LYDDON CONSULTING SERVICES LIMITED

INPUT TO THE STAKEHOLDER CONSULTATION ON THE PSR MARKET REVIEW INTO THE OWNERSHIP AND COMPETITIVENESS OF INFRASTRUCTURE PROVISION

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PSR MARKET REVIEW INTO THE OWNERSHIP AND COMPETITIVENESS OF INFRASTRUCTURE PROVISION

INPUT TO STAKEHOLDER CONSULTATION

Introduction

Lyddon Consulting Services is specialist consultancy in international banking, focusing on matters related to the core domain of Payments and Cash Management. That leads to market change aspects such as the Euro and SEPA, as well as Payment Services Directive, Anti-Money Laundering Directives, and regulations around cards, mobile, eMoney and mandatory information in funds transfers.

We are currently engaged by two organisations operating in this space and attach our feedback into this process, which accords with the views we have given to those two organisations. We say this because it is possible that they may respond direct as well and in a similar vein, assuming they have accepted our views and also decided it is in their interests to make a response.

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Questions and responses, set under each proposed remedy

Remedy 1: Competitive procurement processes

1. Would this remedy be effective in addressing the problems we have identified?

Possibly, but it could also cause significant detriments. Changing the infrastructure for a payment system is infinitely more complicated and requires the coordinated efforts of many more market actors than, say, altering the franchisee on the East Coast Main Line.

Users have migration costs and efforts imposed on them, without a business case. This was the lesson of the SEPA migration for a vast numerical majority of users, mitigated by the adoption of "Additional Optional Services" (enabling the mimicking of the legacy schemes through the SEPA Schemes but at the cost of diversity) and by translation services (enabling users to continue to use legacy data formats in their own systems).

As a generality we are of the opinion that detriments identified in this Market Review point to the market for payments being closed, and then the reason for this closure is attributed to ownership of the infrastructure. In our view the biggest single cause of market closure is the issue of whether or not a Payment Service Provider is permitted a Settlement Account or not. This major issue has not been given its due weight in the PSR's report. The Bank of England is having a review of their policy, with no certainty that it would be changed, and yet that one change would dissolve issue after issue: many more PSPs would become scheme members and would have their voice heard in the forums of the scheme companies, and in turn would be eligible to be Vocalink shareholders and have their voice heard in the related forums. This would go a long way to offsetting any issues of perceived lack of responsiveness, openness to innovation and so on.

2. What are the relevant potential costs and benefits that we should consider?

If the provision were to be put out to tender on a basis that would satisfy a need for regularity, the contract term could not exceed five years. Each bidder will then be needing to recover their bidding and implementation costs over a quite short period, with a negative impact on the price to the end-user. The overall implementation costs of a switch of infrastructure provider could be very large indeed, and Payment Service Providers might well baulk at having to share them.

There could be no certainty that the infrastructure could be switched without any effect on end-users – see SEPA.

A regularly-moving contract would in our view have the exact opposite effect of encouraging service innovation.

To recover costs, the infrastructure provider would not invest in new functions once the contract was won.

To ensure the ability to re-tender at the next rollover, the buyer (the scheme company) would not want to embed functions that were proprietary and involved IP that the infrastructure provider might own.

To ensure the practicability of migration to a new provider, all parties – including Payment Service Providers – would want to ensure that the functionality was generic.

Regular competitive tendering risks reducing the investment that the parties will want to make in real value, and causing the schemes to lapse into a lowest common denominator mode, which is what has happened with the SEPA core schemes. Countries have either preserved the added-value in their legacy schemes via AOS, or are now rebuilding it in other ways, meaning the bigger banks are doing it themselves, and the smaller ones are being left just with the core functionality.

3. Would this remedy give rise to unintended consequences and how might these be prevented or mitigated?

If there are four or five schemes and each is bidding out its infrastructure provision every five years in a way that fulfils the PSR's criteria for a genuinely competitive tender, there could be either a major migration happening every year, or a series of high-risk Big Bangs. The risks could be mitigated by introducing as much commonality as possible in the operation of the schemes and in the interface with PSPs, e.g. by separating out all tables and reference databases, and by having all data exchange in ISO20022. Nevertheless, the scenario of a perpetuum mobile will be unappealing to a business in which stability is paramount.

4. Is there an alternative remedy that would be equally effective but that would be less costly and/or intrusive?

Separating out all tables and reference databases, and by having all data exchanges in ISO20022.

The Bank of England altering its policy and allowing all licenced PSPs to have a Settlement Account as a matter of course. The rationale for their current policy – that only banks with a Reserve Account and who are part of the Reserves system can have a Settlement Account – is based on the idea that the banks in the Reserves system have enough current accounts that a change in the BoE Base Rate feeds through into the customer account terms and therefore into the real economy.

The Bank of England has not changed the Base Rate for n years so that policy is outmoded. In addition it wishes to foster more competition, meaning it should not exclude/inhibit new entrants in this way. If the new entrants are successful, current account provision will be spread over far more market actors, and the BoE will need those market actors to be part of the Reserves system in orde for their policies to have any effect.

5. What implementation issues do we need to consider, including (but not limited to):
o Generally?

PSPs and end-users being constantly made to plan for disruptive change, for possibly marginal benefits to their business.

o Are the operators best placed to undertake the procurement exercise?
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o The timing of the proposed procurement exercises.

As stated, a poor choice between separate exercises leading to perpetual change, or Big Bangs involving high risk.

o Would there be benefits and/or detriments if these processes were coordinated?
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Remedy 2: Interoperability
1. Would this remedy be effective in addressing the problems we have identified?

Yes, in our view it would deliver the greatest direct benefits, would not be seen by market actors as either retrograde, marginal or unnecessary, and would deliver ancillary benefits, such as:

- more consistent business processes between payment schemes, increasing competition between the schemes for payment traffic
- easing future migrations
- replacing Sort Codes and the UK Basic Bank Account Number with BIC and IBAN, of which there is no shortage and which every PSP could have without the issues raised in this Market Review and in the one on Indirect Access
- bigger payload of remittance data
- Ultimate Debtor/Ultimate Debtor functions, which are required both by large corporates and by smaller PSPs who do not have their own sort code: currently these smaller PSPs have to populate the UK payment messages using the remittance data fields for beneficiary and remitter data, leading to less efficient payment handling
- access to the ancillary set of messages available under the SWIFT Exceptions and Investigations service and used in SEPA for the R-messages (Rejection, Return, Reimbursement etc)
- easing compliance with future regulations such as the EU Regulation on information accompanying funds transfers, under which UK domestic payments are permissible to be done as IBAN-only

2. What are the relevant potential costs and benefits that we should consider?

See above for benefits. Costs would be substantial but one-time, and with the proven SEPA technological methodology to work off (albeit that the SEPA business methodology demonstrated shortcomings – described below – which should act as learning points for the UK).

3. Would this remedy give rise to unintended consequences and how might these be prevented or mitigated?
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4. Is there an alternative remedy that would be equally effective but that would be less costly and/or intrusive?
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5. What implementation issues do we need to consider (including the length of a transition period)?

SEPA only got properly into gear when the EU passed the SEPA Migration End Date Regulation in late 2012, demanding an end date of February 2014 – postponed to August 2014 and only achieved then thanks to certain 'safety valves' that have weakened SEPA's integrity. We believe it is essential and beneficial for the UK to study the positives and negatives from the SEPA Migration experience.

The Payment Strategy Forum's role in examining message standards – foreseen on page 6 of the PSR's report – needs to be carefully controlled to make sure that the proponents of blockchain do not exercise undue influence over its outcome.

6. Are there any other aspects of the technical standards or other rules (besides common messaging standards) that may act as barriers to entry for potential infrastructure providers?
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Remedy 3: Ownership of VocaLink

1. Would this remedy be effective in addressing the problems we have identified?

The PSR report proves that the UK payments market model <u>differs</u> from the market models of several privatised industries in the UK.

The Lipis Associates report proves that the market model of UK payments <u>differs little</u> from that of the payments markets in other countries, but at the same delivers a very positive verdict on functionality: that the UK is near or at the front of payments offerings generally.

Taken together, there is <u>no proof</u> that a change in market model such as a change in Vocalink's ownership would take the UK forward.

At the same time much is made of SEPA without drilling into:

- that SEPA remains many markets with individual flavours, caused by the 'safety valves' permitted by the SEPA Migration End Date regulation…
- these allowed payment schemes considered (by the national market itself) to be vital to the national market, thus allowing schemes like the Ricevuta Bancaria ('RIBA') in Italy to persist *sine die*
- they also allowed national communities to agree a filling for fields in the ISO20022 format – those left in White in the EPC's message usage guides - that was specific to their market but not used by other markets either at all or in the same way: this is called 'AOS' or Additional Optional Services
- national communities, acting through their national banking associations, have been the definers of the AOS, representers of the continuing need for 'schemes vital to the national market', and selectors of the infrastructure to be used
- Lipis Associates rightly point out that Belgium is an anomaly, almost the only country that did not re-appoint its domestic ACH as its SEPA-compliant CSM
- Finland's position is an anomaly in a manner that does not come out as clearly in the Lipis Associates report, namely that the retail banking market is highly concentrated on just one bank: Nordea. Nordea is a full member of Euro Bankers Association and Clearing Company (which runs EURO1, STEP1 and STEP2), and the next tier of Finnish banks are EBA members too. Finland never had a direct debit scheme of significance: business-to-consumer debts

were and are managed via an Electronic Bill Presentment mechanism through each bank's customer eBanking tool. This leads to the customer agreeing to pay by making a credit transfer, in full or in part, at once or over a period. The process is extremely similar to that proposed by Payment UK/World Class Payments in their recent proposal paper 'Request to Pay'. In the context of 'Infrastructure' it is important to take away that Finland only requires Credit Transfer Initiation and Reachability, and Direct Debit Reachability – but not Direct Debit Origination. Finland defined just one piece of national AOS – the tax payment date – and another piece of AOS that has subsequently been adopted into the main EPC scheme – the ISO Corporate Reference.

- Hence STEP2 is a completely adequate infrastructure solution for Finland's needs, but might well not be for the needs of other national communities. STEP2 has established itself as (i) the leading interconnector for cross-border SEPA payments initiated in national infrastructures like SIBS and Iberpay and with endpoints in others like Equens (ii) the leading infrastructure for cross-border SEPA payments between its member banks…
- …but less as an infrastructure-of-choice for national communities.
- as a result SEPA can in no way be regarded as an example where there are multiple infrastructures for the same service in the same market
- at most it can be regarded as an example of several national markets in parallel supporting a scheme in multiple instances with 90-95% commonality between the instances: a much less impressive role model for the UK to follow
- SEPA's greatest problem at present is the automation of the R-messages, particularly those sent under the Core Direct Debit scheme, and this is leading to higher costs and inefficiency than was experienced in the equivalent national schemes pre-SEPA.

2. What are the relevant potential costs and benefits that we should consider?
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3. Would this remedy give rise to unintended consequences and how might these be prevented or mitigated?

As Lipis Associates point out, Vocalink supports what can be termed a 'fat' ACH, in two ways:

- services supportive of the automation in the PSPs of the day-to-day handling of payments, such as Direct Debit return items – a particular problem in SEPA
- overlay services such as CASS and Paym

These have significant value and should not be subjected to a give-up in order to simply to alter the UK payments market model to become more like other market models. These are exactly the kind of functions that bidders for 5-year contract might either (a) not agree to take over; or (b) want to have share of the IP in so that they could continue to earn on what they had invested even if they were no longer the infrastructure for the scheme any longer; or (c) charge a premium price for developing these functions on their infrastructure – which would feed through to the Payment Service Providers and then to the end-users.

A principle of SEPA – that no customer should experience a reduction of functionality – was a good one, even if resulted in both AOS and the retention of one-country-only schemes like RIBA. In the UK there is no need to give up functionality to achieve harmonisation with other countries.

Instead, through ISO20022, it should be possible to achieve a harmonisation between UK schemes but on a high level of functionality – at the very least today's functionality plus capabilities in ISO20022 format that cannot be accommodated in Standard18, SWIFT MT, or the versions of ISO8583 in use at FPS and LINK.

7. Is there an alternative remedy that would be equally effective but would be less costly and/or intrusive?

Adoption of ISO20022 and separation of tables and databases needed by all UK schemes, including CHAPS and Cheque&Credit.

5. What implementation issues do we need to consider, including (but not limited to):
o General

Since Voca (who then only ran BACS) and LINK originally made a joint bid to be the infrastructure behind FPS, it is to be expected that Vocalink's IT topology for running the FPS makes use of BACS and LINK components behind the scenes. By extension it can be assumed that Vocalink operates components that service all three schemes. There will not be a self-contained BACS operation, with all tables and databases independently established, nor a self-contained FPS nor a self-contained LINK operation. The PSR report does not touch this issue. It may not even be feasible to unbundle the provision behind one of the schemes, that is unless a prior and specific unbundling project were undertaken.

It is possible that certain components could be running on very old technology and that considerable effort and cost might be required to move to an environment where it was possible for another company to take over the infrastructure provision for one scheme without taking over all of them.

The issue of ownership of the intellectual property of these facilities would have to be addressed since, if Vocalink were to be sold, the sale price required by existing shareholders could vary considerably depending upon the ownership and valuation of these assets.

The ownership of Vocalink itself is not central to this practical issue. Requiring ownership changes at the Vocalink level might detract from a focus on making practical alterations to the arrangement and ownership of assets that are currently run by Vocalink, a focus that could lead to more beneficial outcomes for the market model than simply altering who owns Vocalink.

o Who should be required to divest their shareholding?
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o Timing of the divestment
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o What (if any) purchaser suitability criteria should be applied?
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o What (if any) additional measures are required to ensure security and resilience?
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o Should the divestment be full or partial?
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o If partial, to what level should an individual PSP shareholding be reduced?
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o If partial, should the total shareholding held by PSPs also be limited?
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o Should changes to Board composition also be stipulated?
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Remedy 4: LINK
1. Would this remedy be effective in addressing the problems we have identified?
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2. What are the relevant potential costs and benefits that we should consider?
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3. Would this remedy give rise to unintended consequences and how might these be prevented or mitigated?
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4. Is there an alternative remedy that would be equally effective but that would be less costly and/or intrusive?
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For the package of remedies as a whole
1. Would these remedies be effective in addressing the problems we have identified?

Not necessarily; focus should be on interoperability, unbundling and getting a policy change at the BoE on Settlement Accounts. The ownership of Vocalink is an academic point when measured against those three, and might not alter market conditions even if it were done.

The PSR's evidence does not prove the case for a change in Vocalink's ownership. The evidence suggests that the UK is well-served in terms of functionality, and is in line with other payments markets as regards the market model.

2. How effective would the package be if one or more of the remedies above were excluded?

Equally effective if the ownership of Vocalink was excluded, but the unbundling of Vocalink IT topology and separation of tables/databases are important enablers.

3. Are there any relevant potential costs and benefits of the package as a whole (other than those considered above under each remedy) that we should consider?
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4. Are there any unintended consequences of the package as a whole (other than those considered above under each remedy) and how might these be prevented or mitigated?

Yes: see responses to earlier questions.

5. Are there any alternative remedy packages that would be equally effective but that would be less costly and/or intrusive?
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6. What implementation issues do we need to consider (including timing)?
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Gateways
7. May the accreditation process for Bacstel-IP prevent other providers from entering the market?

We do not agree with the PSR's positive opinion regarding Gateways, which has led to this one sole question about Gateways in the consultation.

Gateways are a technical access issue, and presuppose that all necessary business-model enablers exist in good order. We do not consider this to be the case, and no doubt there will be many questions raised by PSPs in their responses to the PSR's interim report on their market review on Indirect Access.

Efforts by scheme companies to promote direct technical access will only be effective if:

- the Bank of England alters its policy on allowing PSPs to have Settlement Accounts, without which they cannot be a direct member of any payment scheme except LINK
- an account balance at the Bank of England is qualified as an allowable manner for Payment Institutions and eMoney Institutions to safeguard customer monies
- Sort codes are more readily available to new PSPs – or rather if IBAN+BIC are adopted, over which there is no shortage
- New PSPs with Settlement Accounts are given the same access to intraday liquidity facilities as are banks that are members of the BoE Reserves system

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