new entrants because they are likely to find it hard to win customers, even if they have a favourable offering.
- 6.104** This means some IPSPs cannot always secure the best possible price and quality outcomes, either through switching or through negotiating a better deal with their existing IAP. This limits their ability to compete and innovate in the provision of payment services.
- 6.105** Many IPSPs, both agency and non-agency, appear to perceive difficulties with the switching process, in particular around business continuity and disruption. From the experience of those who have switched, this appears to be justified. The difficulty with the switching process can deter IPSPs from switching, even if they consider there to be improved price or quality outcomes with a different provider.
- 6.106** The costs of searching for and assessing alternative IAPs and then switching can be high, and for many agency IPSPs who have complex indirect access relationships, these costs may outweigh the potential price and quality benefits. For some non-agency IPSPs, there is also a more limited choice of IAPs who are willing to supply them, which acts as an additional barrier to switching (we explained in Chapter 4 why this is the case). The ability to switch IAP can be important in driving competition, and in Chapter 8, we discuss some developments that should make switching easier for IPSPs. We are also seeking input now about whether there is anything more we can do to assist in making switching easier as part of this review.
- 6.107** The evidence we have seen suggests that there is a reasonable level of negotiating ability and bargaining power amongst agency IPSPs, although this appears to be stronger for larger IPSPs. We have also seen evidence that some larger non-agency IPSPs are able to negotiate on price and other terms of access. However, we have limited evidence about smaller non-agency IPSPs' ability to negotiate. Given the limited choice many of these smaller non-agency IPSPs face, they are likely to have little bargaining power with their current IAP. This means they have little influence over the price they pay, the quality they receive, or other terms such as notice periods and liabilities. This limits some IPSPs' ability to compete and innovate in the provision of payment services.
- 6.108** We have also seen evidence that some IPSPs' technical and operational capability can in itself affect the services that they are able to offer customers (such as 24/7 access to FPS). Although around 70% of respondents said that they do not currently have the capability to offer near real-time payments 24/7, most IPSPs who responded to our survey did not consider their internal capability to be a significant factor which limited their customer service offering.

## Summary

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- 6.109** Our interim findings on behavioural factors which affect competition are:
- Financial crime regulation is a market characteristic that has an important influence on IAP behaviour (**Finding 6**). Some IAPs apply minimum revenue thresholds for new IPSP customers and have introduced de-risking policies for existing IPSPs – where they terminate access for customers perceived to be higher risk – in order to mitigate the perceived risks and costs

associated with financial crime (chiefly money laundering and terrorist financing). This has particularly affected small non-agency IPSPs.

- IAPs also have different commercial appetites for attracting new (and retaining existing) IPSP business. Some want to expand their IPSP activities, while others are more selective about which IPSPs they serve. Generally speaking, large agency IPSPs and medium (agency or non-agency) IPSPs are seen as most attractive, while many IAPs have only limited interest in smaller non-agency IPSPs.
- The rate of switching between IAPs is low for all categories of IPSPs (**Finding 7**). All IPSPs are concerned about potential service disruption if they do switch. Due to the complexity of agency relationships, for large agency and medium agency IPSPs this can be attributed to the cost, time and resources required.
- The transferability of sort codes in C&C currently also limits switching for agency IPSPs. However the new Image Clearing System for cheque payments will address this concern. For small non-agency IPSPs, lack of choice of IAPs is a key factor that makes switching difficult.
- As we explained in Chapter 4, IPSPs who face a limited choice of IAPs may not be able to obtain the services they would like, and have limited ability to negotiate on price and service terms. This may reduce competition and not be in the interests of service-users in the markets served by these small IPSPs.

**6.110** In Chapter 8 we consider possible measures for addressing our interim findings on the intensity of competition in the supply of indirect access. As discussed in Chapter 8 there are a range of measures that have or are being taken which should help to improve the switching process and reduce potential barriers to switching. We would welcome stakeholder comments on whether there are further technical or regulatory matters that can be addressed to further reduce switching barriers.

# 7

## Summary of interim findings and conclusions

- 7.1** This chapter summarises our interim findings regarding the supply of indirect access to interbank payment systems, based on the evidence we have collected and the analysis we have undertaken to date. Based on these findings, it then presents our interim conclusions regarding whether the supply of indirect access is working well for service-users.
- 7.2** In the following chapter, we set out and discuss our current thinking on how the supply of indirect access to payment systems might be improved.

### Overview of the provision of indirect access

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- 7.3** An important aim of this review was for the PSR to develop a deeper understanding of the supply of indirect access.
- 7.4** Indirect payment service providers (IPSPs) can be agency or non-agency IPSPs. Agency IPSPs have one or more unique sort codes which they need to provide certain payment services, such as the provision of payment accounts. Non-agency IPSPs generally provide payment services that do not require the use of unique sort codes, such as money remittance and card acquiring.
- 7.5** Our aim is to ensure that PSPs that need access to payment systems to provide competitive, innovative and dynamic services to their customers can get it without unnecessary barriers or burdens. We would prefer that an effectively competitive market deliver good outcomes for IPSPs and ultimately end users of payment systems, rather than us having to put in place additional regulatory measures. As discussed below, if there is not effective competition then we will consider using our regulatory powers to address the remaining issues.
- 7.6** Our work to improve direct access to interbank payment systems means this is becoming a realistic option for more PSPs. Developments in direct technical access, and the emergence of aggregators, are also changing the access options for some PSPs. However, these options are not available to all PSPs, and some will continue to rely on indirect access as the only way of accessing payment systems.
- 7.7** The most suitable access options for an individual IPSP will vary according to a number of factors, particularly the number of transactions it processes. A small non-agency IPSP would typically process no more than a few thousand transactions per year. A large agency IPSP would typically process in excess of ten million transactions per year.
- 7.8** The four largest UK retail and commercial banks – Barclays, HSBC, LBG and RBS – are the only indirect access providers (IAPs) supplying agency IPSPs.<sup>109</sup> They are also the primary indirect access suppliers to non-agency IPSPs. However, there are a number of additional IAPs that provide indirect access services to a relatively small number of non-agency IPSPs. This includes supply on a nested basis, which is where an IPSP provides indirect access to another non-agency IPSP.
- 7.9** Indirect access is rarely provided as a standalone service to most IPSPs. Rather, it is typically provided as part of a wider banking services relationship between the IPSP and IAP. Other services that IAPs

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<sup>109</sup> The Co-operative Bank still supplies indirect access to a small number of agency IPSPs, but is in the process of withdrawing from this activity.

may provide to IPSPs include international payments, and other financial products and services related to lending, deposits and risk management.

## Choice, service quality and price

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- 7.10** Another aim of this review was for us to understand the indirect access prices, services and choice that IPSPs receive from IAPs.

### Finding 1

- 7.11** The four main IAPs (Barclays, HSBC, LBG and RBS) all provide services to agency IPSPs and non-agency IPSPs. A number of other IAPs also provide non-agency indirect access services. However, **the choice available to some non-agency IPSPs appears to be limited, particularly for small IPSPs, and those perceived to be higher risk.**
- 7.12** If these IPSPs are not satisfied with the services they receive from their IAP they will have little or no power to negotiate with their IAP and little or no choice in finding an alternative IAP. Large IPSPs tend to have a wider choice of access options, and many are exercising that choice, including through alternative options such as direct access and aggregators. Work to date by the PSR has helped to make these alternative options available to a wider number of IPSPs.

### Finding 2

- 7.13** **Overall there is a reasonable level of satisfaction with the quality of indirect access offering that IPSPs receive. However, we have identified some service quality issues for each of the different categories of IPSPs.**
- 7.14** Large agency and medium agency IPSPs have concerns about the quality of technical access to FPS and its availability. This is a particular issue for banks and building societies given their customers' increased demand for real-time payments. Small non-agency IPSPs have raised concerns about notice periods for the termination of indirect access agreements and the relationship management provided by IAPs.

### Finding 3

- 7.15** The evidence on pricing is inconclusive. Analysis of different pricing indicators shows a wide spread in the prices paid by IPSPs for indirect access to each of the interbank payment systems. **Some IPSPs have expressed concern about prices, although the overall feedback we have received to date does not indicate a widespread level of concern with price. Large IPSPs tend to pay relatively lower prices and some do not appear to pay more for indirect access compared to the fees they could expect to pay if they were direct PSPs (DPSPs).**
- 7.16** The differences in price appear to be down to a number of factors, including: the level of the IAP's revenues from the wider commercial relationship with the IPSP; an IPSP's individual ability to negotiate and influence prices; tariff structures; volume of transactions; and how transactions are processed (e.g. batch or individual transaction processing).
- 7.17** Given that the pricing of indirect access services appears to be determined as part of a broader relationship between IAPs and their customers, we consider that some caution needs to be shown in drawing stronger conclusions based on the pricing information for indirect access only.

## Finding 4

**7.18 IPSPs receive indirect access services alongside other banking services as part of a wider commercial relationship. The provision of indirect access services does not appear to generate significant revenues for IAPs on a standalone basis.**

**7.19** In addition, the majority of IAP revenues from indirect access are derived from a small number of relationships with large IPSPs. The combination of low revenues and significant ongoing monitoring and compliance costs suggests that the commercial incentives for some IAPs to provide indirect access on a standalone basis to some IPSPs are limited.

## Factors affecting the number of IAPs

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**7.20** A further aim of this review was for us to understand the factors that influence the incentives for PSPs to become IAPs, or for existing IAPs to expand their service offerings.

## Finding 5

**7.21 While levels of entry and expansion into the supply of indirect access have historically been low, this appears to be changing. We are aware of four potential entrants planning to become IAPs.** They are responding to various commercial, technological, market and regulatory changes, and are all pursuing different business strategies.

## Behavioural factors influencing competition in indirect access provision

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**7.22** We also sought to understand the supply and demand-side behavioural factors that influence competition in indirect access provision. Our key findings relate to financial crime regulatory risk and the low rate of IAP switching.

## Finding 6

**7.23 Financial crime regulation is a market characteristic that has an important influence on IAP behaviour.** Some IAPs apply minimum revenue thresholds for new IPSP customers and have introduced de-risking policies for existing IPSPs – where they terminate access for customers perceived to be higher risk – in order to mitigate the perceived risks and costs associated with financial crime (chiefly money laundering and terrorist financing). This has particularly affected small non-agency IPSPs.

**7.24** IAPs also have different commercial appetites for attracting new (and retaining existing) IPSP business. Some want to expand their IPSP activities, while others are more selective about which IPSPs they serve. Generally speaking, large agency IPSPs and medium (agency or non-agency) IPSPs are seen as most attractive, while many IAPs have only limited interest in smaller non-agency IPSPs.

## Finding 7

**7.25 The rate of switching between IAPs is low for all categories of IPSPs.** All IPSPs are concerned about potential service disruption if they do switch. Due to the complexity of agency relationships, for large agency and medium agency IPSPs this can be attributed to the cost, time and resources required.

**7.26** The transferability of sort codes currently also limits switching for agency IPSPs. However, the new Image Clearing System for cheque payments will address this concern. For small non-agency IPSPs, lack of choice of IAPs is a key factor that makes switching difficult.

## Interim conclusions

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**7.27** An important aim of this market review was to consider whether competition in the supply of indirect access is working well for service-users.<sup>110</sup> The group of service-users most directly affected by the provision of indirect access is IPSPs. Through IAPs, IPSPs indirectly use the services provided by payment systems to provide payment services to their end users. If the supply of indirect access is working well, this will lead to better outcomes for IPSPs and can be expected to do the same for end users.

**7.28** Based on the data we have collected and the responses and information which have been given to us to date, our interim conclusion is that competition in the supply of indirect access is producing some good outcomes:

- large IPSPs have **a number of options** to access payment systems
- there is a reasonable level of **overall satisfaction with the quality** of the indirect access offering that IPSPs receive
- the overall feedback we have received to date does not indicate a widespread level of concern with **price**
- we are seeing **investment and innovation** in new and improved service offerings, which should improve quality and choice outcomes for all IPSPs

**7.29** However, we have identified specific concerns that limit competition and innovation in the provision of payment services, and the interests of service-users such as the people and businesses that use them. Our concerns are:

- While large IPSPs tend to have a wider choice of IAPs, and many are exercising that choice (for example through options such as direct access and aggregators), many small non-agency IPSPs have a **limited choice** of IAPs. This limited choice constrains the ability of these smaller non-agency IPSPs to negotiate on price, or to find an alternative provider if they are not satisfied with the services they receive.
- IPSPs in all categories are experiencing a number of specific **quality-related issues** with indirect access. Large agency and medium agency IPSPs, particularly banks and building societies, have concerns about the quality of technical access to FPS and its availability. Small non-agency IPSPs have raised concerns about notice periods for the termination of indirect access agreements and the relationship management provided by IAPs. These issues limit some IPSPs' ability to compete in related markets, such as retail banking.
- IPSPs in all categories face **barriers to switching** IAPs, which reduces the competitive pressure on IAPs and prevents IPSPs from securing the best possible price and quality outcomes.

**7.30** Although these concerns affect all IPSPs, the nature and extent of specific concerns differs among small, medium and large IPSPs.

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<sup>110</sup> PSR MR15/1.1, *Market review into the supply of indirect access to payment systems*, Terms of reference (May 2015), paragraph 1.5: <https://www.psr.org.uk/psr-publications/market-reviews/mr1511-final-terms-reference-indirect-access>

**7.31** These concerns limit competition and innovation in payment services, and the interests of service-users such as the people and businesses that use them.

**7.32** We consider these concerns are primarily a result of three market characteristics:

- **Industry responses to financial crime regulations:** The perceived risk of compliance failures under financial crime regulations influences the behaviour of IAPs. These responses could be limiting the provision of indirect access for some IPSPs.
- **Lack of entry of IAPs:** The historic rate of entry of new suppliers of indirect access has been low, which limits the competitive pressure on IAPs to improve their indirect access proposition and limits the choice available to IPSPs wanting to find an alternative provider.
- **Increase in demand for real-time payments:** When FPS was launched, IAPs primarily supplied FPS services to IPSPs based on the SWIFT messaging service, since they considered it was the most cost-effective and convenient option for IPSPs at that time. The growing demand in real-time services has since brought into question whether the technical solutions provided to IPSPs still meet customer needs.

**7.33** In Chapter 8 we set out a number of proposed steps to improve the supply of indirect access.

## 8

# Improving the supply of indirect access to payment systems

Our interim proposal is to principally focus our attention on supporting developments, some market-led, some led by PSR or other regulators, which have the potential to address the various concerns with the supply of indirect access we have identified. We will review any further evidence and responses to this report to assess the effectiveness and proportionality of our proposed approach for our final report. Our interim proposal is that we will monitor these developments and will consider taking further regulatory action either as part of this review, or if our concerns are not sufficiently addressed within 12 months.

- 8.1** This chapter sets out our early thinking on how the supply of indirect access to payment systems might be improved. The options set out in this chapter are in response to the interim findings and conclusions we set out in Chapter 7.
- 8.2** As set out below, a number of developments are underway or anticipated which we consider are likely to address the concerns we have identified. These developments, some market-led, some led by PSR or other regulators, are changing the way many payment service providers (PSPs) can access payment systems. Given these developments, our interim proposal is that we will monitor these developments and we will consider taking further regulatory action either as part of this review, or if our concerns are not sufficiently addressed within 12 months.
- 8.3** This chapter first discusses the developments which we consider, at this stage, could improve competition in the supply of indirect access to payment systems. However, in recognition of the fact that some of these developments may not come to fruition as expected, or may not have the anticipated effect in terms of improving indirect access to payment systems, we then set out our early thinking on possible, credible remedial options that could be considered in such circumstances.
- 8.4** We encourage stakeholders to consider our proposed approach and tell us whether they consider it is the most effective and proportionate way to improve the supply of indirect access.

### Current or anticipated developments that may improve outcomes for service-users

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- 8.5** A number of developments are occurring or anticipated which have the potential to address our concerns and improve outcomes for service-users. These developments include in particular:
- **Our programme of work on direct access:** We have introduced various measures to improve PSPs' ability to become DPSPs of interbank payment systems. These measures are expected to provide additional access options for larger indirect PSPs (IPSPs) in particular, and result in a greater number of PSPs gaining direct access to interbank payment systems. This could also increase the number of indirect access providers (IAPs). In response to our survey of IPSPs, at least 15 IPSPs said they plan to become direct PSPs in the next three years. Nine IPSPs currently have letters of intent with different operators of interbank payment systems to become direct PSPs.

- **Market entry and expansion:** We have been told of at least four businesses planning to become IAPs, and that two of the four main IAPs are seeking to expand and improve their indirect access service, over the next 1-2 years. Entry and expansion of IAPs should lead to greater choice for IPSPs, including small non-agency IPSPs, and increased competitive pressure on the IAPs currently supplying indirect access.
- **Improved IAP FPS access offerings:** Two of the four main IAPs are making investments, or rolling out products, which should offer agency IPSPs options for an improved quality of technical access to FPS (including 24/7 availability).
- **Improved direct technical access for IPSPs:** Alternative direct technical access models for interbank payment systems are emerging, including the development of aggregator arrangements for FPS. Further, both Bacs and FPS are currently undertaking reviews of their access models, and access options for C&C are also set to improve as part of the development of the Image Clearing System. These developments should provide improved technical functionality and choice for IPSPs. In relation to existing direct technical access options, we note the conclusion of our market review into the ownership and competitiveness of infrastructure provision that there generally appears to be effective competition in the provision of gateway solutions and that PSPs have enough choice of providers.<sup>111</sup>
- **Development of the Image Clearing System:** The Image Clearing System for cheques is aiming to make sort codes fully transferrable, which should improve the ability of agency IPSPs to switch IAP.
- **The Bank of England's strategic review of its real-time gross settlement (RTGS) infrastructure:** The Bank of England is currently reviewing its settlement account policy in response to changes in payments arising from 'technological innovations' and 'a more dynamic focus on competition and innovation driven by the PSR'. The review, which will take place during 2016, will consider the demand for access to settlement accounts from different types of institutions as well as the risks involved in extending access.
- **IAP Code of Conduct:** In our policy statement PS15/1 (March 2015), we set out our expectations on industry to develop an IAP Code of Conduct. On 1 September 2015, Payments UK, working with us and the four main IAPs published an interim Code of Conduct setting out a range of measures and commitments to improve indirect access to interbank payment systems. These include the ability to request a written contractual agreement from an IAP, the communication of important information, a commitment from IAPs to support IPSPs during a transitional period when becoming a DPSP or when switching to another IAP, and treatment of IPSPs' confidential information. We welcomed the interim Code of Conduct and we will work with industry to finalise it. We expect it will improve business continuity concerns associated with switching.
- **Information-related initiatives:** The PSR's Sponsor Bank Information Direction (Specific Direction 1) requires the four main IAPs to publish access-related information. The industry has also developed an information hub to improve the disclosure and transparency of information for PSPs wishing to access interbank payment systems. Taken together, these information-related initiatives are expected to increase transparency and reduce the search costs PSPs incur when getting information about different IAP services and could incentivise switching.
- **Reviews of financial crime regulation:** We are aware of at least six reviews underway or recently concluded which may affect the way financial crime regulation applies in the UK and internationally. These reviews are aimed at improving the transparency, clarity and effectiveness of the UK's anti-money laundering and counter terrorist financing framework. For example, the FCA has responded to de-risking by clarifying the requirements for banks to manage financial crime

<sup>111</sup> <https://www.psr.org.uk/psr-publications/market-reviews/MR1522-interim-report-infrastructure-provision>

risks.<sup>112</sup> It has also commissioned research to gather evidence about the nature, scale and drivers of the issue, and plans to publish a report shortly.

- **Payments Strategy Forum (the Forum):** The Forum is an independent body that we set up in 2015 to guide the industry's strategy for collaborative innovation. One of the Forum's working groups will 'examine whether and how payment systems can be developed to simplify access'. The Forum's work on common messaging standards, the simplification of the rules, governance and structure of payment system operators and the use of aggregators to support access across more than one payment system could make it easier to gain access and switch IAPs.

Another working group will consider centralised functions aimed at preventing financial crime and ways to reduce the costs of compliance. This could increase the incentives for some IAPs to provide indirect access. The Forum is expected to publish a draft report in July 2016 and its final strategy in October 2016.

- **The CMA's proposed measures to improve switching as part of its Retail Banking Market Investigation:** Among the CMA's proposed remedial measures are: (i) to prompt customers to review their business current account provider at times when they may have a higher propensity to change; and (ii) to increase the awareness of the potential savings or rewards that could be obtained by changing business account provider. These measures could help some smaller IPSPs who receive indirect access primarily through a business bank account with their IAP. The statutory deadline for the CMA to publish its final report is 12 August 2016.
- **Current Account Switch Service (CASS):** CASS provides a guarantee to banking customers that they can switch their bank in seven days. It supports businesses with an annual turnover and/or balance sheet total that does not exceed £6.5 million and that employ fewer than 50 people. A number of small, non-agency IPSPs who get indirect access through a business bank account are likely to be under this threshold, so it could help to address their concerns about business continuity when switching.

**8.6** Table 12 shows how these developments could address the specific concerns we have identified for the different categories of IPSP.

<sup>112</sup> <https://www.fca.org.uk/about/what/enforcing/money-laundering/derisking>

**Table 12: How developments could address our specific concerns**

IPSP type	Access options	Main Concerns for some IPSPs	Developments
<b>Large agency</b> e.g. challenger bank, building society, acquirer	<ul style="list-style-type: none"> <li>• Direct access</li> <li>• Direct technical access (e.g. via an aggregator)</li> <li>• Indirect access</li> </ul>	<p><b>Quality:</b> 24/7 access to FPS (if indirect)</p> <p><b>Switching:</b> Costly, complex, time-consuming</p> <p><b>Switching:</b> Business continuity</p>	<ul style="list-style-type: none"> <li>• Our direct access programme is making direct access an easier option.</li> <li>• Payment systems operators' access programmes should improve the quality of access and provide additional access options, including technical access to FPS through an aggregator.</li> <li>• Improved IAP FPS access offerings should offer options for an improved quality of technical access to FPS.</li> <li>• The Code of Conduct should help address business continuity concerns.</li> <li>• Market entry and expansion ([&amp;lt;], Raphaels and [&amp;lt;]) should provide new IAP choices.</li> <li>• The Forum's work on simplification of access should help switching.</li> <li>• Bank of England review of RTGS will consider the demand for access to settlement accounts from different types of institutions.</li> <li>• Development of the image clearing system should improve the ability of agency IPSPs to switch IAP.</li> <li>• Our Sponsor Bank Information Direction should increase transparency and reduce the search costs which could incentivise switching</li> </ul>
<b>Medium agency or non-agency</b> e.g. smaller bank and building society, large money remitters	<ul style="list-style-type: none"> <li>• Direct technical access (e.g. via an aggregator)</li> <li>• Indirect access</li> </ul>	<p><b>Quality:</b> 24/7 access to FPS (if indirect)</p> <p><b>Switching:</b> Business continuity</p> <p><b>Choice:</b> Could be limited for some</p>	<ul style="list-style-type: none"> <li>• Payment systems operators' access programmes should improve the quality of access and provide additional access options, including technical access through an aggregator. It should also increase IPSPs' bargaining power.</li> <li>• Improved IAP FPS access offerings should offer options for an improved quality of technical access to FPS.</li> <li>• The Code of Conduct should help address business continuity concerns.</li> <li>• Market entry and expansion ([&amp;lt;], Raphaels and [&amp;lt;]) should provide new IAP choices.</li> <li>• Bank of England review of RTGS will consider the demand for access to settlement accounts from different types of institutions.</li> <li>• Our direct access programme is making direct access an easier option.</li> <li>• Our Sponsor Bank Information Direction should increase transparency and reduce the search costs which could incentivise switching.</li> <li>• Development of the image clearing system should improve the ability of agency IPSPs to switch IAP.</li> <li>• The Forum's work on simplification of access should help switching. While its work on financial crime is looking at ways to reduce the costs of compliance, and potentially increase the incentives for some IAPs to provide indirect access.</li> </ul>

IPSP type	Access options	Main Concerns for some IPSPs	Developments
<b>Small non-agency</b> e.g. electronic money institution, money remitters, credit unions	<ul style="list-style-type: none"> <li>Indirect access</li> </ul>	<b>Choice:</b> Limited <b>Price:</b> Little bargaining power <b>Quality:</b> Relationship management <b>Switching:</b> Short notice periods <b>Switching:</b> Business continuity	<ul style="list-style-type: none"> <li>Market entry and expansion ([&lt;], Raphaels, [&lt;]) should increase IAP choices and therefore IPSPs' bargaining power.</li> <li>Payment systems operators' access programmes may encourage more PSPs to become IAPs, which should increase IAP choice and IPSPs' bargaining power.</li> <li>Financial crime reviews may support change in IAP behaviour, which may increase choice.</li> <li>Our Sponsor Bank Information Direction should increase transparency and reduce the search costs which could incentivise switching.</li> <li>The Forum's work on simplification of access should help switching. While its work on financial crime is looking at ways to reduce the costs of compliance, and potentially increase the incentives for some IAPs to provide indirect access.</li> <li>The Code of Conduct should help address relationship management, short notice periods and business continuity.</li> <li>CASS and CMA work may help the switching process.</li> </ul>

- 8.7** We consider effective competition in the provision of indirect access to be an important, and our preferred, means to deliver good outcomes to service-users. We propose to focus our attention on supporting the market and regulatory developments set out above, which have the potential to improve choice, quality and price outcomes for all categories of IPSP.
- 8.8** The paper published alongside this interim report, *Indirect access to payment systems: insights from access theory and practice*, discusses regulatory approaches when a market is undergoing change.<sup>113</sup> In some settings, even when actual or potential access problems are identified, the approach adopted has been to forbear from introducing any specific remedies. In most cases, the forbearance approach has been based on an assessment that the market is undergoing rapid and significant change, and that this change is likely to mitigate actual or potential access problems.
- 8.9** We will review any further evidence and responses to this report to assess the effectiveness and proportionality of our proposed approach for our final report. We will monitor these developments and we will consider taking further regulatory action either as part of this review, or if our concerns are not sufficiently addressed within 12 months. We will intervene only where we have clear evidence that we need to do so and where we expect the benefits of our regulation will outweigh any costs or unintended consequences.
- 8.10** We recognise that switching IAP can be important in driving competition. Some developments should make switching easier for some IPSPs: CASS could help address smaller IPSPs' concerns about business continuity when switching, the CMA's proposed measures could help smaller IPSPs to switch IAP and the Forum could make it easier and simpler for larger IPSPs in particular to get access and switch IAPs. We are also seeking input now about whether there is anything more we can do to assist in making switching easier as part of this review, or in the event that developments do not improve the ability to switch IAP for those IPSPs who wish to.
- 8.11** We also have powers under the Financial Services (Banking Reform) Act 2013 (FSBRA) and UK and EU competition law to further address or investigate individual cases relating to the supply of indirect access. We are also developing a framework for how we will handle applications to take specific

<sup>113</sup> <https://www.psr.org.uk/psr-publications/market-reviews/MR1512-access-theory-and-practice-report>

regulatory action regarding granting of new access or varying existing access terms (under sections 56 and 57 of FSBRA). We intend to consult on this framework either as part of or alongside our final report for this market review.

- 8.12** Further regulatory developments are also expected to be implemented into UK law in accordance with the requirements of Articles 35 and 36 of the second EU Payment Services Directive (PSD II). These provisions include rules for objective, non-discriminatory and proportionate access to payment systems and full reasons for any rejection to be provided to PSPs and/or the authorities.
- 8.13** The other financial regulators, the Financial Conduct Authority, the Bank of England and the Prudential Regulation Authority also have a common regulatory interest in access to payment systems. In addition, in discharging our general functions, we must have regard to financial stability considerations and how our work could impact on the stability of, and confidence in, the UK financial system. We will take a lead on matters relating to access to payment systems for PSPs, but we will continue to coordinate with the other authorities, in particular on matters relating to financial crime regulation and on issues such as access to bank accounts.

### **Remedial options if current and anticipated developments do not sufficiently address our concerns**

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- 8.14** As discussed above, at this stage, we consider that market and regulatory developments should improve the supply of indirect access to interbank payment systems and address the concerns we have identified.
- 8.15** Indirect access has been, and will remain, a priority area in our ongoing work programme. Our interim proposal is that we will monitor these developments and we will consider taking further regulatory action either as part of this review, or if our concerns are not sufficiently addressed within 12 months.
- 8.16** In this section, we set out our early thinking on possible and credible remedial measures that could be introduced if current and anticipated developments do not sufficiently address our concerns. Before setting out the options, we set out the principles that we will apply when considering them, and some observations on the context in which they would be applied.

### **Principles for considering possible remedies**

- 8.17** In considering possible remedies, our approach is guided by how far they might advance one or more of our payment system objectives. These are to promote:
- effective competition in the market for payment systems and the markets for services provided by payment systems in the interest of service-users
  - the interests of service-users
  - innovation in payment systems in the interest of service-users

**8.18** As discussed in our guidance<sup>114</sup>, we have a range of options that we could explore in developing the potential remedies. Some of these are actions we can take, some are actions we can ask others to take. These include:

- making new, or amending existing, directions
- making directions on specific participants or categories of participant
- requiring the disposal of all or part of an interest in an infrastructure provider and/or payment systems operator in relation to a regulated payment system
- making recommendations for further industry initiatives or enhanced industry self-regulation
- making proposals to the Bank of England, FCA or Prudential Regulation Authority as appropriate
- publishing guidance
- asking the Competition and Markets Authority to consider investigating the market(s)

**8.19** In developing remedies our priority is measures that will be effective in addressing the problems we have identified. We will also ensure that our remedies are proportionate. For example, if there are several effective remedies we will choose the least onerous one.

**8.20** When deciding on our remedies – both individually and as a package – we will consider:

- (a) Effectiveness:** The remedy must address the problem(s) which we have identified and be practicable to implement, monitor and enforce. We will take account of current laws and regulations, as well as those expected in the near future. We will also consider the way in which the remedies interact with each other.
- (b) Proportionality:** The remedy needs to solve the problem(s) we have identified in a way which is no more onerous than necessary. For example, if there is a choice between two equally effective remedies, we would choose the option that is least intrusive. The remedy should also not produce disadvantages which are disproportionate to its aim.
- (c) Consistency:** How the remedy (or package of remedies) fits in with our other policies and actions relevant to the provision of indirect access, including the work of the Payments Strategy Forum.

**8.21** For example, in relation to the latter we note the Forum's ongoing work in respect of simplifying access to markets and financial crime. The Forum is expected to publish a draft report in July 2016 and its final strategy in October 2016. The outcomes of these working groups are relevant to our consideration of the remedies – in particular, whom we address the remedies to, the timing of their implementation and longer-term developments in the market.

### The context in which measures will be applied

**8.22** In considering possible remedial measures we will take account of key contextual factors which condition the supply of indirect access. Failure to account for these factors is likely to give rise to unintended consequences and could detract from the effectiveness of any measures in promoting service-users' interests. Among the most important contextual factors:

- Indirect access is characterised by a structure where there are a number of suppliers of indirect access. The industry is not a monopoly with a single provider of indirect access.

<sup>114</sup> PSR PS15/2.2, *Market reviews, market studies and market investigation references: A guide to the PSR's powers and procedures* (Markets Guidance) (August 2015): <https://www.psr.org.uk/markets-guidance>

- There is scope for entry into the supply of indirect access services by DPSPs of payment systems who have chosen not to be IAPs, or who have to date adopted a selective approach to who they serve.
- Some IPSPs have substitution possibilities, including becoming a DPSP of a payment system, or obtaining direct technical access of some payment systems, including through an aggregator arrangement.
- Some IAPs may have incentives to exit the market, or certain segments of the market, if they consider that any remedial measures expose them to greater risk or potentially impact adversely on other aspects of their activities.
- The effectiveness of some remedies may be conditioned by the risks associated with compliance failures in respect of financial crime regulations. Exposures to these risks have an important impact on the incentives of IAPs to supply indirect access to certain IPSPs. As discussed in Chapter 6, these risk exposures have UK, EU and international dimensions.
- Various policy developments at the European level have the potential to change how PSPs access payment systems in the future, and the terms on which indirect access is supplied. Important among these are proposed access requirements for accounts maintained with a credit institution as contained in Article 35 of the Payment Services Directive 2 (PSD II).

**8.23** At the start of this review we commissioned a report, which was completed in July 2015, which considers in more detail the relevant context for considering indirect access to payment systems, drawing on relevant economic theory, and the experience of regulatory practice. We are publishing that report alongside this interim report.<sup>115</sup>

### Early thinking on remedial options

**8.24** At this stage of our review we are outlining our early thinking on possible remedies that could be introduced should current and anticipated developments fail to sufficiently address our concerns and improve indirect access. We are asking stakeholders for their views to help us in our further consideration of these options. Our final report will set out any proposed remedies with supporting analysis and relevant considerations. We will consult on such proposals as appropriate.

**8.25** In setting out our early thinking on remedial options we appreciate that there is a balance to be struck between identifying remedies that might be introduced in the future and the potential impact that this could have on some of the developments described above. In particular, we recognise that by setting out remedies that could be introduced, we could potentially stifle some market developments (e.g. entry by potential new DPSPs or IAPs, or the development of new forms of alternative access arrangements). This could have the unintended consequence of limiting the expansion of choice which would have occurred otherwise.

**8.26** Nevertheless, we think it is important to be transparent about our thinking, and to invite views on what types of credible remedial options could be considered once we have monitored current and anticipated developments for 12 months and if those which have occurred have not sufficiently addressed the concerns we identified. However, we emphasise that, at this stage, we are merely inviting views on options that could be considered in those circumstances, rather than advocating any particular remedial measure. This would require a fuller assessment of the costs, benefits and impacts of each remedial measure.

<sup>115</sup> <https://www.psr.org.uk/psr-publications/market-reviews/MR1512-access-theory-and-practice-report>

### **Choice**

- 8.27** In the event that current and anticipated developments do not expand the choice of IAPs that some IPSPs have, one possibility is to consider using our statutory powers to issue a direction which requires all DPSPs to act as IAPs (or to act as IAPs in relation to, for example, non-agency IPSPs). Variations on this option could include applying such a direction to certain categories of DPSP (for example those above a certain size), or to the provision of indirect access to certain categories of IPSP (for example non-agency IPSPs). We could also consider issuing a direction which requires all PSPs who are able to (or subsets of PSPs such as banks) to become direct participants of specified interbank payment systems. These measures could, in theory, expand the choice of IAPs available to IPSPs.

### **Quality**

- 8.28** Should current developments fail to improve the quality-related concerns we have, one option we could consider is to issue a direction which requires IAPs to satisfy specific minimum quality standards (including in relation to contract terms) and termination notice periods.
- 8.29** Another option to address the specific concerns about the quality of access to FPS might involve issuing a direction requiring all FPS DPSPs to provide an equivalent quality of service to the IPSPs (or a subset of IPSPs such as agency IPSPs) they serve in terms of speed, availability, prices and processes, as they provide to their own downstream retail activities.

### **Price**

- 8.30** Should developments fail to result in an increased choice of IAPs and corresponding improvements in price outcomes for those IPSPs who are currently not satisfied with the price of indirect access, there are a number of possible regulatory options which could be taken to improve the pricing outcomes for these IPSPs. One possibility is to set a specific, or maximum, price for indirect access, or introduce charge controls. Another possibility is to introduce a requirement on IAPs to introduce measures which could improve transparency of prices. This could include requiring IAPs to publish and adhere to price lists, thereby enabling all IPSPs to see the prices that are being charged for indirect access across IAPs. Any remedies relating to price will require consideration of how indirect access is priced as part of the wider supply relationship.

### **Switching**

- 8.31** We recognise that switching IAP can be important in driving competition, and we are therefore seeking input now about whether there is anything we can do to assist in making switching easier. There are various possibilities we can consider as part of this review, or in the event that developments do not improve the incentive and ability to switch IAP for those IPSPs who wish to. Among the options are: the firming up of existing switching guarantees to all IPSPs to mitigate concerns about business continuity; examining how the switching process could be further standardised or made easier; extending a CASS-like switching process to a wider category of smaller IPSPs who obtain indirect access through a business bank account; and imposing requirements on IAPs to provide more regular and transparent information to enable IPSPs to make meaningful comparisons of different IAP offers.

## 9 Next steps

During the next phase of this market review, we will:

- continue to engage with relevant stakeholders, including undertaking a consultation on this interim report
- reflect on feedback we receive on the interim report, amend our conclusions as appropriate and consider in more detail our proposed approach
- publish the final report, setting out our final conclusions
- consult, as appropriate, on any policy interventions proposed in the final report

**9.1** Indirect access will remain a priority area in our ongoing work programme. The purpose of sharing our thinking through this interim report is to engage with stakeholders on our findings and our approach to improving indirect access to interbank payment systems. We will review any further evidence and responses to this report to assess the effectiveness and proportionality of our proposed approach for our final report. Our interim proposal is that we will monitor these developments and we will consider taking further regulatory action either as part of this review, or if our concerns are not sufficiently addressed within 12 months.

**9.2** If we consider that further regulatory action is required, the next stage would involve a formal assessment of the effectiveness and proportionality of any measures we propose, a full consideration of the matters to which we need to have regard under FSBRA, and a consultation with stakeholders. When considering potential regulatory action, we will consider the constraints from relevant EU and domestic initiatives.

**9.3** We welcome views on our interim conclusions, the questions below (which are reproduced in Annex 6 of this interim report), and our proposed approach. We also set out below a number of questions to help inform our assessment.

### Consultation questions

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1. Do you agree with our interim findings? Please provide evidence to support your response, in particular if you disagree with our findings.
2. Have we identified the key concerns with the supply of indirect access to interbank payment systems? If not, please identify any other key concerns you have and to the extent possible provide evidence to support your comments.
3. Do you think that the current and anticipated developments we have listed are likely to address the concerns we have identified?

4. What other steps could we take to promote or support the developments, in particular the entry of new IAPs and/or expansion of existing IAPs/direct PSPs, or any further steps we could take to make the process of switching easier/more transparent? In particular, are there any technical or regulatory matters that are acting as barriers to switching, which we could seek to address?
5. Are there any important developments that are likely to affect the supply of indirect access that we have not identified in this interim report? If so, please also set out the timelines for these developments, and any factors that might impact on the likelihood of them occurring. Please also indicate how you think these developments might address the concerns we have identified.
6. If the developments do not sufficiently address the concerns we have identified in the next 12 months, what action, if any, do you consider we should we take at that point? What would be the advantages and disadvantages of such action?
7. Is there any regulatory or other action that you consider we should take now? What would be the advantages and disadvantages of such action?

## Stakeholder feedback

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- 9.4** We welcome views on our interim conclusions, the consultation questions above (which are reproduced in Annex 6 of this interim report), and our proposed approach.

Please send your comments (in electronic Word and PDF versions) by 5 May 2016 to [iamr@psr.org.uk](mailto:iamr@psr.org.uk).

Or in writing to:

Indirect Access Market Review Team  
Payment Systems Regulator (15<sup>th</sup> floor)  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

## Final report

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- 9.5** We expect to publish the final report in July 2016. This report will set out our finalised conclusions and approach to improving the supply of indirect access.
- 9.6** We will also consult, as appropriate, on any proposed policy interventions aimed at improving the supply of indirect access.

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