FINANCIAL CONDUCT AUTHORITY
PAYMENT SYSTEMS REGULATOR

Market review into the ownership and competitiveness of infrastructure provision – Final Report

Responses to Final Report

September 2016

Contents

Payment Systems Regulator
Infrastructure market review team
25 The North Colonnade
Canary Wharf
London E14 5HS

22 September 2016

PSR MR15/2.3/KMH/20160921

Introduction

Bacs Infrastructure Market Review Response

Bacs are pleased to respond to the Payment Systems Regulator's (PSR) Final report 'Market Review into the ownership and competitiveness of infrastructure provision' (MR15/2.3).

In our response we have provided comments in respect of the potential remedies that either apply to Bacs or affect the manner in which we currently conduct our business.

Specifically we are responding to the potential remedies covering:

- The competitive procurement of core infrastructure services for Bacs, FPS and LINK; and
- Interoperability and messaging standards.

We will also comment, where appropriate, in respect of the third potential remedy covering the 'ownership of VocaLink'.

Overall, to support the selection of the proposed infrastructure remedies being proposed in the Final report, our view is that it would be helpful to conduct an independent full and comprehensive evaluation and analysis of the proposals. Adopting this approach will also provide the UK with the level of analytical rigour we think is necessary to justify the recommendations and will also help measure the effectiveness of change.

Please see the attached Appendix for our response to the potential remedies in the PSR Final report.

Yours sincerely

Appendix

Bacs comments and responses to MR 15/2.3 Market Review into the Ownership and Competitiveness of Infrastructure Provision – Final Report: Potential Remedies

1. Competitive Procurement Exercises

In a competitive market for infrastructure supply and where there is a clear reason to do so, we think PSOs should undertake competitive procurement exercises. Of the four high level options outlined in paragraph 8.57, page 126 of the Final report we think a modification of option c. may be the most appropriate, if our favoured option a. is to be discarded.

We do not favour the appointment of an independent third party to carry out the procurement exercises. In our view PSOs are the only entities who should be responsible for procurement and part of that is ensuring the process they elect to use stands up to external scrutiny. We therefore propose an independent audit is developed to assess the manner in which a PSO carries out the competitive procurement process.

If PSOs – including Link - are going to be mandated to carry out competitive procurement exercises (option c.) there are arguments for and against carrying out such an exercise as:

a. A ‘big bang’ right across the industry;

b. Phased by PSO / payment service provided (e.g. for all or some of Bacs services, followed by Faster Payments or vice versa); or,

c. With some form of parallel running across the outgoing and incoming supplier.

Our natural inclination in respect of the above is for a prudent (possibly more expensive) approach because any form of failure by the selected supplier is not an option once formal notification from PSOs to terminate contracts with an existing supplier has been delivered. We believe that the PSR would be required to consider the ramifications of this potential remedy carefully before triggering a sequence of events that may prove difficult to unwind. In this regard we are specifically referring to the possibility that a winning bidder does not, or cannot, deliver as promised for any reason. In addition, aspects such as liability for failure, Guarantees and compensation may need to be factored in.

The specified date / timeline for a competitive procurement exercise must be discussed and agreed with the PSOs individually, and also collectively (as a separate exercise), once the full ramifications and consequences of this approach (intended and unintended have been fully thought through). Part of this should include an independent benchmarking survey (as described below) for and on behalf of the PSOs individually and/or collectively.

Bacs’ current core services contract with VocaLink can be terminated on or after 1 December 2020, with 24 months’ prior notice (i.e. notice can be given from 1 December 2018). Our contract provides a right for Bacs to benchmark the charges for, and quality of, services from VocaLink and we are planning to initiate this exercise as part our next core service procurement. This approach to procurement enables us to interrogate the market effectively and help us identify any potential barriers to participation.

2. Interoperability and Messaging Standards

Adoption of a common messaging standard is already a major part of our company strategy. This means all 'green field' developments adopt ISO20022 from the outset, whereas we take a more measured approach in cases where existing products are used extensively by different organisations ranging in size and capability.

That said we are keen to remove this perceived barrier to entry and have commented on the potential opportunities for interoperability that a common messaging service may offer.

We favour the approach suggested in the Final report (paragraph 8.72, page 128) where connectivity and central infrastructure provision is 'unbundled'. This approach sits well with the existing market driven activity we already have underway to offer and deliver a wider range of aggregator service options. These services will incorporate, but be broader than, our existing aggregator solution (in existence now for many years) and will include greater choice and flexibility, catering for different needs and expanding organisation types.

We have noted the PSR concerns about the above (as noted in paragraph 8.81), and do not think such an approach necessarily precludes alternative infrastructure supply options going forward. If anything we think it has the potential to de-risk and facilitate the development of new model options that could challenge existing frameworks where proven economic benefits help justify implementation. We also believe such an approach will actively foster competition.

We do not think option 2 (page 128 – Mandating the adoption of an international standard and the approach to be used) is the right approach. In our opinion it makes more sense for the regulator to be clear about the market requirements and characteristics applicable for such a standard (and the industry in general), rather than mandating standard itself.

The responsibility for periodically reviewing the options (perhaps with a minimum 5-year gap between review periods, unless there is market demand to review sooner) and selecting the right international messaging standard should lie with PSOs collectively. This should be a formalised activity where the PSO's share the responsibility to commission the assistance of Subject Matter Experts (SMEs).

Within our response we have flagged our already-established approach to adopting the ISO20022 messaging standard and would highlight some of the not inconsiderable challenges to users of Bacs payment products that would need to be overcome with a full (time-boxed) transition to a single messaging standard.

Use of Bacs products (Bacs Direct Credit and Direct Debit) is central to the UK economy; almost everyone's salary, pension and welfare payment is paid by Bacs Direct Credit and virtually all electronic utility and other regularly paid payments utilise Direct Debit. Around six billion annual payments originate from over 130,000 Bacs service users ranging from small and micro businesses to multi-national companies. Therefore, a change in messaging standards would need to be scoped appropriately so that it meets the established requirements of the end-to-end value chain in payments and be justified in terms of the increased cost (that may be transferred on to end users) and complexity by the people using it.

We also urge the PSR to ensure there is strong alignment between the Payment Strategy Forum's Simplifying Access Working Group and their work in this area.

3. Ownership of VocaLink.

We acknowledge the regulatory desire to divest PSP interest in VocaLink. Before any significant change is initiated we would urge the PSR to assess the changes happening elsewhere within the industry, which together form a significant change from the current structure.

We think that it would be helpful to conduct an impact assessment of the proposals before embarking on change. By taking a more cautious approach the law of unintended consequences could be avoided along with the possibility that such measures (if rushed) could introduce risk to UK payment systems not previously observed. If customer confidence in the UK payment systems is impacted it would be difficult to see how that could be recovered in the short to medium term (e.g. within 5-10 years).

We recognise that there is no such thing as a guarantee against commercial failure; however the current ownership model offers some comfort in this regard. Stripping this away may seem like an obvious solution along with the introduction of competitive tendering, citing a levelled playing field as the benefit. However the possibility of introducing a model that triggers an upward spiral in payment prices for end users must be recognised as one outcome of a view that Infrastructure provision in the UK should be an unfettered commercial enterprise rather than a quasi-utility. As things stand today end users are protected through the rigorous infrastructure contract renewal process undertaken by PSOs.

It is for the above reasons that we believe any change in this area needs to be critically assessed and underpinned with appropriate evidence so that the change when implemented does not bring unintended consequences to the UK payments industry or its users.

Memo

14 September 2016

To Payment Systems Regulator
Infrastructure market review team
25 The North Colonnade
Canary Wharf
London E14 5HS

From The Cheque and Credit Clearing Company

MR15/2.3 - MARKET REVIEW INTO THE OWNERSHIP AND COMPETITIVENESS OF INFRASTRUCTURE PROVISION

The Cheque and Credit Clearing Company (C&CCC) welcomes the opportunity to respond to the Payment System Regulator's "MR15/2.3 – Market review into the ownership and competitiveness of infrastructure provision".

Background

The Cheque and Credit Clearing Company (C&CCC) was established in 1985 and, from that time until the present day, is proud of its record in providing members with the central payment system services for the exchange and settlement of cheques and credits.

Our objective is to ensure that cheques and credits remain a viable, secure and efficient choice of payment for all users. To achieve this we promote innovation and competition choice by driving improvements in processing, service and efficiency; and provide a trusted centre of excellence for anyone with an interest in cheques or credits.

In the evolving payments landscape, cheques and credits remain a preferred and trusted payment option among certain groups and for certain types of payment. For example, cheques remain a convenient way for businesses to pay a trade supplier and manage cash flow, and amongst consumers, are a popular way to pay utility bills, tradespeople and clubs or societies. Over the past year, nearly 9 in 10 UK charities and two-thirds of UK businesses both received and made payments by cheque over a monthly period. In total, 558 million cheques were written in 2015 with a total value of £624 billion.

C&CCC is working to deliver the Image Clearing System (ICS), which will bring the cheque into the digital age via the implementation of an image-based cheque clearing process in the UK.

A full account of our background and objectives can be found on our website, as can more information on the Image Clearing System.

Response

Section 6: Ownership and Control of Payment Systems

The Cheque and Credit Clearing Company (C&CCC) is a non-profit making industry body funded by its Members. The company is limited by shares. In total there are 11 shares with one vote each, one for each Member.

Each member is allowed to appoint one director. Banks, which are part of a larger banking group, are limited to one director per group. So each unique Member (or group) has the right to appoint a director and a vote at Board. The Bank of England, although a Member, has not appointed a director but is an observer at Board with no voting rights. There are therefore eight Member appointed directors on the Board of the company. Additionally the CEO, the two independent directors and the independent Chair also have seats on the Board and voting rights. Therefore, there are a total of 12 votes on the Board and a resolution needs 75% of votes to pass and it is only valid when there is a 75% quorate. It therefore takes four votes to block a resolution and nine to approve.

The ownership and control of C&CCC is therefore significantly different to other Payment System Operators (PSOs). However, the voting model used by C&CCC (as described above) ensures that one PSP, or a small group, cannot 'control' a vote.

In the PSR's examination of the ownership and governance arrangements of the operators by PSPs we were surprised to see C&CCC omitted.

Section 8: Potential remedies

Remedy 1: Competitive procurement exercises

We support a remedy that encourages a competitive procurement process as this will increase competition in the provision of central infrastructure services. As the review rightly points out, this will benefit service-users by introducing more efficient and innovative service offerings. However, such a process should be owned by the Operators with no third party involvement. The Operators should remain responsible for procurement and devise a procurement strategy which is agreed by its Board. The strategy should include competitive tender to an appropriate timetable.

Remedy 2: Interoperability and messaging standards

C&CCC is in full support of common messaging standards. The Image Clearing System (ICS) (being delivered by C&CCC) will be ISO20022 compliant.

The Payments Strategy Forum has asked members of the payments community for comments on their proposals to move the UK to a modern payments messaging standard. To avoid duplication and confusion, this review may wish to wait until the outcome of the Payments Strategy Forum's draft strategy for consultation before making final remedies in this area.

Please let us know if you would like any clarification.

Yours faithfully

14 September 2016

To Infrastructure Market Review Team
Payment Systems Regulator
25 The North Colonnade
Canary Wharf
London E14 5HS

FASTER PAYMENTS SCHEME LIMITED RESPONSE TO THE MARKET REVIEW INTO THE OWNERSHIP AND COMPETITIVENESS OF INFRASTRUCTURE PROVISION – FINAL REPORT

FPSL welcomes the opportunity to respond to the Payment Systems Regulator's (PSR) proposed high level options for potential remedies in the Market Review - Final Report.

Since the launch of the Market Review in 2015, we have been engaged with the PSR and will continue to do so to support them in advancing their statutory objectives to promote effective competition, to promote innovation and to ensure payment systems are operated and developed in the interests of all service users. We broadly support the potential remedies being proposed based on the PSR's findings in their Final Report.

In this letter we detail our views on the specific high level remedies proposed in the Final Report.

Remedy 1 – Competitive Procurement exercises

As noted in the Final Report, FPSL intends to procure a successor to its current managed outsourced technology provision in time for the end of its current contract in 2020 using a competitive tendering process. FPSL is developing a target business/technical architecture for its current and future services and will be developing a technology and procurement strategy, working with service users and the Payments Strategy Forum final strategy which is expected at the end of this year. Against this background, FPSL has the following comments for each of the proposed remedy options in this area:

- **Option A** – In the next few years, FPSL will be building on its own procurement and tendering experience, as used for the initial competitive process that selected its current managed service provider, as well as some more recent experience in outsourcing PKI services. Given the complexity and importance of this work, FPSL expects to engage a variety of external consultants as well as enhance its own internal capabilities. FPSL would also welcome guidance on procurement best practice from the PSR and is therefore supportive of this option.

- **Option B** – As stated above we are already in the early stages of developing our procurement strategy and agree with this option that Payment System Operators (PSOs) should develop such strategies. We intend to share our approach with the PSR. However, we believe that a requirement to publish, in full, this strategy would undermine the objectives of this remedy by providing potential bidders with an insight into our approach that could compromise our negotiating position and would not work in the interests of obtaining best value for service users from the tender process. Clearly, publication of guides and information that maximises the interest of potential bidders and their ability to compete is essential, but this is different from publication of FPSL's procurement strategy.

- **Option C** – As stated in the Final Report FPSL intends to competitively tender for its next managed services contract and is therefore supportive of this option. We would seek to discuss with the PSR which elements are included, but our overall aim will be to limit a central procurement to the minimum set of functions that need to be procured together, and look to obtain other elements (if they exist) in separate tenders to maximise the competitive benefits. However, we would like to clarify the intention of the sunset clause with the PSR.

- **Option D** – We would like to understand further what the PSR intends in this option. As part of our procurement process we would certainly seek to engage independent third parties to provide us with assurance about our process. This would be in addition to using our own internal audit capabilities. In this option it is unclear which entity or from whom 'independence' is required from in your suggestions. The FPSL board is required to be chaired by an independent chair, and includes two independent non-executive directors. In addition to the duty that all its directors have to act independently and in the interests of FPSL, our independent directors also have a duty to clearly act in the public interest, and indeed are provided with a powerful public interest veto in all board decision making. Ultimately, as a systemically important payment system, designated by HM Treasury and overseen by the Bank of England, the board is entirely accountable for the impact of FPSL's service on UK Financial Stability. This is irrespective of what elements of the procurement process are outsourced to third parties, and while they will clearly consider information provided, they cannot delegate as critical a decision as this to any other party.

As a systematically important payment system, FPSL cannot see any other body that would be in a position to execute its procurement process other than FPSL, albeit supported by any expert procurement resources it would choose to bring in for the purpose with complete oversight from the FPSL board.

We do not agree that an independent body should conduct a competitive procurement exercise on behalf of the PSO which will have long term responsibility for the operation of the ultimate contract and delivering against the CPMI-IOSCO principles for FMIs. FPSL has the expertise and knowledge to determine what it and its service users need and will need, and what is and could be available.

However, as it goes through its procurement process, FPSL must consider the eco-system wide business case for change and the broader impact on competition, e.g. through short or medium term impacts on access to payment systems and the costs and benefits to all PSPs.

As mentioned above, and reinforced by the Payments Strategy Forum's proposed solutions published in July 2016, specifically the Simplified Delivery Mechanism (SDM) and overlay services functions, FPSL believes where possible these should be procured and sourced independently as detailed in our letter to the PSR dated 21 April 2016.

We also believe that the new remedy we proposed of separating central infrastructure services from connectivity services is an important enabler for running an effective competitive tender as we consider that it will further support easier supplier switching.

Finally, although we agree with the bulk of this remedy, we have yet to see evidence from the PSR that FPSL lacks the incentive to seek alternative technology infrastructure options, that we have failed to look for alternative suppliers without good reason and that we do not intend to hold periodic procurement exercises.

Remedy 2 – Interoperability and messaging standards

FPSL is supportive of option one and welcomes this as a solution. As per our response in April 2016, we agree that there are significant long term benefits from ensuring that the next generation of infrastructure fully supports real-time ISO 20022, and also provides transitional backward support for our current ISO 8583[1] international standard to underpin PSP migration, as an important requirement if a transition is to be enabled and the interests of service users are to be protected.

Option one enables the co-existence of new and existing standards for a time, so that full transition to new standards can be managed in full consideration of the benefits and costs of change to individual service users (such as corporates) and PSPs, and can be balanced with the collective good to the economy of services exploiting enhanced data.

FPSL's current international standard, ISO 8583 already fully supports the enhanced data carrying capacity in use in the numerous ISO 20022 variants for SEPA Credit Transfers. However, while this capability has been fully supported in the current central infrastructure since launch in 2008, the PSP market has not chosen to exploit this capability to provide enhanced data payment

[1] FPS already operates on a simple derivative of the most common payments messaging standard in the world, ISO 8583. It is based upon the most common international payments standard used globally and is not a barrier to entry for new infrastructure

services to service users in the competitive space. This may well be a 'PSP action' problem amongst PSPs (and their corporate customers, many of whom wanted Faster Payments to be compatible with the formatting requirements of Bacs, which their systems already interacted with) that can be solved by recommendations for action coming from the PSF, but, in the case of FPS, it is not a central infrastructure barrier.

In April 2016, we did not agree that complete migration to the real time version of ISO 20022 and termination of ISO 8583 access support at the next re-procurement is required to ensure a wide variety of credible and potentially successful bidders for the next procurement exercise. In fact, conversations with multiple FPS aggregation vendors, operating on £million contracts with new PSPs have and continue to support our existing international standard and confirmed their comfort in providing backward support for ISO 8583.

Finally, in para 8.72 the Final Report highlights that FPSL has proposed an additional interoperability remedy: unbundling connectively and central infrastructure provision. In para 8.81 the report expresses concern that this additional remedy would preclude the development of a fully interoperable model with multiple infrastructure providers being able to contract directly with the PSP. FPSL's view is that the opposite will be the case. We see the introduction of a competitively provided multi-vendor connectivity layer as a critical enabler of new models for infrastructure provision from multiple providers, including potentially bilateral or multilateral services between PSPs that do not require any central infrastructure and is entirely consistent with much of the PSF strategy thinking. FPSL intends to share its evolving proposals in this space with the PSR and Bank of England.

Remedy 3 – Ownership of VocaLink

FPSL is limiting its comments concerning this remedy to those that remain relevant given the publically announced majority sale of VocaLink to MasterCard.

The report remains very focussed on the impact on VocaLink decision making that complete or partial ownership by a set of PSPs has, given their cross membership of PSOs. We contend that this misses the vital point. VocaLink's board, no matter who sits on it, will not make the ultimate decision on whether it wins the next FPSL tender or not. That decision will be made by the board of FPSL.

The competition concern as we see it is that if some FPSL participants retain an economic interest in VocaLink and its future value via shareholdings in VocaLink, then they might seek to bring undue influence upon the board of FPSL to select VocaLink over alternative suppliers in the next tender process run by FPSL to maximise the value of their shareholding in VocaLink.

This conflict can be resolved in one of two ways:

- either by ensuring that FPSL participants have no incentives resulting from material economic interests in the value of VocaLink as a company (as shareholders in VocaLink), that would provide a motivation for them to retain VocaLink as FPSL's supplier in the next competitive tender

- or, by ensuring unambiguously that FPSL's corporate governance does not allow any participant, who retains an economic interest in VocaLink, to influence the decision making of the FPSL board on the basis of this particular economic motivation.

For clarity, this problem should not be confused with the broader and legitimate concern that all participants in FPS will have about the costs in their businesses of any transition to a new vendor. These costs will need to be factored into the full business case. Transition costs, whoever suffers from them, will be real and ultimately will have to be borne by customers or shareholders of PSPs.

Conclusion

FPSL welcomes the conclusions of the Final Report and in general sees the proposed remedies as being entirely in alignment with the approach and process that we intend to take in renewing our technology infrastructure over the next four years. We look forward to continuing to work with the PSR, when needed, to ensure the needs of service users and the UK economy is at the forefront of our decisions and actions in this important area.

Payment Schemes, Industry &
Innovation
Barclays Bank PLC
1 Churchill Place
London
E14 5HP

Date issued: 22 September 2016

Barclays response

PSR market review into the ownership and competitiveness of infrastructure provision

September 2016

Table of Contents

1. Executive summary

1.1. Barclays welcomes the opportunity to comment on the remedies that the Payment Systems Regulator (PSR) has proposed in its final report on the ownership and competitiveness of infrastructure provision[1] and to detail some thoughts in respect of the findings and proposed remedies.

1.2. First, in respect of tendering (*remedy one*), Barclays remains of the view that the most proportionate approach to delivering competition in the provision of payments infrastructure is to require payment system operators to produce infrastructure strategies. These strategies should set out how and when the payment system operator will carry out a full competitive tender for payment infrastructure provision.

1.3. Our principal concern is to ensure that effective and well-designed procurement exercises occur. If the PSR imposes a generic and inflexible deadline for any tendering process there is a risk that procurement exercises will not deliver the desired outcomes. In the absence of a proscriptive process, the PSR will still be able to supervise the payment system operators based on these plans: This seems to be a more proportionate response to the findings in the final report.

1.4. Second, broadly speaking we see merit in moving the UK payment system onto a common international messaging standard as part of a longer-term vision, and during upgrades of legacy systems (*remedy two*). However, we believe a comprehensive cost-benefit analysis is required for each payment system, before any decision is taken.

1.5. The costs of implementing *remedy two* could be significant not only for financial institutions but also customers, such as corporates paying employees via Bacs. For Bacs every year six billion annual payments originate from over 130,000 non-PSPs. This includes small and micro businesses to multi-national companies.

---

[1] Payment Systems Regulator (July 2016), *Market review into the ownership and competitiveness of infrastructure provision: Final*

Each is currently using payment solutions and processes based on the existing standards.

1.6. Finally, Barclays does not accept that it, either collectively with other PSPs or individually, controls VocaLink or the payment system operators. Barclays does not consider that the evidence presented is sufficient to support such a conclusion and considers the conclusions in the final report on this point to be incorrect. However, as Barclays has agreed to sell the vast majority of its share in VocaLink (retaining only a de minimis (circa [✂]%) interest), which if cleared by the European Commission or the CMA should resolve any competition concerns, we do not believe that the PSR need do more at this stage than note that a divestment is in progress (*remedy three*).

1.7. We address each of these areas in further detail below.

2. Remedy one: Competitive procurement exercises

2.1. Barclays supports payment system operators carrying out procurement exercises for central infrastructure. We think that such a procurement exercise is, perhaps unsurprisingly, a significant exercise. It will require careful planning and a laser focus on effective implementation.

2.2. Barclays considers that the best approach is to require each payment system operator to produce an infrastructure strategy for review by the regulator. The strategy can then form the basis of supervision by the regulator.

2.3. Each infrastructure strategy should set out how the operator proposes to deliver a procurement exercise and the likely timescale. It should also set out how the operator intends to manage the existing infrastructure provider and any procurement exercise in a way that can be relied upon to deliver the desired outcomes and meet the regulatory obligations that each operator is required to comply with. These obligations include those related to the CPMI-IOSCO principles[2] that underpin the Bank of England's regulatory oversight.

2.4. As the PSR would review and publish reports on each infrastructure strategy document, Barclays does not consider it proportionate to require payment system operators to submit their strategies for independent review by a third party. However, we would expect payment system operator boards to assure themselves that there is rigorous testing and challenge of draft strategies. In doing so, they may choose to submit draft strategies to independent review or internal audit review. It may, therefore, be more proportionate, as part of the sign-off and submission process to the PSR, for the payment system operator board to explain to the PSR how it has satisfied itself that the final infrastructure strategy is sufficient and appropriate to deliver infrastructure competition, service innovation and meet the needs of users.

---

[2] Bank of International Settlements and International Organisation of Securities Commissions (April 2012), *Principles for financial market infrastructures*, <http://www.bis.org/cpmi/publ/d101a.pdf> [accessed 22 September 2016]

2.5. Barclays considers that requiring procurement strategies without imposing a fixed date for a competitive procurement exercises is appropriate and proportionate. We also note that such an approach is consistent with other competition regulatory inventions concerning tendering for services: most notably, in the Competition and Markets Authority's market investigation into statutory audit services in the UK. It concluded that re-tendering for audit services was an appropriate action within ten years. But, the company could decide when they would next complete a competitive tender process within that timeframe (subject to relevant transitional provisions) and to justify why the chosen year is in the best interest of shareholders.[3] This is as opposed to a generic date chosen by the regulator.

2.6. If the PSR does consider it necessary to require payment system operators to launch a competitive tender for payment infrastructure services within a specified timescale it is important that the timescale is flexible and appropriate to the particular circumstances of each case. The imposition of an inflexible and/or generic deadline for a competitive procurement exercise has the potential to lead to short-term considerations taking priority in decision making. Such short-termism is unlikely to be in the wider interest of users and may hinder the introduction of more innovative payment services.

2.7. If the PSR is minded to impose a specific date/timeline for a competitive procurement exercise. The timeline should be agreed with the operators individually, and also collectively. This is because we do not consider it desirable to undertake two or three tenders at the same or similar times. A staggered approach should allow a set of more competitive processes with no capacity constraints. A "big bang" approach may lead to potential suppliers being only able to participate in one tender or suboptimal participation in all or some of the tenders.

[3] Competition & Markets Authority (26 September 2014), *The statutory audit services for large companies market investigation (mandatory use of competitive tender processes and audit committee responsibilities) Order 2014*,< https://assets.publishing.service.gov.uk/media/54252e91ed915d1371000ce3/Notice_of_making_the_Order.pdf> [accessed 22 September 2016]

Remedy two: Interoperability and messaging standards

2.8. As noted in our response to the interim report, Barclays suggests that, before deciding on the remedy on interoperability, the PSR should await the conclusions of the Payment Strategy Forum. The reason for this is that the costs and benefits of standardisation are wider than simply competition between payment infrastructure suppliers.

2.9. Broadly speaking, Barclays sees merit in moving the UK payment system onto a common international messaging standard as part of a longer-term vision, and during upgrades of legacy systems. This will enhance the end user experience and link more data items to payments. It will also improve interoperability between the payment systems.

2.10. The question of whether, and if so when, to migrate to a different payment messaging standard goes much wider than the narrowly defined issue of procurement of central infrastructure. Before the PSR makes a decision on the remedy it is essential to conduct a comprehensive cost-benefit analysis. Each payment system needs to be considered individually and on its own merits.

2.11. The PSR should not assume that ISO 20022 must be the preferred international messaging standard. We support an approach which is forward looking and takes into account the development of APIs using lighter-weight standards, particularly in the customer interface. Being too specific and mandating a standard could restrict the scope for innovation.

2.12. Barclays is supportive of the current standards mapping exercises for Bacs and Faster Payments. We consider that the most proportionate approach to this remedy is the delivery of the mapping exercise to stimulate the creation of translation services in the medium term. Over the longer term, the Strategy

Forum is proposing the development of a new payment system using more modern messaging standards.[4]

2.13. In many respects, such an approach would mirror the PSR's successful work to encourage the development of technical access solution to open up direct access to payment systems for payment services providers (PSP) in the short to medium term. However, over a longer time frame payment system operators have begun simplification exercises. These will, hopefully, make direct access even easier for PSPs.[5]

[4] Payments Strategy Forum (July 2016), *Being responsive to user needs: A draft strategy for consultation,* <https://paymentsforum.uk/sites/default/files/documents/Being%20responsive%20to%20user%20needs%20-%20Draft%20strategy%20for%20consultation.pdf> {accessed 22 September 2016]

[5] Payment system operators are currently undertaking work to develop common participation modes and rules. Payment system operator consolidation is also under active consideration.

3. Remedy three: Ownership of VocaLink

3.1. Barclays does not agree with the PSR's conclusion that Barclays, collectively with other shareholders, controls VocaLink or any payment system operator. There is no evidence to suggest any collective voting on the part of shareholder PSPs, including Barclays, in VocaLink, that could give rise to control (on any measure).

3.2. Further, there is no evidence to support the PSR's view that simply because the shareholder PSPs have an interest in ensuring the security, stability and resilience of the UK's payment systems that they control VocaLink. It is not in Barclays view sufficient "commonality" under the Enterprise Act 2002[6] (and the relevant case law) to make a collective finding of control. It is not sufficient evidence to support the conclusion that shareholder PSPs would act together in matters related to the exposure of VocaLink to competition. There is no evidence in the final report to suggest that any director, individually or collectively, has acted in this way.

3.3. That said, Barclays notes that, subject to regulatory approval, it has agreed to sell the majority of its shareholding in VocaLink to MasterCard. Other shareholder PSPs are also selling their interests and MasterCard (subject to regulatory processes) will acquire 92.4% of VocaLink Holdings Ltd.[7] Post-close, Barclays will have a shareholding of around [✄]%.[8] As the PSR noted: "*it appears this transaction would change the ownership arrangements of VocaLink in a way which could address the issues we have identified as causing a restriction of competition currently.*"[9]

3.4. All that Barclays submits is necessary at this stage is for the PSR to note that the major shareholders are selling their stakes to MasterCard and that this will be subject to competition scrutiny by the European Commission or CMA.

---

6 Enterprise Act 2002:< http://www.legislation.gov.uk/ukpga/2002/40/contents>
7 MasterCard (21 July 2016), *MasterCard announces acquisition of VocaLink,* <http://investor.mastercard.com/investor- relations/investor-news/press-release-details/2016/MasterCard-Announces-Acquisition-of-VocaLink/default.aspx> {accessed 22 September 2016.
8 Barclays (21 July 2016), *Sale of majority holding in VocaLink to MasterCard,* <https://www.home.barclays/news/2016/07/sale- of-shareholding-in-vocalink-to-mastercard.html> [accessed 22 September 2016]
9 Page 6, Payment Systems Regulator (July 2016)

HSBC BANK PLC

MARKET REVIEW INTO THE OWNERSHIP AND COMPETITIVENESS OF INFRASTRUCTURE PROVISION

MR15/2.3 – FINAL REPORT

RESPONSE TO REQUEST FOR

FEEDBACK ON THE FINAL REPORT ISSUED

IN JULY 2016

A INTRODUCTION

HSBC is grateful for the opportunity to comment on the PSR's final report in respect of the Market Review into the ownership and competitiveness of infrastructure provision. We set out below our comments on each of the PSR's proposed remedies.

We are disappointed and concerned with aspects of the PSR's substantive findings regarding the ownership of VocaLink. While the issue of VocaLink's ownership may soon be academic (in light of the proposed MasterCard acquisition), we have found some of the PSR's reasoning difficult to understand, and we have concerns about the procedural fairness of the process the PSR has followed. We urge the PSR to reflect and respond to our concerns.

B RESPONSE TO SUBSTANTIVE FINDINGS

The PSR's analysis in respect of the interaction between VocaLink and the Payment Schemes

1. Under section 53 of FSBRA, the PSR is under a general duty to act in a proportionate and transparent manner. Given the nature of the remedies under consideration, it is important for the industry that the PSR's reasoning is set out clearly and that there is clear evidence that the concerns identified by the PSR are sufficiently concrete to warrant the proposed intervention. While this clarity is critical in relation to VocaLink, it is also important for the industry to understand whether there are any broader implications, given that the approach taken by the PSR appears to be very different from that taken by other authorities.

2. In the sections entitled, "framework for assessing control", and "Protecting VocaLink from competition",[1] it is not clear to us what the PSR is seeking to establish, or what purpose it serves to establish it. One specific concern we have is whether or not the PSR is suggesting that bank-appointed payment scheme directors may have acted in breach of their fiduciary duties. In both sections, we consider that the PSR has sought to answer the wrong questions. This leads to incomplete and unclear reasoning, which is not assisted by significant amounts of redaction.

3. Further, the two sections do not build on anything that was contained in the interim report; we have not had any previous opportunity to comment on them. Given that the PSR appears to be (although it is difficult to discern) advancing findings that the largest four shareholders (or their appointed representatives on the payment schemes) may have sought to protect VocaLink from competition, and/or have the incentive and ability to do so, HSBC (as one of those shareholders) should have been given the opportunity to comment on what the PSR proposed to say, and should have had full access to the evidence which the PSR has sought to rely on.

1 Section entitled, "Framework for assessing control"

4. The PSR appears to find that the four largest shareholders in VocaLink have control of VocaLink, and each of Bacs (BPSL), Faster Payments (FPS) and LINK, in respect of matters in which they share a common interest.[2] The PSR states that the areas of common interest are "*matters concerning stability, security and resilience (and in relation to protecting VocaLink from competition* [the PSR discusses this last point in the next section])."[3]

5. We find the reasoning in this section incomplete and unclear. The PSR seeks to establish that the four largest shareholder PSPs exert "control" (as defined in the Enterprise Act) over VocaLink

[1] Paragraphs 6.63 to 6.125 of the Final Report
[2] See paragraphs 6.76 (VocaLink), 6.79 (BPSL), 6.85 (FPS), and 6.91 (LINK)
[3] Paragraph 6.93 of the Final Report

and each of the payment schemes. We consider that the PSR has misdirected itself in seeking to import the concept of control - used as a jurisdictional test in merger control assessments - into a market review which seeks to assess substantive competition in the market. Any substantive assessment of coordination requires a coordinated effects analysis; this requires the authority to provide evidence of coordination and an impact on competition. The PSR is, in any event, vague as to what type of control it is asserting that the four largest shareholders exert.

(a) The concept of control is a jurisdictional concept used in merger control analysis and is not an appropriate framework for a substantive competition assessment

6. As the PSR notes, the assessment of control is a jurisdictional test, whose purpose is to assess whether or not there is a relevant merger situation under the Enterprise Act. The PSR emphasises that, for the jurisdictional test, it is the ability to exert control that should be assessed, rather than whether or not control has actually been exercised.

7. However, the PSR's market review is concerned with a substantive assessment of the nature of competition in the market, and the likelihood of harm to end users, not a jurisdictional assessment of a relevant merger situation. The PSR should focus on whether the ownership arrangements in fact have an adverse effect on competition leading to adverse outcomes for end users, not the more hypothetical question of whether the ownership structure may or may not give an individual shareholder or group of shareholders the ability to exert control.

8. The PSR has not cited any authority for the use of this concept in the context of a substantive assessment of the nature of competition in a market (for example in a market investigation by the CMA or another sector regulator). We therefore consider that the PSR has adopted an inappropriate analytical framework and applied incomplete and unclear reasoning, which generates a risk that the PSR reaches inappropriate findings.

9. To the extent that the PSR considers it necessary to establish that the four largest shareholder PSPs are likely to act in a coordinated manner when taking decisions about infrastructure provision, the PSR should adopt the framework of a co-ordinated effects analysis.[4] Such an analysis requires findings that market conditions conducive to tacit coordination exist, and that there has in fact been tacit coordination which has had an impact on competition.

(b) Even if the concept of control is appropriate in this context, the PSR has not established that the four largest shareholders exert such control

10. In its references to "control", the PSR is not clear as to whether the four largest shareholders exert control (or have the ability to exert control) either individually or jointly, over the decisions of VocaLink and the operators.

11. As regards joint control, the PSR will be aware that the Enterprise Act and the merger guidelines refer to associated persons acquiring joint control. The CMA jurisdictional guidelines note that "*This situation will most commonly arise where the acquiring persons are related or have a signed agreement to act jointly to make an acquisition*."[5] It is clearly not the case that the four largest shareholders are related (this relates to husband and wife or trustee and settlor relationships), and there is no signed agreement in place between them to act in concert.

[4] See the Competition Commission aggregates market investigation for a recent example of a coordinated effects analysis:
https://assets.publishing.service.gov.uk/media/552ce1d5ed915d15db000001/Aggregates_final_report.pdf
[5] Paragraph 4.41 of "Mergers: Guidance on the CMA's jurisdiction and procedure"

12. The European Commission's Jurisdictional Notice[6] states that, exceptionally, joint control may exist where minority shareholders share a strong common interest. The Commission states that the greater the number of minority shareholders, the more remote is the likelihood of such a situation occurring. Further, such a situation will only occur where there is a high degree of mutual dependency between the shareholders (for example where they each contribute technology, know how or supply agreements), in particular where any one shareholder can block certain key decisions. The PSR has not made any factual findings which satisfy these criteria.

13. Further, the Commission states that, in general, "*a common interest as financial investors (or creditors) of a company in a return on investment does not constitute a commonality of interests leading to the exercise of de facto joint control*." It also notes that, in the absence of strong common interests, "*the possibility of changing coalitions between minority shareholders will normally exclude the assumption of joint control*."

14. As regards sole control, the PSR also notes that in certain cases, shareholdings of as low as 17.9 per cent[7] have been found to be sufficient for a finding of control in respect of a single entity. A couple of the largest shareholders may have shares above this threshold. However, the PSR does not analyse whether any individual shareholder exercises sole control over VocaLink or any of the schemes, and does not assert that any one of them does.

15. In its discussion of the "framework for assessing control", the PSR states:

> "*we consider that a group of shareholders together having the ability to control a firm could have real effects on the governance of that company. This would be the case if there are identifiable areas in which these stakeholders have a common interest. Such a common interest would make it likely that the shareholders in question would act in concert*."[8]

16. This statement is difficult to unravel. The PSR appears to find that the four largest shareholders have control over each of VocaLink and the payment schemes in respect of all matters in which they have a common interest (security, stability and resilience, as well as protecting VocaLink from competition).[9]

17. Such a factual finding is an insufficient basis on which to establish a finding of joint control. The PSR has not provided any authority or precedent for its apparent findings. Joint control requires intimate relations or contractual obligations between associated persons, or strong common interests of the sort referred to by the European Commission. The PSR's analysis does not satisfy any of these criteria.

18. In any event, the PSR's factual finding that the four largest PSPs' interests must be aligned, in respect of security, stability and protecting VocaLink from competition, is based on weak inferences from very limited evidence. The PSR's sole source of evidence appears to be the voting record of the boards of each of the operators. Taking each operator in turn:

[6] See articles 76 to 80 of the Commission Jurisdiction Notice on the control of concentrations between undertakings, 2008/C 95/1

[7] In this case (BskyB/ITV) there were other factors, such as the knowledge of the industry and the fact that it was a public company. In regulated sectors, such as water the CMA has not found material influence below a 25% shareholding.

[8] Para 6.66 of the Final Report

[9] See paragraphs 6.74, 6.76, 6.79, 6.85 and 6.91

a. BPSL: the PSR found no instances of the largest four VocaLink shareholder PSPs voting differently from one another, although it acknowledges that there were only two votes in the period 2012 to 2016.[10] These votes related to settlement issues that no longer exist following the introduction of pre-funded settlement in September 2015. The director appointed by HSBC was not present at the second of these votes on 6 August 2013. Both votes were technical and related to the financial stability of the BPSL scheme rather than decisions on innovation, impacts on service users or competition. HSBC therefore believes that it would be incorrect to draw conclusions from these two instances.

b. FPS: all board decisions of FPS were taken unanimously between 2012 and 2016, with one exception where one director stepped out of a vote to avoid a perception that there might be a conflict of interest.[11]

c. LINK: the four largest shareholders control only 45 per cent of the votes on the NMC. The PSR notes that this means the four largest shareholders have the ability to block decisions by other shareholders. The PSR does not identify any occasions when this has happened. The PSR notes that the four largest shareholders voted together in respect of matters relating to security, stability and resilience, or VocaLink's profitability.

19. It is difficult to see what relevance these issues have to any assessment of what impact VocaLink's ownership may have on competition or outcomes for end service users. As we discuss below, the only relevant question is whether the four largest shareholders have an interest in protecting VocaLink from competition (or maintaining its profitability) and whether this interest has any impact on the nature of competition and on outcomes for end users.

20. In any case, this is very limited evidence from which to infer that the shareholders have a common interest in respect of any specific individual matters (whether they are relevant to the assessment of competition or not). To establish in any meaningful way whether the representatives of the four largest shareholders act in concert on certain specific issues, the PSR would need to adduce evidence of a number of occasions on which such issues were discussed by the relevant board, and examine whether or not the four largest shareholder PSP representatives were in agreement with one another in respect of that issue. It has not done this. It is often the case that directors appointed by the four largest PSP shareholders will have fundamental disagreements about the strategy of each operator, including where the strategy touches on issues which the PSR has identified as being ones of common interest (as these issues are rarely considered in isolation from other issues). Such disagreements cannot be detected from voting records.

21. To conclude on this section, it is not clear to us why the PSR considers it necessary to establish the existence of control for the purposes of a substantive assessment of competition.[12] The PSR should focus on assessing how, in practice, the joint shareholdings may affect the nature of competition, without confusing its analysis by importing jurisdictional concepts from the assessment of mergers.

[10] Para 6.35 of the Final Report
[11] Para 6.41 of the Final Report
[12] The only potential implication we can identify is the PSR's statement at paragraph 6.82 that the analysis of control is not affected by the existence of directors' fiduciary duties. While this may be the case for jurisdictional analyses (and we consider that is itself unclear), it cannot be relevant to any substantive assessment.

2 Section entitled, "Protecting VocaLink from competition"

22. The PSR then seeks to establish that the four largest VocaLink shareholders have a common interest in protecting VocaLink from competition. It asserts that if they do have such a common interest, it is likely that they will act together in matters that are related to exposing VocaLink to competition. The implication is that this common interest is then likely to "*reduce the shareholder PSPs' willingness to allow operators to procure infrastructure services competitively*."[13]

23. We also find the reasoning in this section to be unclear and incomplete. The PSR sets out two purposes at the start of the section.

    a. First,[14] to consider whether the four largest shareholder PSPs have a common interest to protect VocaLink from competition. The PSR states that it has already established that the four largest shareholders have the ability to take or block decisions when "acting together".[15] The implication is that if the largest shareholders have a common incentive to act collectively, and the ability to do so, they will then be likely to act in a way which promotes this common interest.

    b. Secondly,[16] the PSR states that it wishes to assess whether VocaLink is able to protect itself, or try to protect itself, from competition using the links between its owners and the operators.

24. As a preliminary point, we consider that the PSR asks the wrong questions. The PSR's overarching focus should be to consider whether VocaLink obtains any competitive advantage over other infrastructure providers due to its shareholding structure. More specifically, when assessing the interaction between VocaLink and the Payment Schemes, the PSR should ask itself:

    a. Whether the four largest shareholders' interests are likely to be aligned in a way that gives them a common incentive to act to protect VocaLink from competition;

    b. Whether the four largest shareholders have in fact sought to protect VocaLink from competition when engaging with the payment schemes; and

    c. Whether VocaLink is able to influence the payment schemes in a way which would not be possible without its shareholding structure. In particular, how would competition develop differently in future, and how would outcomes for end users be different, if the four largest shareholder PSPs did not have a stake in VocaLink?

25. We address each of (a) and (b) (as defined by the PSR) in turn.

(a) the incentive to protect VocaLink from competition

26. It is a truism that in the absence of any other relevant considerations, any shareholder in a company will have an incentive to protect the company from competition, as this will increase the value of the shareholding.

---

[13] Paragraph 6.142 of the Final Report
[14] In paragraph 6.95
[15] The reasoning is confusing: in the previous section the PSR states that the four largest shareholders have the <u>ability</u> to exercise control when they have a common interest; in this section the PSR appears to state that where the four largest shareholders have a common interest, they will also have an <u>incentive</u> to act collectively. "Ability" and "incentive" appear to be based on the same thing.
[16] In paragraph 6.96

27. However, where a shareholder is also a member of the UK's payment systems, the value of its investment in the provider of infrastructure services to those payment systems is a subordinate interest, relative to its interests as a user of the same payment systems. The effective maintenance of the stability and security of those payment systems, and ensuring that the payment systems continue to deliver the best possible outcomes to end users, are likely to be more primary concerns, which it will share with other PSPs. The fact that these concerns may be common to the four largest shareholders in both VocaLink and the payment schemes does not give VocaLink a competitive advantage over other infrastructure providers. The shareholders would have the same concerns even if they did not have any shareholding in VocaLink. VocaLink will only have a competitive advantage if the four largest shareholders have a common interest in protecting it from competition, <u>and</u> this common interest overrides these other concerns. The PSR has failed to demonstrate this.

28. The PSR's assertion is that the incentive to protect VocaLink from competition arises from the financial importance of some infrastructure contracts.[17] It states that this assertion "*is likely to be true*" in respect of the most valuable contracts which VocaLink has.[18] It relies on evidence around the possibility that a failure to renew core contracts would lead to a call on shareholder capital.[19] The PSR has redacted text surrounding this assertion, so we find it difficult to assess. The decision faced by VocaLink's shareholders is not completely dissimilar to that of a technology service which a bank may provide in-house. In that situation, a bank may consider whether to outsource the service to a third party. Such an outsourcing arrangement will typically include the transfer of employees under TUPE as well as assets for value. The PSR has not considered whether similar arrangements might be possible in relation to Vocalink, thereby avoiding any need for a call on shareholder capital. In the event that Vocalink lost a contract, its activities would be re-sized in light of its ongoing activities; it is by no means clear that a call on shareholder capital would be more likely than not.

29. The PSR dismisses the fact that the payment system operators have chosen VocaLink's competitors to provide certain infrastructure services, on the basis that it would be difficult to ascertain with certainty whether these contracts would have been profitable[20] (with the implication being that the four largest shareholders had less or no incentive to influence the payment schemes over these decisions). We find it difficult to understand how the PSR can dismiss this. First, it is never possible to determine with certainty whether a contact is profitable at the outset. Secondly, and more fundamentally, VocaLink's shareholders have done the exact opposite of what the PSR contends: they have consented to the appointment of a competitor instead of VocaLink, on a number of occasions. The presence of competitors in the market also increases the competitive pressure on VocaLink in respect of other contracts, which may in turn facilitate re-negotiations (such as those discussed in the next paragraph).

30. The PSR also dismisses the fact that VocaLink reduced its pricing in respect of Bacs and FPS as part of the contract renegotiation process,[21] and states that such behaviour is consistent with an incentive to protect VocaLink from competition. We struggle to understand how the PSR can reach this conclusion. If VocaLink's four largest shareholders' primary incentive was to protect

[17] Paragraph 6.114 of the Final Report
[18] Paragraph 6.119 of the Final Report
[19] Pragraph 6.108 of the Final Report
[20] Paragraph 6.116 of the Final Report
[21] Paragraph 6.117 of the Final Report

VocaLink from competition, they would not have supported the renegotiation of contracts by the payment schemes in the first instance.

31. The PSR goes on to conclude that the four largest shareholders in VocaLink will have an incentive to protect VocaLink from competition. We consider that this conclusion does not assist the PSR's analysis. The PSR should have asked itself whether, to the extent such an incentive exists, that incentive was likely to influence the four largest shareholders' appraisal of infrastructure procurement decisions by the payment schemes. In our view, it is likely that other considerations which are not relevant to the competitive analysis of the ownership of VocaLink (stability, security etc.) will always outweigh such an incentive. The evidence discussed above supports our view.

32. We urge the PSR to re-consider this analysis and its findings.

(b) Whether VocaLink is able to protect itself, or try to protect itself, from competition using the links between its owners and the operators

33. It is not clear to us what case the PSR is making and we urge the PSR to clarify its position.

34. We are concerned by the stance the PSR adopts towards fiduciary duties.[22] In the previous section, the PSR states that the existence of fiduciary duties does not alter its analysis of control, and relies on the approach taken in relation to analysing mergers under the EC Merger Regulation.[23] The PSR appears to use this finding in respect of control as a means by which to circumvent any consideration of the impact that the fiduciary duties may have had on the nature of the interaction between VocaLink and the payment schemes. This is wholly inappropriate: as we note above, the PSR's reliance on a jurisdictional test of control which is relevant only in the context of mergers is misconceived. It is also inconsistent with the approach under EU competition law, which requires a competition authority to consider factors, including the lawfulness of a certain type of conduct, which may reduce or even eliminate the incentive to engage in conduct which may affect competition.[24]

35. The PSR should be focused on a substantive assessment of what happens in practice. In our view, the fiduciary duty which directors owe to the payment schemes is a relevant factor (indeed a central factor) in any analysis of whether or not VocaLink is able to protect itself from competition by using the links between its owners and the operators. The PSR has not addressed the substantive question of how VocaLink could benefit from a competitive advantage in circumstances where the directors of the payment schemes acted in accordance with their fiduciary duties. We consider that the PSR should assume that the directors have acted in line with their duties, unless it can produce clear evidence to the contrary.

36. The PSR refers to three pieces of evidence that VocaLink sought to use the links between its shareholders and the schemes. We address each of these in turn.

---

[22] For example, HSBC is very clear when nominating directors that they attend and participate in the Bacs and FPS Boards explicitly as individual directors and their responsibilities are to Bacs and FPS and its stakeholders and not to HSBC, as their employer.

[23] Para 6.82 of the Final Report. In any event, it appears to us that the Commission (at para 22 of its Jurisdictional Notice) refers to the power to appoint directors and veto key decisions, and not to the power to influence the individual decisions which directors take.

[24] Case C-12/03 - Commission v Tetra Laval, para 74, Case T-210/01 - General Electric v Commission, para 71.

37. First, the PSR notes[25] that the VocaLink board agreed that the shareholder PSP appointed directors would 'directly engage with their organisations'' appointed representatives to FPSL and BPSL to escalate the delays being experienced with contract renewal. We invite the PSR to outline clearly whether it is suggesting that the FPSL and BPSL representatives would have been influenced to put the interests of their employer ahead of the payment scheme on whose board they sat. If the directors of the payment schemes were not so influenced, it is unclear to us how the influence which VocaLink exerted differed from the considerable influence any other incumbent supplier would be able to exert.

38. Secondly, the PSR[26] also refers to the introduction of ISO 20022 standards. The PSR states that VocaLink did not wish to implement ISO 20022 as it perceived this would reduce its incumbency advantage. According to the PSR, "*the VocaLink board agreed to escalate the issue within the PSPs and Payments Council where its shareholders have an influence*." The PSR does not make any findings as to what influence VocaLink was able to exert on BPSL as a result of its shareholders' influence – and in particular whether this led to a breach of fiduciary duty - separate from the substantial amount of influence it would have been able to exert in any event as the incumbent supplier.

39. Thirdly, the PSR states that VocaLink sought to lobby the LINK Scheme executive to convey VocaLink's disapproval of the plans to establish a new incorporated entity for the Link scheme. It is not clear from the redacted final report[27] what point the PSR is seeking to make with this example. It is unclear how this relates to VocaLink using the influence of its shareholders to affect the nature of competition in infrastructure procurement. In any event, the attempt failed and a separate entity was set up: as such, we do not consider that the PSR can attach any weight to this example.

40. In all of these examples, the PSR has failed to consider what would happen in the counterfactual scenario – one in which VocaLink would continue to be the incumbent supplier, without the shareholder links to the payment schemes. We believe that in such a counterfactual, in each of the examples the PSR discusses above, VocaLink would exert similar forms of pressure on the largest PSPs and the payment schemes.

3 Conclusion

41. In summary, we consider that the PSR has misdirected itself, in seeking to answer questions which do not contribute to establishing whether or not the ownership structure of VocaLink may have an adverse impact on competition. The PSR has not provided sufficient evidence to support any such finding in these two sections. The PSR's reasoning is incomplete and unclear.

42. Further, from a procedural perspective, the analysis in these two sections was not contained in the interim report. Especially given that the findings are ambiguous [✂], we are concerned that the PSR has not given adequate consideration to procedural fairness.

[25] Paragraph 6.109 of the Final Report
[26] Paragraph 6.111 of the Final Report
[27] At paragraphs 6.112 and 6.121

C RESPONSE TO REMEDY PROPOSALS

Timing and sequencing

43. It is important that this market review stays closely aligned to the work undertaken by the Payment Strategy Forum (PSF), and the final strategy, to be published later this year. A number of draft strategic PSF proposals could have an impact on the nature of the remedies being considered by the PSR in this market review. For example, the proposal to move to a consolidated payment system operator model (e.g. with fewer payment scheme operators) for retail-based payments and the proposals around the introduction of the common messaging standard (ISO20022) are important proposed developments that will influence the timing of the proposed remedies.

Potential Remedies

Remedy one – Corporate Procurement exercise

44. HSBC continues to disagree with the PSR that outcomes for end users are being compromised as a consequence of the market dynamics. Competitive procurement processes will not automatically generate better outcomes for end users. That said, HSBC supports the proposed competitive procurement exercises provided they are undertaken in the right way at the right time.

45. As we set out in our response to the interim report, we believe that the sequencing is critical. As referenced in the 'Being responsive to user needs' draft strategy published by the Payment Strategy Forum, we encourage the PSR to focus on the overall structure of the industry, and in particular, issues around technical standards and inter-operability (which remedy two partially addresses), before it turns to considering what type of procurement model will deliver the best outcomes. We therefore encourage the PSR to approach the issue of procurement as part of a broader strategic plan put together by the PSF and the industry.

46. In our view it is essential that any procurement processes are run in parallel across all payment schemes, preferably after common message standards, a simplified rule-book and governance structure are agreed. This will be the most effective way in which to attract the highest number of quality potential providers.

47. In HSBC's view, any future full-scale infrastructure procurement exercise undertaken before the issues around common technical standards are resolved would be expensive, time consuming and would probably achieve very little given the low likelihood of a new provider being incentivised or able to submit a winning bid. As we set out above, we do not consider that this has anything to do with the ownership of VocaLink.

48. HSBC is highly supportive of competitive tender exercises being undertaken as proposed in options c and d. The proposal for the tender exercise to be undertaken by an independent third party will need very careful consideration. The procurement of services for Bacs, FPS and LINK will require technical industry expertise and therefore whilst some form of independent supervision appears sensible, we would not recommend wholesale delegation of the exercise to a third party.

49. As well as considering the high level options described in paragraph 8.57, the industry should also be considering the potential to move to a direct contracting model, where PSPs are able to select the appropriate Payment System Operator-accredited infrastructure provided that meets

their individual customers' needs. This would negate the need for such a wholesale competitive procurement exercise and instead open up the UK market to even greater competition and innovation.

Remedy two – Interoperability and messaging standards

50. HSBC supports the potential remedy to introduce consistent messaging standards and thereby generate enhanced interoperability across the retail Payment System Operators in the scope of this Market Review.

51. It is essential to recognise however, that there is far more to ISO 200022 implementation than just aligning payment standards. To gain the full benefits requires close co-operation with UK businesses to define re-usable business process ISO messages - this will take significant effort to achieve, as set out in the Lipis Report. If we fail to implement a migration to a new standard, such as ISO 20022, in the right way, then we will simply impose cost on corporates, without giving them much in the way of Straight Through Processing benefits.

52. Given the above, and the sizeable impact on all areas of UK business, it is clearly essential to create a robust ISO 20022 cost and benefits business case for the UK. ISO 20022 is a payments infrastructure issue involving a complex set of stakeholders and constructing such a business case will require time and care. As the PSF is undertaking the cost and benefits analysis as part of their summer work programme, we suggest that the analysis is incorporated in the remedies consultation that will be issued later this year.

Remedy three – Ownership of VocaLink

53. As we have explained in our response to the interim report, we fundamentally disagree with the PSR that the ownership of VocaLink has an impact on the nature of competition. The PSR is misguided in focusing on ownership of VocaLink as a factor that will materially affect outcomes for end users of payment systems. That said, HSBC agrees with the PSR that bank ownership of VocaLink is not necessary to ensure stability.

54. [✂]

55. [✂]

56. [✂]

LLOYDS BANKING GROUP

LLOYDS BANKING GROUP PLC

PSR Infrastructure Market Review

Response to Final Report

September 2016

This response contains business secrets. The information contained in this response is provided to the Payment Systems Regulator (PSR) in relation to the PSR's Infrastructure Market Review. Publication or disclosure to any other person of such information would harm the legitimate business interests of Lloyds Banking Group (LBG). Accordingly, no such information should be published or disclosed to any third party without giving LBG the opportunity to redact such information.

LBG Response to PSR Infrastructure Market Review Final Report

1.1 LBG shares the PSR's objectives of encouraging competition, innovation and increased service standards across the payments industry, and is supporting several initiatives to deliver improvements for customers. These include significant investments in LBG's services, such as the approximately £[✂] on maintaining and improving our own payment infrastructure and delivering mandated changes such as PSD2/Open Banking and cheque imaging. LBG is also continuing to work with other stakeholders to drive multilateral change, such as HM Treasury's Open Banking initiative, the CMA's trials of behavioural remedies to enhance customer engagement, and the Payment Strategy Forum ("**PSF**")'s development of its draft strategy for the UK payment systems.

1.2 LBG will, therefore, continue to work with the PSR to deliver improved outcomes for customers. This response is intended to provide early feedback on the PSR's Final Report, in order to support the PSR as it considers its next steps. We do not repeat the evidence provided in previous submissions, and will engage further following publication of the PSR's remedies consultation.

1.3 Since the publication of the PSR's Interim Report, the PSF has published a draft UK payments strategy, which LBG considers will fundamentally reshape the payments infrastructure market. In addition, MasterCard has agreed to acquire VocaLink, subject to regulatory approvals. The outcome of the referendum on the UK's membership of the European Union is also likely to have further consequences.

1.4 These developments require a fresh assessment of any potential remedies package to ensure that it remains relevant to the market, effective and proportionate. LBG is, therefore, encouraged that the PSR has invited views on its Final Report and will consider its potential remedies in more detail before publishing its consultation on remedies.

1.5 As the PSR is aware, LBG does not share all of the PSR's conclusions on the current market. But much of the debate during the course of the review will become academic when these developments take effect. In LBG's view, there is a risk that a remedies package intended to address perceived concerns that arose before these developments are implemented will quickly become redundant.

1.6 One benefit of the PSR's market review powers under FSBRA is that they afford the PSR procedural flexibility in the timing of any remedy implementation. LBG believes that the PSR should use this flexibility to make any remedies decision at the right time, so that it can ensure that any remedies remain relevant, effective and proportionate. Moreover, LBG believes that the PSR can make a bigger and more immediate impact for end-users by prioritising its work to support the payments strategy and ensuring that the strategy's substantial and wide-ranging improvements are delivered as quickly as possible.

1.7 For example, in its response to the Interim Report, LBG submitted that defining appropriate funding mechanisms could slow the pace of change and, unless carefully designed, risk introducing economic inefficiency into the future payment system. We note that the PSR has indicated that it believes that the industry, in the first instance, would be best placed to determine whether and what changes in the funding mechanisms should be made.[1] Based on LBG's experience of trying to drive change (such as LBG's proposal of the Current Account Switching Service), regulatory support is likely to be required if such funding models are to be agreed in the short timescales implied by the draft payments strategy, and LBG believes that the PSR should at a minimum closely monitor the PSF's work in this respect and stand ready to intervene if progress is too slow.

1.8 LBG provides further detail on the PSR's potential remedies below.

Payment messaging standards

1.9 LBG notes that the PSR is conducting a cost-benefit analysis of its proposed remedy to require payment schemes to adopt common international standards. As LBG explained in our response to the Interim Report, we recognise that alternative standards could bring certain benefits to end-users, although we consider it unlikely that any benefits arising solely from any potential increase in competition for infrastructure services would outweigh the substantial costs for payment scheme users of changing the standards for the existing payment schemes. In addition, we do not believe that it would be appropriate to require LINK to migrate to ISO20022 or equivalent.

1.10 We also explained that the outcome of the cost-benefit analysis will depend largely on the implementation approach adopted. For example, the analysis is likely to be far more favourable if a new standard were to be adopted on the PSF's proposed "greenfield" payments platform, than if existing Bacs and FPS schemes were required to migrate to new standards for a transitional period before the new platform is built.

1.11 Therefore, LBG believes that the cost-benefit analysis has to take into account the proposed developments in the UK payments architecture. The logical sequence of decisions should be as follows:

(a) whether to create a new payments platform;

(b) when to create the new payments platform and how to transition from existing schemes;

(c) what messaging standard the new payments platform should use;

(d) whether to migrate the existing payment schemes to a new messaging standard.

1.12 These decisions are interdependent. Moreover, the effect of messaging standards on competition for infrastructure services is just one part of the analysis. Other factors, such as which standard is likely to best meet user needs, be as "future proof" as possible, and facilitate downstream competition between PSPs, are in LBG's view at least as important. Accordingly, LBG believes that the PSF is best placed to consider these issues (as it is currently doing) with the PSR standing ready to provide regulatory support to the PSF if required. LBG considers that the PSR should not mandate a change to standards as part of its remedies package in the market review, and will not be in a position to deliver a fully-informed cost-benefit analysis in 2016 before the PSF has confirmed the future payments strategy.

---

[1] Final Report, paragraph 4.187

1.13 For completeness (although LBG believes this is best considered by the PSF), LBG also notes it is important to take an open minded approach to the appropriate standard, taking account of the factors noted above as well as the perceived impact on infrastructure competition. There should be no assumption that standards currently used elsewhere will deliver the best outcomes for the UK in future.

Competitive tendering

1.14 In its response to the Interim Report, LBG explained that it was neutral on the proposal to require competitive tendering in infrastructure procurement exercises, and recommended further market testing to understand the extent of competition to VocaLink and engagement with the payment scheme Operators to ensure appropriate commercial flexibility in any remedy the PSR introduced.

1.15 Since then, the PSF's draft strategy has produced recommendations which include consolidation of the payment scheme Operators, the creation of a new payments architecture, and the potential use of new payment messaging standards. In addition, MasterCard has agreed to acquire VocaLink. This has several implications for the PSR's proposed remedy:

(a) As LBG explained in previous submissions, there are significant differences between procuring infrastructure for a "greenfield" payments platform compared to an existing platform. Typically, new infrastructure is more amenable to competitive procurement. If the PSF's proposals are implemented, LBG would expect the PSF (or the new payment scheme Operator) to develop a procurement strategy for the new infrastructure involving market testing, and if appropriate competitive tendering. Regulatory intervention in this process is likely to be unnecessary and could risk unduly limiting the Operator's commercial flexibility (for example, there could be significant risks if the Operator were to be required to accept the lowest bid in circumstances where it considered the bidder may not be best placed to execute to time, standard and budget, or if its freedom to adapt to new circumstances during the procurement process were constrained).

(b) It introduces significant uncertainties which make designing an appropriate remedy for the next tender – likely to take place several years from now – impractical. For example, it is not yet clear who will be procuring the infrastructure, what kind of platform or services the infrastructure will need to support, whether the current schemes will remain in operation or for how long, the identity of the potential suppliers, or what infrastructure technology will be available.

(c) Completion of the VocaLink transaction would remove any perceived advantage arising from VocaLink's current ownership status in the next tender.

1.16 Accordingly, LBG does not believe that it would be appropriate for the PSR to mandate competitive procurement at this time, or that a remedy could be constructed without significant uncertainty as to its future relevance. LBG believes that the PSR has made its expectations clear during the review and the industry has understood these expectations (whether or not it shares the PSR's view on historic procurement exercises). The PSR should take advantage of its procedural flexibility to revisit whether a procurement remedy is required after the PSF has taken its decisions on the future payments strategy, including its decision on whether to create a new payments platform. LBG believes that close engagement from the PSR during that process is likely to be sufficient to ensure that its objectives are met without the need for a more intrusive remedy.

1.17 [✂]

Divestment of VocaLink

1.18 As LBG set out in its response to the Interim Report, LBG strongly disagrees with the PSR's finding that VocaLink's largest shareholders control VocaLink and the operators of the Bacs, FPS and LINK payment schemes.

1.19 LBG notes that the Final Report provides a different basis for finding control, and narrows the group of shareholders held to have control, from that provided in the Interim Report. LBG is disappointed that the PSR did not consult or provide any opportunity to respond to this new line of reasoning, particularly given that LBG has engaged constructively with the PSR throughout the review and provided substantial evidence to the contrary, and that this finding may directly affect LBG's legitimate interests.

1.20 LBG notes that the PSR has not indicated that this finding is open to consultation. However, LBG continues to strongly disagree with the finding of control and reserves its right to rebut the PSR's new rationale for the finding in light of that disagreement and the lack of consultation prior to issuing the Final Report.

1.21 Nevertheless, as LBG has stated from the outset of the review, it is not wedded to VocaLink's current ownership structure. Indeed, VocaLink's shareholders have agreed to sell VocaLink to MasterCard. The transaction is legally binding [✂]. Completion and timing of the transaction is, therefore, outside the current shareholders' control.

1.22 Given that, as the Final Report suggests, the transaction would resolve the PSR's concerns, and that the shareholders are legally bound to complete the transaction [✂], no remedy is required for the PSR's perceived concerns in relation to control. If the transaction does not complete, the PSR could revisit its position at that time to consider whether a remedy is required, and what approach would be most effective and proportionate.

1.23 For completeness, LBG notes that, even if the largest shareholders did control VocaLink (which they do not), there can be no basis for intervening in the agreed sale of VocaLink to MasterCard. Post-completion, LBG would own less than [✂]% of VocaLink, and the combined stake of the four shareholders alleged by the PSR to control VocaLink would be less than [✂]%. In a private company with a majority shareholder holding 92.4% of the shares, there is no realistic prospect that this shareholding could confer control. Given that any intervention in this legally binding transaction would be unnecessary and wholly disproportionate, LBG welcomes the PSR's initial view that the transaction would address its concerns.

Santander

Santander UK

2 Triton Square

Regent's Place

London

NW1 3AN

PSR Head Office

Infrastructure Market Review Team

25 The North Colonnade

London

E14 5HS

22 September 2016

Dear

Confidential

Market Review 15/2.3 Ownership and competitiveness of infrastructure provision Final Report

Santander UK ("San UK") welcomes the Payment Systems Regulator's ("PSR") final report into the ownership and competitiveness of infrastructure provision.

We are generally supportive of the potential remedies as outlined in your final report and would like to take this opportunity to note our three observations on the PSR findings.

Competitive procurement exercises

San UK agree with the principles behind this remedy aimed at enabling other infrastructure providers to offer provision of infrastructure services, which will create the potential for more efficient and innovative services. We consider this measure to be necessary to ensure the industry feels the right approach is taken in future for supplier management.

Santander

Divestment of Vocalink

San UK agree with the remedy to instigate the divestment by the four largest VocaLink shareholder PSPs of their interest in VocaLink. We confirm that San UK is involved in this development and would add that we are supportive of the Vocalink / Mastercard deal.

Enhanced Interoperability and a common international messaging standard

San UK agrees with the PSR's action to address the barrier to entry due to the lack of common international messaging standards in the UK and considers that it is critical for the future and also fits well with the Payment Strategy Forum positioning.

We look forward to discussing these matters with you further over the coming months.

Yours faithfully,

Payment Systems Regulator
Infrastructure market review team
25 The North Colonnade
Canary Wharf
London E14 5HS

22 September 2016

Dear Sir/Madam

Virgin Money response to PSR MR15/2.3 – Final report: market review into the ownership and competitiveness of infrastructure provision

Virgin Money welcomes the opportunity to respond to the PSR's final report related to the market review into the ownership and competitiveness of infrastructure provision.

We are supportive of the final measures proposed in the report, as we were for the proposed measures in the interim report – specifically:

- **Competitive procurement exercises:** We continue to support the PSR's proposed remedy with regard to competitive procurement exercises for the provision of services to payment schemes. In addition to the remedy for the current scheme arrangement, we are supportive of the Payments Strategy Forum (PSF) report which discusses a move to new core scheme (single payments platform).

  This proposal would enable a move away from a single central infrastructure provider thereby enabling increased competition in the market. We suggest that the PSR should consider how these new scheme models could further enable competition by allowing multiple providers to enter the marketplace rather than the current scheme reliance on a single infrastructure provider.

- **Interoperability:** We continue to support the PSR's proposed remedy to move to a single, international payment standard to help enable further competition. We support the recommendation to move to international standards also referenced in the PSF report.

  Interoperability will enable additional functionality and have benefits for PSPs (as referenced in our response to the indirect access market review) as well as enabling infrastructure competition. As noted by other respondees, there needs to be a balance between the speed of introduction of new standards and the cessation of old standards. This would help reduce the impact on PSPs but still provide the benefits associated with a full migration. We would therefore recommend an enforced end date for the move to a new standard.

- **Divestment of VocaLink and separation of LINK:** We note and support the current divestment of VocaLink to MasterCard and continue to support the separation of the LINK scheme

We are keen to continue to work closely with the PSR on the various issues raised during the course of this market review. Please do not hesitate to contact us if we can be of further assistance.

Mastercard response PSR ‘*Final report: Market review into the ownership and competitiveness of infrastructure provision*’

MR15/2.3

22 September 2016

Introduction

1. Mastercard welcomes the publication of the PSR's Final Report on its market review into the ownership and competitiveness of infrastructure provision. In particular, without wishing to comment on the PSR's conclusions about the current ownership structure of VocaLink, we agree with its observation that Mastercard's proposed acquisition of VocaLink could address certain competition issues identified in the PSR's review.

2. As the PSR correctly notes, the deal is subject to clearance from the relevant merger control authority. While mindful of that process, including the competition review that will be undertaken, we wish to provide the PSR with our views on the interplay of the proposed transaction and the potential remedies on which the PSR is consulting. We are also keen to respond to some observations in the Report by third parties about Mastercard's potential ownership of VocaLink.

3. In order to understand why Mastercard believes that the acquisition will enhance competition, it may be useful first to provide an overview of Mastercard's commercial rationale for wishing to acquire VocaLink, which is broadly as follows:-

   - Combining the businesses will allow Mastercard to build upon VocaLink's complementary interbank payment infrastructure offering. It will expand Mastercard's activities into new business-to-business, person-to-person, retail, disbursement and recurring bill payment flows.

   - Together, VocaLink's interbank and Mastercard's card-based assets will allow Mastercard to develop strong payment capabilities at both the network infrastructure level (i.e. interoperability between Mastercard's network and network security products and VocaLink's interbank payment technology) as well as at the application level (e.g. VocaLink's Zapp mobile payments application and Mastercard's MasterPass digital wallet solution).

   - The Mastercard brand and global acceptance network will assist the VocaLink business to expand internationally to win payment processing contracts in other countries and help accelerate the commercialisation of solutions that VocaLink is currently developing (such as Zapp), which have the potential to be widely-adopted by consumers to facilitate point-of-sale transactions. UK consumers will benefit from the accelerated commercialisation of these innovative products and services and consumers more generally will benefit from the increased scale, knowledge and expertise gained by Mastercard through its ownership of VocaLink's interbank technology.

Ownership of VocaLink

4. It is clear that the acquistion is fully in line with the PSR's objectives to increase competition and would remove the need for imposing the third aspect of the PSR's proposed remedy package, namely the divestment by the four largest shareholders of their interest in VocaLink. It should also

result in a more efficient outcome than a forced divestiture, ensuring that VocaLink is acquired on commercial terms by a purchaser intent on developing and expanding the business.

5. While certain of the current shareholders will retain a minority stake in VocaLink, with the collective ability to appoint one Director, none of them will have the ability to exercise material influence over VocaLink following completion of the deal.

6. Mastercard notes that some respondents to the PSR's market review made comments that may be relevant to the acquisition and are contained at page 131 of the Report under the heading "*unintended consequences*". We address each of the points below:

   - An operator queried whether transferring ownership of VocaLink to an infrastructure / switch provider might result in a decrease in the number of potential providers in the market, creating competition concerns. While this point will be considered by the competition review of the proposed acquisition we would highlight that Mastercard and VocaLink have largely complementary activities and the combined business will face material competitive constraint from a significant number of alternative credible providers. However, at para 3.46 and Box B of the Report the PSR has identified at least ten potential participants in future competitive tenders for the Bacs, FPS and LINK contracts. Many of these providers (such as FIS, SIA, STET and Nets) possess experience in providing infrastructure to batch and real-time interbank payments systems which Mastercard presently lacks. In the area of ATM switching infrastructure, Mastercard notes that over 20 companies were identified (and four shortlisted) in LINK's recent RFI process, and agrees with the PSR's assessment at para 4.205 that additional providers beyond the shortlisted four could compete.

   - At para 8.94, the PSR quotes one respondent which asked if there was a risk of creating an "*unchecked monopoly provider . . . if credible competition does not materialise following the transfer of ownership*". As outlined above, Mastercard expects that the combined business will face significant competition in the provision of central infrastructure services, facilitated also by the likely adoption of the PSR's proposed remedies which mandate competitive procurement and greater interoperability, which Mastercard fully supports. Given these measures (which will fundamentally impact the competitive dynamic in this market), combined with the PSR's statutory duty to promote competition (and its wide-ranging powers to do so), it is inconceivable that the scenario described by the respondent will come to pass.

   - Some respondents, referred to at para 8.95, queried whether new owners of VocaLink could place more emphasis on priorities such as cost reduction, "*to the detriment of security, stability and resilience*". Such concerns are entirely misplaced, in view of the extremely strong pedigree that Mastercard has in this area built up over the last 50 years. Payment scheme operators play a critical role in the UK's financial services infrastructure and have no incentive to award critical contracts to parties who will not provide service of the requisite quality, as it is clearly contrary to the commercial interests of all parties concerned for them to do so. Mastercard has built a global brand on the back of a strong reputation for security, stability and resilience and has no incentive to jeopardise its brand for the short term aim of cost reduction. Stability and resilience are necessarily integral to its operations, whilst its Enterprise Security Solutions division provides leading edge solutions in order to meet both regulatory requirements (such as those introduced by the upcoming revised Payment Services Directive) as well as the commercial demands of its customers. By combining huge investment with unparalleled expertise and extensive R&D, Mastercard's solutions in this area continually evolve thereby providing issuers, cardholders and merchants with the means of ensuring that transactions are as secure as they can reasonably be. Mastercard's recent appointment by the Home Secretary to the Oversight Board of its Joint Fraud Taskforce is testament to its work in this area.

- Another respondent, referred to at para 8.96, asked whether a new owner of VocaLink "*may be unwilling or unable to take over the value added and overlay services that VocaLink currently provides without demanding higher prices or longer contracts*". Mastercard is willing and able to continue offering VocaLink's current value added/overlay services in a competitive environment. Again, it would not be in its business interests not to provide services which its customers demand, on commercially attractive terms.

7. In short, Mastercard's acquisition of VocaLink would fully address the competition concerns identified by the PSR, thereby avoiding the need for a divestment remedy whilst at the same time not creating any of the theoretical adverse unintended consequences raised by certain respondents to the PSR's review.

Timing / sequencing of remedies

8. As the PSR is aware, on 21 July 2016 Mastercard and the current owners of VocaLink entered into a legally binding agreement under which completion of the deal is conditional upon clearance by the applicable competition authority. In the circumstances, Mastercard considers that the PSR should either pause its consideration of a divestment remedy in relation to the current ownership of VocaLink, or should the PSR wish to proceed, this should only take effect in the event that the proposed acquisition fails to complete. This would allow the deal to proceed on commercially agreed terms without undue intervention while ensuring that the PSR's objectives would still be met in the unlikely event of the acquisition failing to complete.

9. While Mastercard recognises that the PSR views the proposed remedies as a package, the above method of proceeding would not compromise the effectiveness or timing of other aspects dealing with the procurement process and interoperability, the merits of which are in no way dependent on divestment. In particular, the timing of the proposed acquisition or divestment would not hinder the introduction of these remedies (given that the next retendering opportunities for the UK central infrastructure contract are likely to be in 2020/2021).

Other proposed remedies

10. Mastercard supports the PSR's objective of increasing competition in the provision of central infrastructure services by ensuring competitive procurement exercises. However, for remedies to be effective, they must be carefully considered and fairly implemented. Mastercard is therefore pleased that the PSR is no longer proposing that competitive procurement be introduced at the break clauses of current contracts, as this would have been disruptive to VocaLink's existing arrangements with UK payment scheme operators, creating the risk of unintended adverse consequences. Of the four options the PSR is considering, set out at para 8.57, Mastercard would support the adoption of the third option of mandating public procurement without additional requirements such as an independent audit or an independently-run process. Such additional requirements would be unnecessarily restrictive and intrusive, as well as unjustified in the absence of any evidence that they are either required or would be effective. They would also be unduly onerous and burdensome and go well beyond the requirements of established procurement regimes.

11. Mastercard also supports the second aspect of the remedy package proposed by the PSR, relating to the adoption of interoperable messaging standards, consistent with the implementation of the other remedies and with current international practice. Regarding the PSR's two options for implementation, set out at para 8.74 of the Report, Mastercard would support the adoption of a standard without mandating the approach to be used. The Payment Strategy Forum is likely to be best placed to determine the optimal approach to adopting the new international standard.

VISA EUROPE

PSR CONSULTATION: Market Review into the ownership and competitiveness of infrastructure provision

1 EXECUTIVE SUMARY

1.1 Visa Europe ("**Visa**") welcomes the opportunity to provide comments in response to the Payment System Regulator's (the "**PSR's**") Final report as part of its *Market review into the ownership and competitiveness of infrastructure provision* (MR15/2.3) (the "**Final report**").

1.2 We welcome the PSR's stakeholder engagement following the Interim report consultation, and we look forward to continuing to engage with the PSR on these issues. We also appreciate that the PSR has now presented a range of options for consultation under each of the proposed remedies.

1.3 However we continue to have concerns with the approach adopted by the PSR in its market review. In this response we reiterate the concerns that we raised in our Interim response: namely, that the PSR has not followed best regulatory practice in its market review process[1]; and, in particular, that the PSR has set out its conclusions before undertaking a robust analysis of the problems that it is trying to address, or the remedy options that it is proposing.

1.4 Our response is structured as follows. In Section 2 we set out our comments on the PSR's overarching approach and process in this market review, and the intersection between this review and the work currently underway by the Payments Strategy Forum (the "**Forum**").

1.5 In Section 3 we provide our views on the specific remedies that have been proposed. We welcome the PSR's decision to consider a broader range of competitive procurement options, but remain concerned that some elements of the options are overly prescriptive and disproportionate. We also reiterate our view that the PSR must undertake a full cost benefit analysis before reaching any decision regarding competitive procurement, the adoption of common international messaging standards or divestment of VocaLink, and demonstrate that there is clear evidence of the benefit to consumers.

1.6 [✂]

2 OUR GENERAL COMMENTS ON THE PSR'S PROPOSALS

The PSR's approach should be driven by evidence and quantitative economic analysis

2.1 In our response to the PSR's interim report, we set out our view that the PSR's approach should be driven by evidence and robust economic analysis. We raised concerns that the PSR has relied heavily on previous studies dating back to the turn of the century, and has not adopted a sufficiently robust analytical approach or an appropriate process when undertaking its market review. In our view, it is particularly important to follow good

[1] For example, see: FCA, Economics for Effective Regulation, Occasional Paper 13, which sets out a framework including: problem diagnosis, design of interventions and impact assessment.

regulatory practice given the extreme nature of a number of the proposed remedies, including the forced divestment of VocaLink.

2.2 We appreciate the PSR’s focus on stakeholder engagement following the Interim report consultation, and its efforts to engage with stakeholders through roundtable discussions with stakeholders and meetings. We also welcome the PSR’s decision to set out a range of potential options for each remedy in its final report, and its commitment to undertake further analysis and consultation on the draft remedies decision.

2.3 However we remain concerned with the approach and process adopted by the PSR in its market review. In particular we are concerned that, at this late stage in the review, and by its own admission, the PSR is still yet to carry out a quantitative analysis to assess the extent of the problem or the potential costs and benefits of the proposed remedies to services users, and ultimately, end customers.

2.4 In our view, the PSR should have conducted a detailed assessment of the problem, and of the high-level remedy options, at a much earlier point in the process. We believe that the regulator has a duty to assess carefully the quantitative impact of the problem and its proposed solutions, before publically releasing its diagnosis of the market failure, and before proposing any remedies.

2.5 As set out in our response to the Interim report, the announcement of the proposed remedy without analysis and evidence to support its findings can impose potentially significant costs on market participants, and ultimately, on consumers. For example, the proposal to force the divestment of VocaLink places its owners in the position of a distressed seller before the merits of the proposal have been fully assessed. More broadly, without a fully evidenced case, the PSR runs the risk of introducing regulatory uncertainty into the market. Even the perception that the regulator is not following best regulatory practice has the potential to impact negatively on the sentiment of market participants (for example in the way that investment decisions are made) which will ultimately be to the detriment of customers.

2.6 We believe that the PSR should review the process and approach undertaken in this review, and consider revising its approach for future reviews. In our view, the PSR should undertake a careful analysis at the inception of the review to identify the specific market failure, and where possible quantify the harm caused harm to customers. The Interim report and consultations should focus on the PSR’s assessment of the market failure, and the PSR should, at the very least, conduct a high-level quantitative assessment of its proposed remedies before releasing them publically.

The interaction between the PSR’s infrastructure market review and the Payments Strategy Forum’s draft strategy

2.7 As pointed out in the final report, there are a number of interactions between this review and the work being undertaken by the Forum to identify areas where the industry needs to work together to promote innovation, and develop a strategy for the UK payments industry.

2.8 In particular, the effectiveness of the PSR’s proposal to hold competitive procurement exercises will clearly depend on which entity is procuring the infrastructure, the incentives of that entity and the associated governance and oversight arrangements.

2.9 As we set out in our response to the Forum’s draft strategy, there is currently a lack of detail around the Forum’s proposals to consolidate three of the interbank schemes and its longer term vision to develop a new simplified layered architecture for the UK interbank payment system. This is likely to make it difficult for the PSR properly take account of the Forum's work when developing its remedy on competitive procurement.

2.10 Nonetheless there are potentially important implications resulting from the Forum's work. For example, if the schemes are consolidated, it may be more likely that there would be only be one tender for services that cover the entire interbank infrastructure. This, in turn, could limit the number of potential providers that are able to tender, and reduce competition for the market.

2.11 Similarly, both the PSR and the Forum are considering the proposal to introduce common international messaging standards. While the Forum is currently proposing that common international messaging standards should be adopted by all interbank payment systems, including LINK, the PSR are proposing that LINK should be excluded from the proposal.

2.12 As we set out in our response to the Forum's draft strategy, we believe that the PSR, as the sector's regulator, needs to undertake a full and independent analysis of the Forum's proposals to ensure that any changes are fully aligned with the PSR's work in this review to promote competition in interbank infrastructure, as well as other areas of the PSR's work, and its overarching statutory objectives. We believe that the PSR must undertake this analysis of the Forum's proposals before it finalises the remedies as part of this review.

3 SPECIFC COMMENTS ON THE PROPOSED REMEDIES

3.1 This section provides Visa Europe's high level view on each of the three remedies proposed by the PSR in its Final report.

Remedy 1: Competitive procurement exercises

3.2 As set out in our response to the PSR's Interim report, Visa broadly agrees that a competitive procurement process may go some way to addressing a perceived lack of competition in the market for interbank infrastructure, but we would caution strongly against the PSR imposing overly prescriptive tendering requirements on interbank payment system operators.

3.3 We were pleased to see that the PSR has taken account of stakeholder views and is now considering four options, ranging issuing guidelines, through to more prescriptive and intrusive options that mandate competitive procurement and impose additional requirements.

3.4 We would support the PSR's proposal to mandate that competitive procurement is undertaken by a specified date as set out in Option C. We note that the contracts for Bacs, FPS and LINK all expire between 2020 and 2021,[2] and consider that the PSR should review whether it is appropriate for these contracts (which have not been competitively procured) to remain in place until this time. If the PSR considers that competitive procurement is an appropriate remedy, it should seek to impose it as early as is practicable. We also believe that the contracts should be tendered separately to attract a broad range of potential providers.

3.5 However, we are concerned that other elements of the PSR's proposals in Option C and even in Option B are overly prescriptive and disproportionate. These include the proposal

[2] However there is a potential break clause in the contract that would allow FPS to be procured from July 2019.

that the PSR specifies elements of the contract and that the process should be audited by an independent third party.

3.6 We believe that the PSR needs to strike the right balance between ensuring that the competitive procurement process is effective and implemented as quickly as possible to ensure that gains from increased competition and innovation can be realised, while also allowing operators the flexibility to design and run a process that best suits their requirements.

3.7 To this end, we believe that the PSR should examine the approach taken by regulators in other sectors, and benchmark the requirements for competitive procurement across a range of regulated industries with varying degrees of competition. For example, the requirements for procurement processes proposed by the PSR, which includes the condition that procurements must be monitored by an independent person, go significantly beyond even those stipulated for recognised natural monopolies. This is despite the PSR's conclusion that the provision of central infrastructure is not a natural monopoly.

Remedy 2: Common messaging standards

3.8 We would reiterate our views set out in our Interim response that, while there are potential benefits associated with the adoption of common international messaging standards, there are a range of potential drawbacks that should be considered by the PSR as part of a full cost benefit analysis before any decision is reached.

3.9 It is not clear that there is a significant direct benefit resulting from interoperability across interbank payment systems in the UK and in continental Europe. Conversely, any migration would impose significant costs across the payment system, including for infrastructure providers, operators, and Payment Service Providers (PSPs). It is likely that these costs would be passed through, at least in part, to end customers. There is also a risk that standardisation could inhibit innovation by locking in a sub-optimal solution, and potentially increase the cost of transitioning to superior technologies in the future.

3.10 While we understand that these issues are also being considered by the Forum, we believe that the PSR, as the payment systems regulator, has a duty to complete a full and independent analysis of the proposed options to ensure that they are effective and proportionate, and to ensure that they are aligned with the PSR's statutory objectives.

Remedy 3: Ownership of VocaLink

3.11 Here we reiterate our concerns set out in our Interim response that the PSR needed to clearly demonstrated a link between the ownership structure of VocaLink and harm to consumers, and conduct a cost-benefit analysis before announcing the proposal to divest VocaLink.

3.12 The announcement of the proposed remedy without analysis and evidence to support its findings potentially imposes significant costs on the owners of VocaLink because it places them in the position of a distressed seller. To date, we do not believe that the PSR has undertaken the analysis of the costs and benefits of this proposed remedy fully and robustly. This approach appears to fall short of regulatory best practice and has, in turn, the potential to cause significant harm to customers. More broadly, we note that even the perception that a regulator might not adopt a full and rigorous analytical approach to assessing a proposed intervention in the market is likely to have a serious negative impact on market participant sentiment – potentially increasing costs of finance and undermining investment – ultimately to the detriment of customers.

3.13 With respect to the specific options proposed by the PSR, we would ask that the PSR provides further details on its underlying analysis so that we can provide an informed perspective on their effectiveness and proportionality. We would reiterate our concerns that the PSR should conduct a full analysis of the effectiveness and proportionality of each of the options, and should not impose prescriptive governance changes unless there is clear evidence of the benefit to consumers.

SEPTEMBER 2016

VOCALINK'S RESPONSE

VOCALINK'S RESPONSE TO THE PSR'S FINAL REPORT: MARKET REVIEW INTO THE OWNERSHIP AND COMPETITIVENESS OF INFRASTRUCTURE PROVISION

[Intentionally left blank]

Contents

[Intentionally left blank]

Executive summary

1. In July 2016, the PSR published its final report for the market review into the ownership and competitiveness of infrastructure provision ('infrastructure market review"). This document represents VocaLink's response, as invited by the PSR.

2. In our 2015 Vision document, we set out our vision for how competition in UK payments could be enhanced and, as a result, drive even better outcomes for consumers. Both VocaLink and the PSR wish to see a vibrant and competitive payments market that delivers for UK consumers, and this is reflected in the many similarities between the PSR's final recommendations and VocaLink's Vision.

3. When we consider the market outcomes that have resulted under the current core scheme contracts, we continue to be encouraged that the evidence strongly supports the findings that good market outcomes, in particular value for money and service quality, have been delivered for customers and users. We maintain that, in the future, direct contracting between infrastructure providers and PSPs can deliver significant improvements, in particular for innovation. We are disappointed that the PSR has not considered our suggestion that it should assess the appropriate functions of the scheme companies and in particular whether scheme companies should have a procurement function or whether that would better sit with the PSPs (i.e. direct contracting between PSPs and infrastructure providers).

4. However, we also maintain that the PSR has not proven that competition in the provision of infrastructure to the Bacs, FPS and LINK schemes has been ineffective. While we support the introduction of full procurement processes, we consider that even in the absence of such processes, competitive pressures exists and have resulted in the good market outcomes that the PSR has evidenced.

5. Within its assessment of the market, the PSR's core concerns relate to the mixed incentives caused by the current ownership of VocaLink and scheme companies. The PSR's other concerns - such as ensuring value for money, quality of services, and encouraging innovation in the payment systems - stem from these core concerns of incentives and competition. We believe that initiatives that address scheme governance and the ownership of VocaLink should be largely sufficient to address the PSR's concerns.

6. In designing any market or regulatory intervention, the PSR should take due account of other developments that have the potential to address its concerns. In particular on 21 July 2016 MasterCard announced that it had entered into a definitive agreement to acquire 92.4 per cent of VocaLink (the 'transaction'). We consider that this transaction addresses one of the PSR's core concerns - a view shared by the PSR. We are greatly encouraged that, in the Infrastructure Final Report, the PSR acknowledged that it appears that this transaction would change the ownership arrangements of VocaLink in a way which could address the issues the PSR have identified[1].

7. We note the importance of this proposed remedy to the PSR, given the prominence that this particular remedy was given in the PSR's media statements following the publication of its

[1] PSR, *'Infrastructure Final Report'*, July 2016, paragraph 1.19.

Interim Report in February 2016[2]. This transaction delivers the PSR's proposed remedy on the ownership of VocaLink and delivers greater benefits than a mandated divestment. Both we and the PSR are therefore aligned on the change of ownership.

8. The merger review process to assess the transaction has formally begun. We believe that there is a significant risk to the industry and to the parties from the regulatory uncertainty that would be caused if the PSR continued to detail its proposed divestment remedy at the same time as the competition authority is conducting its merger review. Therefore, for the sake of users, stakeholders and investors, we ask the PSR to pause its work on the proposed divestment remedy under Financial Services (Banking Reform) Act 2013 (FSBRA). We note that this remedy can be re-visited, if the acquisition is prohibited. This will avoid any conflicts between the two processes.

9. We are supportive of a move towards ISO 20022 message standards if it can be achieved in a cost effective manner. However, we consider that further analysis is required, including cost benefit analysis to assess whether translation services (including payment aggregator services such as our PayPort products) offer a faster, more cost effective and, therefore, more proportionate way of delivering most of the benefits in the short run.

10. We appreciate the significant amount of work which the Payments Strategy Forum (PSF) and its working groups have been undertaken, and have recently responded to the consultation on the PSF's Draft Strategy. However, we remain concerned with the process, and in particular how that strategy will be implemented.

11. We agree with the PSR that there is effective competition in the provision of gateway solutions.

12. We would welcome the opportunity to discuss this response directly with the PSR ahead of the completion of the market review, and to engage positively for the benefit of our customers and the wider market.

[2] PSR Press release 'Banks should sell their stake in UK payments infrastructure to help increase innovation and competition', 25 February 2016 https://www.psr.org.uk/psr-publications/news-announcements/banks-should-sell-stake-payments-infrastructure-help-increase-innovation-competition

Chapter 1

Introduction

1.1. In July 2016, the PSR published its final report with the market review into the ownership and competitiveness of infrastructure provision ('infrastructure market review'). This document represents VocaLink's response, as invited by the PSR.

1.2. The structure of this response is as follows:

- In Chapter 2, we set out why we believe that the market is producing good outcomes for our customers;
- In Chapter 3, we comment on the PSR's continued work on the proposed VocaLink divestment remedy;
- In Chapter 4, we comment on the other remedies from the PSR's market review; and
- Finally in Chapter 5, we comment on the significant work required to govern and implement the PSF's outcomes and the PSR's role therein.

1.3. We would welcome the opportunity to discuss this response directly with the PSR ahead of the completion of the market review, and to engage positively for the benefit of our customers and the wider market.

Chapter 2

Market outcomes are good

Introduction

2.1. In this chapter, we comment on the PSR's evidence on market outcomes. In particular, we note that outcomes in terms of value for money and service quality are good and that our ability to innovate is hampered by the current scheme working practices.

2.2. Specifically, we make the following points:
- the PSR's assessment of competition does not sufficiently take into account the good market outcomes;
- the PSR's standard for effective competition is unreasonable;
- there are a significant number of competitors against VocaLink;
- there is effective competition in gateway solutions; and
- we are disappointed that the PSR has not fully considered the potential for competition.

The PSR's assessment of competition does not sufficiently take into account the good market outcomes

2.3. We welcome the PSR's acknowledgement that the market produces good outcomes in terms of value for money, service levels and innovation.

2.4. In respect of value for money, we welcome:

- the evidence that the PSR obtained that *'the operators and many direct PSPs said they are satisfied with the value for money they receive from VocaLink, given the high quality of service it provides'*[3];

- the PSR's acknowledgement that operators have secured price discounts (and other positive outcomes) in previous contract renegotiations with VocaLink[4]; and that

- the operators and four direct PSPs agreed with VocaLink that the past contract renegotiations have delivered outcomes (both financial and non-financial benefits) similar to what could have been achieved with a competitive procurement exercise[5].

2.5. In respect of quality of service, we welcome:

- the evidence obtained by the PSR that *'the operators and many direct PSPs (both shareholders and non-shareholders) were very positive about the quality of service. They stated that VocaLink's services had been highly resilient and stable. The direct PSPs said these are their main priorities given the significant impact that payment service outages can have on their customers. None of the operators or direct PSPs said they are dissatisfied overall with VocaLink's services'*[6];

3 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.87.
4 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.106.
5 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.88.
6 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.121.

- PSR's acknowledgement that VocaLink has almost always met its SLAs[7]; and

- PSR's acknowledgement that the Lipis report finds that UK payment systems are functionally rich compared with most other payment systems considered[8].

2.6. In respect of innovation:

- we welcome the evidence obtained by the PSR that '*many stakeholders believed that UK payment* systems *are innovative*'. Stakeholders also told the PSR that *'the Lipis report suggests that UK payment systems are among the most innovative in the world, and offer richer functionality and product diversity than other countries'*[9]; and

- we agree with the PSR that our ability to innovate can be limited by our contractual obligations[10].

2.7. We agree with the PSR that the provision of infrastructure for payment services is not a natural monopoly[11], and this is supported by the evidence that the PSR has presented on economies of scale, asset lives and the market structure that exists in other parts of Europe which is characterised by multiple providers.

2.8. We are encouraged by the PSR's recognition that '*it is possible to have competition in the market for the provision of central infrastructure services. This can occur when PSPs directly purchase central infrastructure services from multiple infrastructure providers (a different market structure to what currently exists). An example of this in practice is the SEPA Euro clearing system*'[12]. As stated in our response to the PSR's interim report and at paragraphs 4.14 *et seq* we request the PSR to consider in its future work ways to achieve this aim (e.g. through direct contracting) as a matter of priority.

2.9. We consider that the good market outcomes, which are acknowledged by the PSR, are consistent with effective competition. We consider that this is evidence that good outcomes can be achieved in the absence of the so-called 'best practice' procurement processes against which the PSR appears to be comparing the schemes' historical exercises. We set out in detail these points in our response to the PSR's Interim Report. In particular:

- the importance of other sources of competitive pressure such as bargaining (in the absence of full procurement process);

- the role of outside options for the scheme companies (e.g. the numerous competitors that the PSR has identified) and that competitive pressures can be and often are created with only a few bidders or potential suppliers;

- evidence of the effects of competitive pressure on the outcomes of the contracting process with Bacs, FPS and LINK; and

- the reliance of VocaLink on the core contracts.

2.10. The PSR's position appears to be that without full procurement processes, the schemes do not understand what alternatives to VocaLink exist. The PSR's view implies that the PSR

7 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.138.
8 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.138.
9 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.146.
10 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.177.
11 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.6.
12 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.15.

considers that the scheme companies are not fully informed when they tell the PSR that they are satisfied with the price and service provided by VocaLink.

2.11. We disagree with this position, and are concerned that the PSR unreasonably places no (or only limited) weight on the evidence of good outcomes that it has obtained. In our response to the Interim Report we put to the PSR our view that the schemes build their understanding outside of formal procurement exercises. The PSR has put forward no evidence that outcomes could be better and has, despite evidence to the contrary, relied upon its theoretical economic arguments that competition has not been effective. The PSR must take this evidence of good outcomes into account when considering the proportionality and effectiveness of proposed remedies.

The PSR's standard for effective competition is unreasonable

2.12. The tests to which the PSR is assessing competition are biased towards an ineffective competition finding. This is demonstrated through the PSR's conclusions on competition: '*we [the PSR] do not observe [procurement] processes that would <u>ensure</u> that the outcomes observed meet the current and ongoing needs of <u>all</u> service -users*'[13]. We are concerned that the PSR requiring that processes *ensure* market outcomes to meet *all needs of all service users*, is an extremely high test, and it is almost impossible to meet in even the most competitive of markets. We believe that this high test represents an unreasonable standard.

2.13. We believe that a more reasonable standard would be that market outcomes *more likely than not* meet the needs of service users. Indeed, the PSR appears to acknowledge that this likelihood of meeting the test is the reasonable and correct standard in its conclusion that '*the full ongoing benefits of competition are unlikely to be achieved*'[14]. But this likelihood standard is framed in respect of *full ongoing* benefits, again making the overall standard very high and unreasonable.

There are a significant number of competitors against VocaLink

2.14. The PSR asked and identified a number of domestic and non-domestic competitors to VocaLink. The number of providers who said they would be interested in competing was Bacs – seven providers; FPS - seven providers and LINK - five providers, although as we note in paragraph 2.9, only a few competitors are required in order to create competitive pressure and achieve competitive outcomes.

There is effective competition in gateway solutions

2.15. We concur with the PSR that there is effective competition in the provision of gateway solutions. In particular, we agree with the PSR's finding that:

> *'there is currently effective competition in the provision of gateway solutions and payment service providers (PSPs) seem to have sufficient choice in providers. The costs and risks of switching providers are not a high barrier. VocaLink does not appear to benefit from a competitive advantage due to its role as the central infrastructure provider. We [the PSR] find that the Bacs accreditation process or costs for certain Bacs gateway solutions are not a high barrier to entry for potential BASS gateway providers'*[15].

---

13 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.73 and 4.307 emphasis added.
14 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.73.
15 PSR, *'Infrastructure Final Report'*, July 2016, Box, page 80.

We are disappointed that the PSR has not fully considered the potential for competition

2.16. In its Infrastructure Final Report, the PSR considers briefly the extent to which there is competition in the market for payment schemes (compared to competition *for the market* for infrastructure provision)[16]. We welcome the PSR considering such wider issues and in particular whether the current market structure delivers the best outcomes for users. However, the PSR should go further and assess competition *in the market* for infrastructure provision (and not only competition in the market for payment systems) and direct contracting between banks and infrastructure providers. in particular. We are also concerned that the views expressed by the PSR on the extent of scheme competition are based on very little evidence or analysis.

16 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.17 and 4.18.

Chapter 3

Proposed divestment remedy

Introduction

3.1. In the Infrastructure Final Report, the PSR found that the four largest PSPs' common ownership and control of both the scheme companies and VocaLink are likely to reduce the level of competition. In particular, the PSR's view that the common ownership by the banks means that the scheme companies do not have a strong incentive to encourage competition between infrastructure providers. The PSR found that *'there is a lack of incentives for operators to look for alternative infrastructure providers that could better meet the needs of their service-users. We[the PSR] consider that this is partly due to the fact that the operators and the infrastructure provider are both owned and controlled by the payment service providers (PSPs) who use them'*[17]. Further, the PSR found that *'the four largest VocaLink shareholders control the operators and VocaLink in relation to matters related to exposing VocaLink to competition. This gives them the ability to protect VocaLink from competition'*[18].

3.2. The PSR has proposed a divestment by the four largest VocaLink shareholders of their interests in VocaLink. Further, the PSR is considering three high level options for the application of this remedy, which includes: i) partial divestment; ii) full divestment; and iii) partial or full divestment plus governance changes.

3.3. The PSR noted that the MasterCard acquisition of VocaLink ('the transaction') would change the ownership arrangements of VocaLink in a way that could address the issues that the PSR has identified[19].

3.4. Specifically, we describe why:
- the transaction will resolve the PSR's core concerns;
- MasterCard meets the PSR's purchaser suitability requirements;
- full divestment and/or governance changes would be disproportionate; and
- the PSR should pause its proposed divestment remedy to allow the transaction to complete.

The transaction will resolve the PSR's core concerns

3.5. We believe that the transaction would be a proportionate way to meet the PSR's concerns while ensuring that the UK payments system continues to provide value for money, quality of service and innovation into the future.

3.6. The transaction would end the four largest PSP's significant ownership and control of VocaLink. In total, after the transaction has completed, the current shareholders will hold only 7.6 per cent of VocaLink, compared to MasterCard's 92.4 per cent shareholding. [✂].

3.7. The benefit of some banks retaining a very small shareholding as part of this transaction is that it will provide an element of stability and continuity during the transition to ensure seamless and continuous service, while removing the incentive issues that the PSR has identified on core contract re-tendering. As stated by some respondents to the PSR's interim

[17] PSR, *'Infrastructure Final Report'*, July 2016, box page 3.
[18] PSR, *'Infrastructure Final Report'*, July 2016, paragraph 6.124
[19] PSR, *'Infrastructure Final Report'*, July 2016, paragraph 1.19.

report, partial divestment would *'ensure that the larger PSPs no longer had control in the new ownership structure but remained to offer their insights and expertise'*[20].

3.8. The reduction in the size of the PSPs' shareholding reduces, to an insignificant level, their ownership interests, and therefore after the transaction, they can be expected to act in a manner consistent with their interests as customers of the infrastructure.

3.9. Further, these bank shareholdings are significantly below the threshold for control based on any reasonable measure. The banks' minority stake would not be sufficient to give them individual or joint control (de facto or de jure) of VocaLink: no individual banking group will have more than a [✂] per cent shareholding of VocaLink and the shareholding of the four largest banks[21] (which the PSR considers currently control VocaLink) will decrease from [✂] per cent to [✂] per cent.

3.10. Interestingly, the PSR's analysis draws a parallel between the current and future shareholding structures concerning the definition of shareholder control over VocaLink. The PSR has concluded that the four largest shareholders currently control VocaLink; it has not concluded that the current fifth largest shareholder (Santander Group) controls VocaLink, with its individual minority holding of 7.8 per cent. Therefore, under the new shareholder model, the bank minority shareholding of 7.6 per cent cannot be said to exert control over VocaLink.

MasterCard meets the PSR's purchaser suitability requirements

3.11. The PSR identifies likely purchaser suitability requirements within the proposed divestment remedy, focusing on resilience and competition. As we noted in response to the PSR's interim report, it is not clear that the PSR has the legal capability to specify such requirements. Nevertheless, we believe that MasterCard fulfils these two areas of concern:

- **Resilience:** MasterCard has significant expertise and experience in running critical national programmes similar to the UK schemes for which VocaLink provides the infrastructure. MasterCard operates a global payments networks that delivers 99.99 per cent availability to more than 40 million retailers and 2.3 billion cardholders in more than 210 countries and territories across the globe. Therefore based on this track record, MasterCard ownership and control should ensure the infrastructure provided by VocaLink continues to perform seamlessly; and

- **Competition:** MasterCard is an excellent strategic fit and will enable VocaLink to deliver greater innovation and compete in the payments space, both in the UK and internationally.

Full divestment and governance changes would have been disproportionate

3.12. The PSR sets out three options in its Infrastructure Final Report for the implementation of its ownership of VocaLink proposed remedy[22]:
- partial divestment (and the PSR has suggested that the four largest PSP's reduce their holdings to less than 25 per cent);
- a full divestment; and
- a partial or full divestment plus governance changes (for example requiring the four largest PSPs not to seek or accept board representations at VocaLink).

[20] PSR, *'Infrastructure Final Report'*, July 2016, paragraph 8.105.
[21] Barclays Bank PLC, HSBC Bank PLC, Lloyds Banking Group and Royal Bank of Scotland Group.
[22] PSR, *'Infrastructure Final Report'*, July 2016, paragraph 8.112.

3.13. Any remedy imposed by the PSR must be proportionate and necessary to achieve the objectives pursued, particularly if it envisages requiring the current owners of VocaLink to dispose of their shares. In this context, that means that any divestment of a shareholding required by the PSR should be limited to the minimum divestment remedy necessary to address the competition concerns identified by the PSR.

3.14. Clearly, we are working towards a fulfilment of the current transaction with MasterCard, which features a partial sale of current shareholders' stakes. As stated above, we believe that this transaction, as an example of a partial divestment scenario, addresses the PSR's core concerns; and MasterCard meets the PSR's purchaser suitability requirements. Given this example, we believe that a full divestment remedy and governance changes would be a disproportionate remedy, for the following reasons:

- **Full divestment:** The transaction will change the current incentive structure. Therefore, it would be disproportionate for the PSR to require a greater divestment than that proposed in the transaction. Indeed, in reducing the banks' minority stake to 7.6 per cent the transaction goes significantly beyond the level of divestment needed to achieve the PSR's objectives. Therefore, if the PSR were to mandate divestment, a proportionate remedy would allow the banks to retain a holding significantly above the level of 7.6 per cent agreed as part of the transaction; and

- **Governance:** We do not see the need for the PSR to impose governance changes in addition to the ownership changes that the PSR is proposing. We consider that the change of ownership envisaged by the transaction will be an effective and sufficient remedy for the issues identified by the PSR. Therefore, any such governance changes that may have been proposed by the PSR in its remedies consultation are not necessary as the transaction will address any issues that any governance changes would otherwise have addressed.

The PSR should pause its proposed divestment remedy to allow the transaction to complete

3.15. In response to the PSR's interim report, we asked the PSR to pause its proposed divestment remedy to avoid disruption to the current ownership change process. We are disappointed that the PSR chose not to act upon these concerns. We believe that these concerns remain and we ask the PSR again to pause its proposed divestment remedy to allow the current transaction to complete.

3.16. This transaction will enable the PSR to meet its change of ownership objective in a more expedient timeframe than it could have achieved through the formal exercise of its legal powers. Further, the transaction has many elements which the PSR may find desirable, but which its legal powers do not enable it to mandate when seeking to require the disposal of an interest in an infrastructure provider[23]. (For example mandating a sale to a purchaser with significant experience in running important infrastructure, or mandating the sale of share capital to the extent of this transaction.) This demonstrates that VocaLink's and the PSR's objectives are very much aligned on this issue and that this alignment of interests will continue once the transaction has completed.

3.17. The transaction can only complete once merger clearance has been obtained. Clearance would mean that the competition authority believes that the transaction gives rise to no substantial lessening of competition. Indeed, the transaction – by virtue of addressing several of the concerns the PSR had in its market review – will support more competitive outcomes within the payment infrastructure.

[23] We set out our views on the limitations of the PSR's powers under s.58 FSBRA in paragraphs 5.47 to 5.53 of our response to the PSR's interim report.

3.18. We are concerned that the timetable for the PSR to consult on and consider its proposed divestment remedy under FSBRA will coincide with the competition authority's merger review process under competition law. Parallel reviews by the competition authority and the PSR would risk the processes and conclusions conflicting with each other. Such potential regulatory conflict would cause undue uncertainty and is likely to be detrimental to customers, innovation and investment. Further, the risk of inconsistency between the competition authority and PSR would also be incompatible with the Good Regulation principle of consistency[24].

3.19. In particular, it would be disproportionate and a waste of resources for there to be two parallel regulatory inquiries seeking to address the same issue: the ownership of VocaLink. The competition authority will be required to assess whether there is a realistic prospect of a substantial lessening of competition arising from the transaction. The Better Regulation Principles suggest that if the PSR wishes to act in addition to the competition authority, then it needs to demonstrate that satisfactory outcomes cannot be achieved by the competition authority as part of the review it will be required to conduct under competition law[25]. Seeking to demonstrate that the competition authority cannot achieve satisfactory outcomes before it has concluded its inquiry would be inappropriately premature, and could undermine and potentially prejudice the competition authority's process. Further, the PSR has already stated that it is reasonable to expect that it will be satisfied in relation to competition issues relating to the transaction if the competition authority is itself satisfied[26].

3.20. In view of the above, we suggest that the PSR pauses its proposed divestment remedy, in particular its consideration of the options for the proposed divestment remedy in its remedies consultation. [✂] the formal implementation of a divestment remedy by the PSR is unlikely to be necessary or relevant, particularly as the transaction is anticipated to complete [✂]. If for some reason the transaction does not complete, then the PSR still has the ability to revisit the remedy and take any steps it considers necessary under FSBRA to put it into effect at that time.

24 Better Regulation Taskforce, *Principles of Good Regulation,* 2003.

25 'It is Government policy to regulate only as a last resort, having demonstrated that satisfactory outcomes cannot be achieved by alternatives, self-regulatory or non-regulatory approaches.' Department for Business, Innovation and Skills, 'Better Regulation Framework Manual Practical Guidance for UK Government Officials', March 2015, Paragraph 2.3.14.

26 PSR, Infrastructure Final Report, July 2016, paragraph 8.115.

Chapter 4

Market reform and other remedies

Introduction

4.1. In this chapter we comment on the PSR's other remedies: i) competitive procurement exercises; and ii) interoperability and messaging standards.

4.2. While we do not disagree with the PSR's direction of travel with these remedies, we remind the PSR that our view of the opportunity to promote competition and innovation fully comes from greater market reform, as outlined in VocaLink's Vision, specifically through reforming the scheme arrangements and direct contracting. We are disappointed that the PSR has failed to consider these opportunities, which we believe makes the market review incomplete.

Competitive procurement exercises

4.3. We welcome full and competitive procurement exercises. Such processes will enable the purchasers to fully assess the options available to them.

4.4. We note that although the recent LINK Scheme Limited (LSL) process achieved good outcomes for itself and the PSPs, despite only inviting a limited number of bidders. As we noted in our response to the Interim Report, competitive tension can be created with only a few bidders, and the good outcomes for LSL as a result of the most recent contract negotiations clearly demonstrate this to be the case. However, we agree that a more open procurement process would enable more bidders to participate in the process for all core scheme contracts.

4.5. The historical procurement and re-contracting processes have led to the good outcomes observed by the PSR (see Chapter 2). In our response to the Interim Report we noted that each contract delivered better outcomes than the previous contract[27].

4.6. While we welcome full, competitive procurement processes, we consider that the incentives to run such processes (whether that is undertaken by the banks in a direct contracting market structure, or the scheme companies in the current market structure ('the procurement agent')) will be significantly strengthened by the change in ownership of VocaLink. We would therefore be more supportive of a procurement remedy which placed the fewest mandated requirements on the procurement agent, and gave them the freedom to run a procurement process that best meets their needs. If the PSR seeks to be prescriptive as to the procurement process to be followed, not only could that be disproportionate, but it could also prevent the procurement agent from running procurement processes that meet their requirements and interests.

4.7. In this regard, the PSR should not confuse outcomes with process. It is possible that good outcomes could result from a variety of processes. For example, the PSR notes that *'it is not common in other countries to hold competitive procurement exercise'*[28]. As VocaLink demonstrated in its Vision document and response to the PSR's interim report, good

[27] VocaLink, *'Market Reform: VocaLink's Response to the PSR's Infrastructure market review'*, April 2016, paragraphs 2.27 to 2.38.

[28] PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.69.

outcomes have resulted from a process that the PSR has characterised as having 'no effective competition'[29].

4.8. We re-iterate our view that direct contracts between PSPs and infrastructure providers will increase incentives to unlock innovation and drive the best outcomes. We request the PSR to assess the benefits of implementing direct contracting in order to allow for competition in the market as a matter of priority in its future work. We note that the PSR is '*not convinced that direct contracting is a realistic option in this market at this time*'[30]. However, as a minimum, the PSR should retain flexibility in the system to allow for direct contracting and the clear benefits it could deliver.

4.9. For these reasons, the PSR should take account of these developments and apply a rigorous principle-based approach to any intervention. In particular, there may be less justification for setting rigid rules on how a competitive tender process should be run.

Interoperability and messaging standards

4.10. In principle we support the move to a common message standard, and in particular ISO 20022 subject to it being delivered in a cost effective manner.

4.11. A move to adopt new messaging standards may be driven by the increased competitiveness in the sector that will result from a change in ownership of VocaLink. Moreover, the PSR acknowledges that VocaLink's ability to deliver on innovation is hampered by scheme procurement processes. For this reason, we support the PSF's proposal to develop a single standards body to oversee the transition[31].

The role of translation services

4.12. We are encouraged that the PSR has acknowledged the role that PAS and translation technology such as PayPort can play in removing barriers to entry. The PSR correctly notes that '*the PSPs could use message translation services for a period to avoid having to make immediate changes to their internal systems. They could then implement the transition at a suitable time – for example, when they next refresh their internal systems*'[32]. This means that PAS and translation services can remove the barrier to entry in a quicker manner than transitioning to ISO 20022. The PSR needs to consider the reasonableness of its common standard proposed remedy against the alternative of PAS and translation services. PAS and translation services could constitute more effective and proportionate interim solutions to the issues, even if common message standards are a better long-term solution. The PSR has not made the case that mandating a common standard is better and more proportionately addresses the issues it has identified: that current standards are a barrier to entry. We agree that there may be wider benefits of ISO 20022, but that these may be outside the PSR's framework to assess its the effectiveness and proportionality of its proposal to remedy the competition issue (the barrier to entry) that it has identified.

4.13. The PSR notes that the use of message translation services may represent a possible solution to the barrier represented by UK messaging standards subject to the completion of outstanding mapping exercises between existing standards and new standards[33]. The PSR

[29] PSR, '*Infrastructure Final Report*', July 2016, paragraph 4.71.
[30] PSR, '*Infrastructure Final Report*', July 2016, paragraph 4.15.
[31] PSR, '*Infrastructure Final Report*', July 2016, paragraph 7.18.
[32] PSR, '*Infrastructure Final Report*', July 2016, paragraph 4.226.
[33] PSR, '*Infrastructure Final Report*', July 2016, paragraph 4.285.

should therefore include this remedy as an alternative to its common standard remedy in the upcoming remedies consultation – to do otherwise would be unreasonable.

Market reform

4.14. In our Vision document and our response to the PSR's Interim Report we set out how we thought that the market for payment services and infrastructure could develop:

- **Changing the current VocaLink ownership model:** The Vision articulated the benefits that would accrue from changing VocaLink's current ownership arrangements. As explained above, the acquisition by MasterCard has been agreed and is now conditional only on merger clearance from the appropriate competition authority. Accordingly, for the reasons set out above, we suggest that the PSR does not pursue consultation on the remedy options relating to VocaLink's ownership model at the present time;

- **Reforming the scheme arrangements:** We are encouraged that the PSF is considering scheme governance reform, and we welcome the PSR's acknowledgement that collective procurement in the core services has led to less innovation than that found in non-core services where the PSPs can gain a competitive advantage[34]. Direct contracting between PSPs and infrastructure providers would further increase incentives for innovation. We agree with the PSR that '*in the current market structure of collective procurement, the operators and direct PSPs do not have a strong incentive to innovate or shop around for more innovative services*'[35]. The PSR also notes that '*in this structure with collective procurement, incentives to switch provider may be more limited than in a structure where PSPs contract directly with providers*' [36].

  The PSR's views imply that the competition issues identified could be remedied by reforming the functions of scheme companies, and in particular by direct contracting between bank and infrastructure provider. It is therefore incumbent on the PSR to consider such a remedy as a matter of priority in its future work, and to factor this into its consultation on the three potential remedies proposed in its Infrastructure Final Report in the current market review.

  We are disappointed that the PSR has not considered our suggestion that it should assess the appropriate functions of the scheme and in particular whether scheme companies should have a procurement function or whether that would better sit with the PSPs (i.e. direct contracting between PSPs and infrastructure providers);

- **Making access to payment systems easier:** Indirect access portals or payment aggregator services ('PAS') portals, such as VocaLink's PayPort product[37], will provide technical access to systems. This will increase competition and make access to systems easier;

- **Reducing the barriers to entry and switching for infrastructure providers:** We noted that the new PAS technology is enabling opportunities to reduce the segmentation between the UK and the rest of Europe. PAS products, such as VocaLink's PayPort are able to translate between UK and international message standards, including ISO 20022

---

34 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.188.
35 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.117.
36 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 4.244.
37 In the Vision, we discussed the 'Single Front Door' product, which has now been rebranded as 'PayPort', and is an extension of the current portal product offered for access to Faster Payments.

and SEPA standards. Therefore, the provision of translation services between message standards helps to remove a barrier to entry for, and switching to, European infrastructure providers in the UK (see paragraph 4.12 *et seq* below); and

- **Managing the remaining network effects:** While the impact of network effects has reduced, some network effects will remain in the industry. Our Vision proposed the creation of an industry Interoperability Code of Conduct, as well as stressing the importance that the PSF should be successful. While we are encouraged by the PSF's draft strategy, we continue to have concerns with the PSF process. We set out these concerns in Chapter 5.

Chapter 5

The role of the PSF

Introduction

5.1. In this chapter we comment on the PSF and PSR processes.

5.2. We are encouraged by the level of participation in the PSF and the volume of work that this is generating. We recently responded to the PSF's draft strategy consultation and would welcome the opportunity to work with the PSF to ensure that the final set of recommendations and proposed initiatives are appropriate for the industry, contain the appropriate balance between market and collaborative solutions, fit in with other changes in the market, and are responsive to all user needs.

5.3. However, we continue to have some concerns about the status of the PSF and the implementation of its proposals. We set out these points below:

- the cost benefit analysis and prioritisation work need to demonstrate positive industry business cases if the PSF's strategy is to succeed;
- the governance process around the fulfilment of the PSF's strategy is unclear; and
- the PSR must follow its objectives while implementing the PSF strategy.

The PSF's cost benefit analysis and prioritisation work need to demonstrate positive industry business cases if the PSF's strategy is to succeed

5.4. We believe there needs to be a positive industry business case behind each of the individual projects within the final strategy if the industry is to be sufficiently motivated to deliver.

5.5. The PSF does not have power to mandate change on the industry; nor is the industry bound to accept the PSF's strategy. The strength of the PSF lies in bringing together industry participants to agree on measures that require co-operation, in order to advance the provision of services that better meet user needs. However, this does not mean that the industry would proceed with projects that do not have a positive business case, and as such would be unprofitable.

5.6. Therefore, in order for the strategy to succeed, it needs to identify projects with positive business cases. Specifically, this means that the individual changes proposed need to fulfil consumer, corporate and/or government demand. Thereafter, the individual projects need to result in cost savings or new user charges that cover the development, implementation and running costs, as well as a risk premium.

5.7. Calculation of positive business cases needs careful analysis. We note that there is a difference between the assessment of business cases and cost benefit analysis. Further, we note that the choice of analysis methodology needs careful consideration. For this reason, we call on the PSF not to:

- **Outweigh a negative financial business case with positive non-financial economic welfare calculations, to create a positive benefits case:** Without a positive financial business case, then the project will be loss making for the industry and the correct commercial incentives will not exist;

- **Inappropriately group individual projects together to generate a positive business case:** Each individual and separable project should be assessed separately, in order to calculate the business case. The grouping of positive and negative business cases for separable projects would merely create inefficiencies, and a perverse incentive on the industry to avoid the negative business case project; and

- **Inappropriately group roadmap stages within a single business case assessment:** Where the PSF sets out a progression of developmental stages for the industry, the business case assessment should consider each stage separately, rather than to group stages together. This is important if the benefits can be achieved in the early stages, while the majority of the costs are incurred in the later stages. In this scenario, there may be a negative business case for the later stages and therefore, such stages should not be undertaken.

5.8. This places an onus on the PSF and its consultants to correctly specify the cost benefit analysis to deliver the right results for the industry. Without a positive industry business case for individual projects, then the industry will not be sufficiently motivated to fulfil the projects and the PSF's strategy will fail.

5.9. In terms of context for the cost benefit work, it would also make sense for this activity to be informed by looking at experiences in other geographies, such as The Clearing House in the USA.

5.10. Further, when prioritising which initiatives should be taken forward, the PSF will need to recognise that the draft strategy cannot be viewed in isolation from wider market developments. By definition, it will not be an all-encompassing payment strategy for the UK given that certain major payment instruments, particularly cards, have not been considered (due to the PSF's focus on interbank scheme payments), and given that the scope is further limited to domestic payments in Sterling.

The governance process around the fulfilment of the PSF is unclear

5.11. We note that the PSF does not have power to mandate change on the industry; nor is the industry bound to accept the PSF's strategy. This further emphasises the need to ensure that each individual initiative proposed for implementation has a clear positive business case, ensuring a clear motivation for proceeding with the PSF's strategy and that only those initiatives which cannot be delivered by the market are proposed as candidates to be considered for taking forward on a collaborative basis.

5.12. As we noted in our response to the PSR's 2014 Consultation paper, the PSF cannot be regarded as being a representative body that properly reflects the complete UK payments systems industry – as illustrated by the lack of infrastructure provider representation in the PSF's membership. This emphasises the need for the PSF's strategy to be consulted over a reasonable timeframe, to allow all members of the industry to comment – and for those comments to be considered fully by the PSR.

5.13. Moving forward, we believe that industry governance over the implementation of the strategy needs careful consideration and we urge the PSF to clarify the proposed governance model as soon as possible, in order to ensure a successful implementation of the strategy. At this stage, there are no proposals for how to ensure that appropriate decisions are taken and that in collective areas of co-operation within the industry there is fair industry representation. The collaborative aspects of the subsequent implementation process will also need careful and disciplined management. We would see that the new combined scheme company would be a strong candidate to be given the task of overall coordination of the implementation of final set of collaborative implementation activities, once agreed.

The PSR must follow its objectives while implementing the PSF strategy

5.14. We note that the PSF strategy features in the infrastructure market review remedies. If the PSR wants to 'use' the PSF's strategy, in whole or in part, it must satisfy itself that that strategy proposed is appropriate, and in doing so the PSR must follow its duties and objectives as well as the process and practices generally required of a public body, and in particular, the PSR's general duty to consult under s.103 of FSBRA.

5.15. A practical concern is the PSF is not an independent body and thus it is subject to commercial interests, as a result of its composition and discussions. As a consequence and for example, our response to the PSF contains only non-confidential information, because to do otherwise would potentially (i) give a competitive advantage to our competitors, customers and suppliers; and (ii) risk a breach of competition law. We anticipate that other respondents to the PSF's consultation would have similar concerns. For that reason, we also are also concerned that the PSF will not have full information about the payment systems industry when it is formulating its strategy proposals. This concern is compounded by the fact that market participants have no way of challenging any PSF process that has erred in fact, law or judgement.

5.16. In its Infrastructure Final Report, the PSR refers to the '*alignment*' of the implementation of any proposed remedies with the work being undertaken by the PSF[38] and that when developing its remedies the PSR will '*where appropriate … take into account*' the ongoing work of the PSF[39]. We appreciate that the PSR will, where relevant and appropriate, wish to take into account the PSF's work and recommendations. However, we emphasise that the PSR cannot simply rely on advice or recommendations given by the PSF without undertaking its own inquiries and making its own objective assessment. Such assessment by the PSR must, as noted above, include a full consultation which meets the standards required of public bodies generally, and the duty to consult specifically imposed on the PSR under FSBRA.

5.17. We would therefore expect the PSR's consultation on its proposed remedies to be a full consultation including any elements of the PSF's strategy which are relevant to the remedy options under consideration. Further, we would not expect the proposed remedy options to be conditional on future output of the PSF or any other body, unless the PSR had conducted its own thorough and robust assessment of that output.

38 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 1.18(b).
39 PSR, *'Infrastructure Final Report'*, July 2016, paragraph 8.6.

[Intentionally left blank]

Head Office
1 Angel Lane
London
EC4R 3AB
United Kingdom

info@vocalink.com

vocalink.com

Registered No. 6119036

Bottomline Technologies – Comments by e-mail on:

PSR MR15/2.3 – Final report: market review into the ownership and competitiveness of infrastructure provision

There are worrying and fundamental issues in the above report relating to Direct Access to Bacs services – this perception appears across a wide range of PSR activities.

The main issue is the perception that Bacs direct submitters are low volume, and that most corporates submit via Bureaux or PSPs.

We calculate c. 20,000 corporates from SME to MNCs connect directly into Bacs (Bacs may suggest more), these are usually larger volume payment transactions – smaller volume customers typically use PSPs. It is in fact extremely rare for a large volume Bacs submitter to submit via a PSP.

Bottomline service [✂] corporates connecting directly into Bacs services (in addition to [✂] Bacs Bureaux). These range from SMEs (c. 10 employees and above) to MNCs ([✂]%+ of the FTSE 100 use Bottomline solutions). The majority of large volume users of Bacs services either connect directly via Bottomline solutions, or via other Bacs solution suppliers. Our solutions handle over [✂]BN Bacs transmissions a year – through the direct Bacstel-IP channel [✂] – One [✂] customer of Bottomline alone processes 55 million items a year through our solutions. [✂]

There are no Corporates submitting via ETS or STS. The only non FI using either channel: [✂] cannot be classed as a corporate. The ETS and STS channels are not suitable for corporate grade Direct Debit and Credits.

To ignore this whilst proposing remedies into ownership and competitiveness of infrastructure provision will have major impacts on the tens of thousands of corporates – who choose NOT to submit via a PSP.

My comments below on the Bacs section of the report.

"Bacs
5.12 The choice available to a PSP for its gateway provider (for obtaining direct technical access) depends
on the communication channel it uses to connect to the Bacs central infrastructure. There are three channels:

• Bacstel-IP: This is typically used by indirect PSPs and corporates with smaller volumes of transactions, and is input-only."

Bottomline: Incorrect – It is typically larger volume submitters that use the service, as PSPs channels cannot typically handle the data volumes, Bacs scheme requirements for Direct Debit, provision of the A services necessary for CASS to operate properly, nor corporate requirements in terms of timely or reliable access to services.

"5.13 Direct PSPs in the Bacs system need to connect using either ETS or STS because they get output
information from the central infrastructure to debit and credit customers' accounts. Some indirect PSPs get Bacs output directly – direct technical access – so must also use either ETS or STS.

5.14 Indirect PSPs and corporates that only need an input channel can choose between the three channels
to submit payment instructions (here, indirect PSPs get their Bacs indirectly from VocaLink, via their sponsor bank). For example, some corporates that submit very high volumes use ETS or STS. Indirect PSPs and corporates can also submit indirectly through their sponsor bank or using a Bacs bureau service."

Bottomline: Indirect PSPs and corporates that only need an input channel have the following choices

1) *Via Bacstel-IP Direct access solutions (c.20,000 corporates) – typically higher volume users.*
2) *Via a Bacs Bureau Service*
3) *Indirectly through a sponsor bank*
4) *ETS or STS – no corporates using, even if they technically could, neither of these channels provide access the Bacs Payment Services Website, which is fundamental for a large volume Bacs user, as this the channel for provision of Unpaid Direct Debits, Unapplied Credits, Amended or Redirected Accounts.*

To Payment Systems Regulator

From Payments UK

Payments UK's Comments on the Payment Systems Regulator's Final Report on its Market Review into the 'Ownership and Competitiveness of Infrastructure Provision'

1 INTRODUCTION

Payments UK welcomes the opportunity to comment on the Payment Systems Regulator's (PSR) Final Report on the Market Review into the Ownership and Competitiveness of Infrastructure Provision.

Payments UK is the trade association launched in June 2015 to support the rapidly evolving payments industry. Payments UK brings its members and wider stakeholders together to make the UK's payments services better for customers and to ensure UK payment services remain world-class.

Payments UK's main roles:

- To be the payments industry's representative body: providing an authoritative voice in the UK, Europe and globally, and working with stakeholders to share payments knowledge and expertise.
- To be a centre for excellence: supporting the UK payments industry to provide world-class payments, building on experience, thought-leadership and project delivery expertise behind award-winning initiatives such as Paym, the Current Account Switch Service and Faster Payments.
- To deliver collaborative change and innovation: working on behalf of our members to benefit customers and UK plc, ensuring their needs are understood and met, both now and in the future.

In line with our response to the Market Review's Interim report, our comments relate to remedies numbered 1 and 2 and the underlying analysis. We are not providing any comments on remedies 3 or 4. We will continue to work alongside the industry to assist the PSR in the next steps of their Market Review. We will engage with the PSR when they publish their remedies consultation later on in the year.

Payments UK 2 Thomas More Square London E1W 1YN

A Company incorporated in England No 6124842.
Registered Office as above

2 OUR RESPONSE

2.1 General comments

Payments UK is supportive of competition in the payments industry in respect to remedies 1 and 2. However, this should not come at the cost of the stability or integrity of the UK's payment systems. We believe that economic regulation of the payments industry and the powers given to the PSR can help to deliver effective competition and promote innovation for the benefit of UK consumers, businesses and the economy. It is on this basis that we broadly support the overall aims of the review to promote a competitive and innovative market.

As we noted in our response to the interim report, proposed changes by the PSR will have a significant impact on the industry in terms of cost of change, and also lock up significant change capacity. Therefore, Payments UK believes we need to be clear that the steps taken and outcomes will produce significant benefit and will not compromise the industry's stability or resilience. In order to achieve these outcomes, we believe that a number of principles should be considered. Below we have reiterated and built upon the principles set out in our response to the interim report:

- **Ensuring the approach taken aligns with the longer term strategy and that decisions are prioritised and sequenced correctly**:

  As stated in our response to the interim report, there are a number of significant changes to the industry being considered. There is an underpinning requirement for a coordinated approach to the development, implementation and maintenance of industry requirements and recommendations, including this Market Review, the Payment Strategy Forum's (PSF) draft Strategy, and the revised Payment Services Directive (PSD2). The PSR needs to be conscious of the level of change being undertaken in the industry and also the need for the industry to be able to address change effectively. On this basis, the output of this Market Review needs to consider the change agenda.

  The industry needs to remain agile and able to adequately manage the regulatory change agenda in a way that avoids inefficiencies or governance issues. This includes this Market Review. There is an increasingly urgent need to consolidate and coordinate collaborative activities so as to best progress towards better outcomes for end users and to support competition. In order to realise the end-user benefits, the payments industry needs[1]:

  - An approach that is free from legacy issues and governed to engage with the industry's stakeholders and provide them with assurance that their current and future needs will be met, whilst giving regulators the oversight and accountability they need;
  - Coordination of industry and between the various UK and EU regulators of financial services to support implementation in the right sequence and in an efficient and safe way, that is for everybody's benefit and in recognition of the global regulatory influences;
  - The ability to develop implementation plans that allow governance that is appropriate to the fast-changing commercial landscape of the financial services industry; this is particularly pertinent to payments where collaborative innovations are necessary; and

- Decisions prioritised on a thorough understanding of customer needs and clear cost benefit case for proposed solutions.

In broad terms, we believe that the output of the Market Review will need to be delivered in a coordinated way that is considerate of the true scale all industry changes. Such an approach will need to consider the benefits and costs of change, a funding model and a technical implementation plan that sequences and prioritises activity.[2]

- **Ensuring that the procurement strategy and process meets the desired outcomes**:

  Any new procurement process for nationally critical UK infrastructure must be backed up by detailed and thorough economic analysis, and be based on hard evidence rather than perception. There needs to be analysis undertaken to quantify the costs and benefits, and explore issues such as the interaction between competitive pricing and competition, length of contracts, investment and innovation.

  If the economic evidence gathered by the PSR fully supports a competitive procurement process then we would like to see the development of a clear procurement strategy that explores the risks and opportunities associated with different procurement options, including the agency or agencies, such as any future operator, that design the process, own it and make the final decision.

  Any procurement process will need to be undertaken in a way that guarantees the desired outcomes and safeguards against unintended consequences. Ideally, the process should:

  - guard against any unintended consequences, for example additional cost for participants (including duplication and fragmentation), instability issues, imposing barriers to entry to new market participants or reducing interoperability.
  - be based on best practice procurement design following the example of other markets where similar competitive processes have been recently completed, such as Australia and the United States.
  - be designed in such a way that balances the interests of all involved stakeholders.
  - consider whether it may be appropriate to have an independent review mechanism in place to oversee the market testing and award process.
  - be designed as a single common process for procurement across all collaborative services to avoid complexity, duplication and inefficiency.
  - be able to demonstrate, through pre-procurement market testing, the overall economic and innovation metrics that could be realised. This will ensure that the cost of impact on all stakeholders will be significantly outweighed by the benefits.

- **Ensuring a full appraisal is given to all risks associated with any change to critical payments infrastructure**

[2] We set out more detail on our thinking on this approach in our response to the Payments Strategy Forum's draft Strategy.

Any change comes with its own risks but these must be considered against the evidence of any detriment and the assessment of benefits to be gained – emphasising the need for a solid economic analysis as the basis for any decision taken.

2.2 Remedy 1: competitive procurement exercises

Payments UK is supportive of the PSR's ambitions to make the ownership of payments infrastructure work even more effectively for the benefit of the end user. We agree in principle that this could be achieved by the provision of cheaper, more efficient and innovative service offerings. However, as a first step we believe that clarity is needed on the future strategic direction of the development of the UK payment systems before committing to a procurement exercise. It would be most effective and efficient to make the two steps in sequence, rather than duplicate the procurement exercise before, and potentially again as part of, the simplification exercise set out in the PSF draft Strategy.

We also note that this two-step approach must be considerate of the short term ramifications for medium-to-long term change. For example, there are significant changes to the payments industry forthcoming and during the next few years the first break clause for re-procurement of a PSO will arise. The PSR must therefore consider this short term period ahead of any plans for short-to-medium term change

If this case is made, then we would like to see the development of a procurement strategy that ensures the procurement process is undertaken in a way that guarantees the desired outcomes and safeguards against unintended consequences. As we state above, the process should consider whether it may be appropriate to have an independent review mechanism in place to oversee the market testing and award process. This relates directly to the need, for an approach that is free from legacy issues and governed to engage with the industry's stakeholders and provide them with assurance that their current and future needs will be met, whilst giving regulators the oversight and accountability they need;

In addition, there needs to be confidence that by undertaking the procurement process there will be a net cost-saving and clarity over the timescale in which it will be realised. We note, as we did previously, that there are a number of ways to procure ownership, oversee market testing and award process, and regulate a single provider market. Payments UK would welcome evidence that the proposed competitive procurement model is the most efficient way of achieving the aims outlined by the PSR.

2.3 Remedy 2: interoperability and messaging standards

Payments UK agrees that the lack of common international message standards in the UK could potentially act as a barrier for some infrastructure providers. Standards are indeed seen as an enabler of interoperability and efficiency and to help ensure a consistent user experience. Payments UK's members agree that a common technical messaging standard, chiefly ISO 20022, is an aspiration for the UK payments industry and this is articulated in its policy related to the standard[3]. Given the global trend towards ISO 20022 and its adoption, namely in the SEPA region, US, Australia and Canada, and given that payments is an increasingly global business, Payments UK would advocate ISO20022 as the default choice of messaging standard.

Payments UK supports the adoption of a common messaging standard as an enabler of agreed industry innovation and change not as a deliverable in its own right. Therefore, the industry must be clear that the cost of investment and the necessary process to see this brought to market is supported by a robust benefits case. As stated in our previous response, the case for migration to ISO 20022 for each of the existing PSOs should be considered independently of each other in the context of the ultimate aims of increased interoperability and improving competition in the infrastructure supply side. In the case of Bacs, the value of migrating to ISO 20022 solely to cater for Bacs functionality as designed within the current Bacs architecture needs to be considered thoroughly.

Before any decision to mandate the adoption of ISO 20022, Payments UK welcomes further analysis of adoption methods particularly in light of the recommendations in the PSF's draft strategy. Seemingly, the approach as outlined in this Market Review is somewhat conflicted with the proposed strategy of the PSF. Investing in ISO 20022 for the current PSO's as suggested in both options of this report, against the backdrop of a potential decision to consolidate the operational environment in the UK payments market could present both cost and implementation challenges that are undesirable. Greater clarity on the ultimate desired operational conditions for the UK market is needed before any decision to mandate ISO 20022. ISO 20022 is an enabler of agreed upon industry change. Coordination between various requirements relying on ISO 20022 for implementation needs to be carefully thought through to ensure there is an optimum strategy for the UK to adopt the standard, to leverage investment and ensure the benefits are realised.

Payments UK supports a phased transition approach as the ideal and least disruptive to the market, a big-bang implementation is not desirable. Introducing a transitionary period for adopting ISO 20022 ensures that all PSPs can develop or upgrade their back-office systems over time, which will be more cost-effective and less impactful. Payments UK recommends that the migration period be kept as short as possible, without creating unnecessary risk, in order to keep costs to the industry low and to quickly and efficiently reap the benefits of adopting ISO 20022. We accept that there is a need for translation services to be in place during this period and support having a time limit imposed on how long translation services can be used for. Payments UK supports the notion of standardising scheme rules. There is a need to have clear business rules and specific implementation guides (IGs) to foster greater interoperability when implementing ISO 20022. There would be a need for a central body to facilitate the development of a harmonised and consistent set of publically available UK ISO IGs to ensure consistency and avoid divergence of implementation.

[33] Payments UK ISO 20022, Policy: 'Any requirement for the UK payments industry to invest collaboratively in a common messaging format or means of data exchange must, by means of formal assessment, consider the opportunity to invest in ISO 20022; making ISO 20022 the default choice. At its core ISO 20022 uses a data library that represents business data in a standardised way that is independent of syntax therefore it can also be used to enable other industry investments, such as the formation of standardised APIs or support for new syntaxes should the need arise. The option to use ISO 20022 in this way should also be considered as part of any industry investment that requires a level of standardised data.'

As stated in our consultation response in April 2016, any migration and adoption of ISO 20022 for UK electronic payments must avoid:

i. detrimental impact to the integrity of the payments infrastructure;
ii. introducing uncontrolled risks;
iii. detrimental customer impact, whatever the segment of customer;
iv. imposing barriers to entry for new market entrants (challenger banks, agency banks and solution providers);
v. divergences as far as possible with Europe (SEPA) and other global adoptions of ISO 20022 pertinent to the customers of the UK payments infrastructure; and
vi. divergences in the technical and operational documentation and to ensure as far as possible common implementation documentation that is freely and publically available without restriction.

BRC response to PSR market review into the ownership and competitiveness of infrastructure provision

The BRC has serious concerns over the final report of the PSR market review into the ownership and competitiveness of the infrastructure supporting the main interbank systems. Whilst we would support the final findings of the report, the BRC fear that the potential remedy relating to divestment in VocaLink could lead to adverse outcomes that would in fact be worse than the status quo.

The BRC welcome any and all measures to promote a more competitive payments industry and recognise that ownership and control have a key part to play in securing the changes that all end users of the payment systems need to see. Indeed, the experience of the retail market has been such that the BRC would actively encourage reforms in the ownership and governance of the current payments infrastructure, but nowhere more so than within the card payments industry. The BRC is disappointed then that the card payments industry, which is not within the scope of this report but which has consistently failed to deliver transparency and value-for-money for end users – and is in greatest need of reform, has not received a similar level of scrutiny.

The primary concern of the BRC then on divestment in VocaLink is with regards to the entity that subsequently invests in it, and their designs for the management and operation of the company. Both the interbank PSOs and the payments clearing system are core components of the UK's national infrastructure and so must be run and maintained by an appropriately regulated UK-based body.

The BRC would be opposed to a card scheme taking a further role in the PSO market given the poor track record of these industry operators in delivering for end users. Retailers are an end user for BACS for corporate payments and so the BRC is concerned at the prospect of a card scheme moving into the payments market in the area currently operated by the interbank schemes and imposing a new pricing model. If card schemes were to impose an ad valorem pricing system on staff remuneration payments, for example, this could be punishing for retailers and all businesses.

The BRC believes that PSPs need to have controlled access to the three interbank PSOs and that access to those systems needs to be provided in a consistent and standard method at a cost effective price.

PSOs can continue to deliver value provided that the company running the infrastructure to support those payments is not owned or associated with a competitive payment product. The card schemes technical infrastructure should therefore be precluded from running these systems as there will ultimately be a conflict of interest associated with the benefits and/or costs of handling each different type of payment method it handles.

For the same reasons, and for reasons of competition and pricing, the BRC are also opposed to a card scheme taking ownership of a further section of the payments clearing system. Furthermore, their use of non-transparent pricing methods makes it extremely difficult for users to establish the real price of the payment service. The BRC has long campaigned for more transparency in the operation and pricing of the card payments market.

The increases in scheme fees currently underway by the card schemes in order to offset the benefits to end users brought about by the long awaited Interchange Fee Regulation has provided yet another clear demonstration of questionable business practices employed by the card payments industry to the detriment of end users, and provides a further reason to restrict their expansion into other sections of the payments industry.

A payments processing monopoly is now on the horizon, and retailers will potentially be at the mercy once again of a card company for processing payments. The BRC is hopeful that the Competition Commission will recognise this and block the MasterCard purchase of VocaLink.

The focus of the PSR must be to enhance payment services, and to do so in way that is cost effective for end users. The decision of whether or not to proceed with this remedy must undergo a thorough cost-benefit analysis with the long term outcomes for end users of the payments system in mind.

About the BRC

The British Retail Consortium (BRC) is the trade association for the entire retail industry. Our members account for 80% of all UK retail sales. Diverse and exciting, our industry spans large multiples, independents, high streets and out of town, online and bricks and mortar, selling goods across all sectors from clothing, footwear, food and homeware to electricals, health & beauty, jewellery and everything in between, to increasingly discerning consumers.

Our mission is to make a positive difference by advancing vibrant and consumer-focused retail. We stand for what is important to the industry and work in partnership with our members to shape debates and influence outcomes.

All BRC members have an interest in the payment systems as end users, in fact retailers are one of the most significant constituent groups of end users. This is not only in taking payment for the sale of products and services sold online or in stores, but also in processing transactions to pay suppliers and staff.

THE PSR'S INFRASTRUCTURE REPORT

THE ROLE OF COMPETITIVE TENDERING

September 2016

Cambridge Economic Policy Associates Ltd

CEPA

1. INTRODUCTION AND SUMMARY

The Payment Systems Regulator (PSR) has now published its final report on infrastructure provision[i] – focusing on the bundle of hardware, software and services VocaLink supplies, the key payment schemes, Bacs, Faster Payments, and LINK, the operators of the UK's ATM network.

Its verdict is stark – 'there is currently no effective competition in the market for the provision of central infrastructure services [by VocaLink]'[ii] – although the report acknowledges that 'most operators and direct PSPs are satisfied with the value for money, quality of service and innovation they receive'[iii].

The report suggests 'a package of remedies'[iv] – a competitive tendering exercise for core services, standardisation on internationally accepted messaging standards, and divestment by the four largest banks of their interests in VocaLink.

However, there are aspects of this package which have been overtaken by two key developments which occurred in July as the PSR was finalising the report:

- The sale of VocaLink to MasterCard, subject to regulatory clearances, announced on 21st July.
- The publication of the Payment Strategy Forum's draft strategy[v] on 13th July, including a recommendation[vi] to create 'a new architecture for retail interbank payments, the 'Simplified Payments Platform' (SPP)'.

In this note, we[vii] focus on how these two developments have affected the PSR's package of measures, and specifically its call for a competitive tendering exercise for *existing* systems. We agree with the PSR that competitive tendering exercises for asset-intensive utilities can produce significant savings (of the order of 20% or more). However, as we have seen with the saga of rail franchising, there can be difficulties in implementing a competitive tendering approach. It is also worth noting that cost savings do not always automatically flow through to final customers; for instance, savings made in upstream parts of the supply chain, will only flow through to final customers if retail markets are competitive. The fact that most in-credit personal customers enjoy free payment services is an added consideration in this context.

In addition, from a cost perspective, the services supplied by VocaLink are not as asset-intensive as those in energy or transport utilities – instead they are more typical of those provided by data communications companies[viii]. The costs for the central 'switching' service provided by VocaLink are only a small proportion (10% or less) of the total end-to-end cost of making a payment. The other 90% of the costs fall on the originating and receiving Payments Service Provider (typically a bank).

This leads us to ask about the conditions under which competitive tendering can offer significant benefits to end users, and whether a competitive tendering exercise for the Bacs and Faster Payments (FP)[ix] infrastructure would meet these conditions. These benefits could be either cost savings on the bundle of hardware and software services VocaLink currently supplies, or a more innovative approach to the services Bacs and FP can offer their customers. The PSR report emphasises both of these points[x].

As we discuss in the following sections, this analysis leaves us with concerns that a competitive tendering process may be more difficult, and produce fewer net benefits, than the PSR envisages.

In addition, we think that the PSR (and the Payments Community as a whole) would get more 'bang per buck' (or perhaps more accurately, 'bang per hour of effort expended') in ensuring that the new SPP furthers its competitiveness objective, rather than focusing on infrastructure competition for the legacy Bacs and FP systems. This would be in line with the PSR's objective, under FSBRA, 'to use the resources of the Payment Systems Regulator in the most efficient and economic way'[xi].

Our note is intended as a contribution to the ongoing debate about payment infrastructure provision. We note that the PSR states that it has not currently 'carried out a detailed assessment of these high level remedy options for either their effectiveness or proportionality'[xii] – and as the report makes clear elsewhere, proportionality includes cost-benefit considerations[xiii]. Our comments cover both matters and we hope they will prove useful for the next stages of the PSR's deliberations.

2. When is competitive tendering most likely to yield benefits?

It is easiest to start with where we agree – that competitive tendering can produce significant gains for consumers. For example, CEPA has produced two reports[xiv] for Ofgem on the benefits of the competitive tendering regime for offshore electricity network operators. By constructing a counterfactual of what the costs would have been *without* competitive tendering, CEPA was able to demonstrate a range of cost savings varying from 14-27% for the first tender round to 32-45% for the third tender round[1].

Some of CEPA's observations are particularly pertinent to the current payments infrastructure debate. For example, CEPA notes that competitive tendering:

- has removed the asymmetries of information that have traditionally put regulators at a disadvantage to operators regarding efficient operating costs; and
- has allowed *actual* financing costs, rather than those based on a notional rate of return calculation, to be used.

The CEPA work also points to other factors that drive the benefits of competitive tendering, notably 'the structuring of [bidding] opportunities that made bidders willing to bid

[1] Note, however, that these savings did not necessarily accrue to final customers.

efficiently'. These included the significant de-risking provided by the operational nature of the assets and the length of the licence awarded – twenty years.

Not all examples of competitive tendering yield successful results, however: the UK rail franchise system has experienced a number of problems, with around half of the original passenger franchises awarded since 1997 have had to be renegotiated ex-post, and with two major reviews[xv] of the system within five years. One of the problems rail has highlighted is that supposedly 'irrational' bidding tactics (for example, overoptimistic demand forecasts, ignoring downside risks) may in fact be sensible for a bidder if they can renegotiate the franchise terms or, in extremis, walk away from the franchise altogether.

While the CEPA studies looked at competitive tendering for regulated utility assets, the situation is of course similar for procurement in the private sector. Competitive tendering elicits market information, realises commercial benefits and confirms the efficiency of prices, which a single source negotiation would struggle to do because of information asymmetry between buyer and seller – for example between original equipment manufacturers (OEMs) and their suppliers of specialist parts.

But for competitive tendering to yield significant benefits, the purchaser has to base their decision on total cost of ownership - not just the quoted price but *all* of the costs incurred in selecting a competitive tendering approach, including own internal resource costs, risks and opportunity costs. Otherwise the purchaser risks winning a Pyrrhic victory of a low contract price but with high internal resource costs or high probability of future cost creep, or both.

Furthermore, the tender mechanism needs to be carefully designed to incentivise bidders to participate and to submit their best bids. At the very least bidders need to see that they have a fair chance of winning the business. Otherwise they have little reason to invest the effort for putting in *serious* bids.[xvi]

To summarise we might say that, in the right circumstances and with suitable mechanism design, competitive tendering can yield significant benefits, but that the design of appropriate competitive tendering processes is difficult, and takes time and resource to implement effectively.

3. WOULD THESE BENEFITS REALISE FOR THE UK PAYMENTS SYSTEMS?

Against this background, we need to examine whether the proposals to implement a full competitive tendering process for Bacs and FP infrastructure would be likely to deliver *significant benefits to consumers.*

Aside from the question of the relevance of cost savings pass-through in this context, our view is that the PSR has underestimated some of the difficulties that a competitive tender for an *existing* payments system would cause. For example, the Lipis Report[xvii], commissioned by the PSR as an input into the infrastructure review, shows that:

- competitive tenders for payment systems are rare (see, for example, Lipis Report, p 28); and
- only Japan has ever retendered a legacy (i.e existing system) and there the incumbent (NTT Data) has won every time (Lipis Report, p 92).

This leads the Lipis Report to conclude, not surprisingly, that the UK arrangements are fairly typical, and to point out, in its conclusions, that 'in existing systems, incumbent infrastructure providers have a huge advantage over other potential providers'.[xviii] As we have discussed above, this significant incumbent advantage would limit the likelihood of competitors to VocaLink putting in the effort to make a serious bid.

Why is this? One of the key reasons can be found in the response Faster Payments made to the PSR's Interim Report on Infrastructure. After referring to the Lipis Report, FP notes[xix]:

'*Migrating a large scale batch ACH let alone a real time 24 x 7 payment system from one infrastructure to another, seamlessly, has never been done. It is almost certain that an extensive period of parallel running would be required before the operational and financial stability and integrity of a new system could be confirmed. This parallel running in itself adds significant industry-wide cost, especially in participants, and also introduces new operational risks.*'

FP, in this submission, emphasised that the costs of a competitive procurement exercise included not only the bidding costs of designing and running a competitive tendering exercise, but also the 'parallel running' costs of having two payments infrastructures live for a period to ensure stability. These costs would fall both on FP and potentially on the Payment Service Providers (PSPs) using the service.

A second key reason lies in the non-standard messaging system used by Bacs in particular, and here the recommendations made by the PSR are sensible and likely to enhance competition by lessening the incumbent advantage.

Similarly, while neither Bacs nor FP make the point, their last contractual negotiations with VocaLink covered a relatively short contract period – three years in the case of FP – as the Payments Council had required their contracts to be coterminous at some point between 2018 and 2020. No competitor to VocaLink was likely to be interested in challenging an incumbent for a contract which lasted for such a short length of time given the amount of investment that would likely be required.

Payment infrastructure shares three characteristics with IT systems and certain customised engineering products, which could explain the hesitation of Bacs and FP to go to competitive tender.

Firstly, switching suppliers of such systems requires significant investment not only by the new supplier, but also by the purchaser (at least in terms of project management resources and cost of risk). Secondly, the initial investment by the incumbent is sunk and it is therefore irrelevant *now* whether or not another supplier could have built the system more efficiently at its inception, or been more innovative in the services which were offered. Thirdly, the operating costs of such systems should be very similar between different suppliers, which makes it difficult for a new supplier to recover investment costs from an offer that undercuts the incumbent on operation cost, *unless* they can introduce major process innovations (for example, offshoring functions like help desks or system testing).

These three characteristics are found in many situations, from IT systems to supply of engineering parts to OEMs. They give the incumbent a strong advantage in competition with potential challengers. In such situations the rational business decision for the purchaser might be to accept the lock-in and not to go to competitive tender, unless there are other business considerations, such as grievances with the incumbent or strategic re-balancing of the supplier portfolio, or strong reasons to believe that a new supplier could quote on basis of fundamentally different cost structures, for example due to technological innovation or geographic location, and thus beat the incumbent by a margin which allows a rapid recovery of investment costs.

If the lock-in is strong, competitive tendering could even lose its power to reveal market information: Where challengers suspect that they are only used to extract concessions from the incumbent with no chance of actually winning the business, they are unlikely to submit bids that are as strong as they could otherwise be.

The incumbent's advantage is smallest (and the keenness of challengers therefore greatest) where systems have to be upgraded or redesigned in some form anyway. At these natural switching points the investment requirements for incumbent and challengers are similar enough so that challengers have a real chance to overcoming the costs of switching. It is these switching points where the maximum power of competitive tendering should be applied to realise its full benefits – in particular if long lock-ins are to be expected after the award.

For Bacs and FP, the earliest natural point for a competitive tender would be when the present contracts fall due for renewal (between 2018 and 2020). At that point, a longer contract period could be offered, and – if the PSR's recommendations on interoperability and messaging have been implemented – Bacs and FP may find themselves able to run a competitive tendering exercise. for less bespoke solution. While such a competitive tendering exercise would still require significant investment and resources to support switching, the more standardised nature of the requirements could allow competing infrastructure providers to offer major process innovations and hence cost savings.

However, we then come to the second development, referred to in the introduction – the Forum's recommendation[xx] for a new SPP. Given the level of banking industry involvement in the Forum, and the development of the SPP concept from Payments UK's work on a World Class Payments System, there must be a high likelihood of such a platform coming to fruition – although not at any time soon. The Forum sensibly recommends 'further detailed work', to be completed by 2018.

There are several implications of the proposed new SPP. Firstly, as we have seen from the Lipis Report, it is much easier to design competition in to a new payments system than to retrofit it to existing legacy systems – and here the proposals for a layered architecture and the use of Open Access APIs should make the new SPP much less subject to a dominant infrastructure provider than the current arrangements.

Secondly, the likelihood of running a successful competitive tendering exercise would be reduced. It is unlikely that Bacs and FP would wish to make major upgrades or redesigns to their services, as the payments community will have decided to achieve service user improvements via the SPP. And volumes on the existing FP and Bacs systems would be in decline as payment transactions migrate to the new SPP. So the natural 'switching point' referred to above which lessens incumbent advantage will be unlikely to occur, and it would be more difficult (perhaps impossible) to attract infrastructure providers willing to challenge the incumbent (VocaLink).

Thirdly, even if a CT exercise were to be run successfully, the benefits would be less than they would be in a world without the SPP, as payments are likely to migrate away from Bacs/FP to the new SPP system – so even if there were a significant cost saving per transaction, savings overall would be lower because there would be fewer Bacs/FP transactions.

So overall we are sceptical whether the undoubted benefits of competitive tendering could be realised *for the existing payment systems* as the PSR hopes, particularly given the potential development of the SPP. We now comment on what that means for the PSR's package of measures.

4. WHAT SHOULD THE PSR DO NOW?

The two developments we referred to in the introduction have a major impact on the package of remedies that the PSR has proposed.

The sale of VocaLink to MasterCard, provided it secures the necessary regulatory approvals, effectively implements the PSR's recommendations on the four major banks' joint control of both Bacs/FP and VocaLink, which the press statement for the final report acknowledges. It also has implications for the proposed remedies on competitive tendering, where the report sets out four options, indicating a preference for mandating the boards of Bacs and FP to undertake a competitive procurement exercise.

We find difficulties with this approach. If the major banks are not exercising joint control of the boards of Bacs/FP and VocaLink, why cannot the former be left to decide for themselves what form of tendering process is best? As we have seen, while competitive tendering can produce significant benefits, there are major concerns about whether it would do so here. If the boards cannot be trusted to take this decisions, what can they be trusted with?

In this context we need to recall that, in addition to the bank-appointed directors, both Bacs and FP have independent chairs and independent directors who can exercise a veto on any decision not in the public interest – including any proposal on procurement that they consider would fail this public interest test.

So we think that the issue of competitive tendering on legacy systems should be left to the boards – armed now with a report from the PSR which should enhance their bargaining power in securing more concessions from VocaLink's new owners.

Instead, we think the PSR should focus its limited resources on the wider issue of competition between payment schemes which can drive innovation and reduce costs to consumers. We already see this in the competition *between* bank-based operators like Bacs and FP *and* the card schemes, and in the role that 'overlay' providers such as PayPal have played in offering innovative services. From the perspective of customers who enjoy free payment services, the benefits from competition are inherently about quality of service rather than cost.

The development of the SPP will provide further opportunities for competition and innovation – provided it is allowed to compete effectively both with existing bank-based operators and with card schemes. This will depend on what kind of business model SPP is based upon – does it follow the mutual, banking-led model of the existing interbank operators, or the for-profit commercial model into which MasterCard and Visa and other card operators (American Express, JCB, Diners Club) have now evolved? Both the impressive record of the card operators on innovation (contactless, tokenisation) and the history of other central service providers, like the London Stock Exchange, which demutualised and then competed with other platform providers on the global stage, suggest that the for profit route is the way to go.

---

i. See http://bit.ly/2bsRUxu
ii. Para 1.9
iii. Para 1.11
iv. Para 8.3
v. See http://bit.ly/2bJiD7O
vi. Para 8.1
vii Richard Gleed is a Senior Adviser at CEPA; Mark Cockburn is a Director at CEPA; Daniel Wagner is a Managing Consultant at TWS Partners, who advise clients on commercial negotiations.
viii Such as the Data Communications Company that manages the smart metering programme for Ofgem (see www.smartdcc.co.uk)
ix. In this note, we concentrate on these two systems; the wholesale system, CHAPS, is operated by the Bank of England as an integrated system, and the new Image Clearing System for C&CCC has just gone through a competitive tendering process. The PSR Report also covers LINK, but the arguments there are somewhat different.
x See for example para 1.11: 'there is scope for effective competition to drive improved outcomes in terms of value for money, service quality and innovation.'

xi. See Section 53 of Financial Services (Banking Reform) Act 2013 – the authors are indebted to Suzanne Rab for drawing our attention to this.
xii. Para 8.4
xiii. Para 8.15
xiv. Reference required
xv. The McNulty report published in 2011, and the Brown Review of the Rail Franchising Program; in addition there was the Laidlaw Report on one specific tender.
[xvi] Beyond encouraging mere participation, the design of the negotiation mechanism plays a crucial role for how far bidders will push their bids towards efficient prices. Best practice in commercial procurement draws on economic game theory to design negotiation mechanisms that maximise the incentives of bidders for submitting their strongest bids.
xvii. See http://bit.ly/2bPc1XC
xviii. Page 64
xix. See the responses to the Interim Report at http://bit.ly/2bgcr6v
xx. See Chapter 8 of the Forum's Draft Strategy