

First annual progress report of the Payment Systems Task Force

A report prepared for the Payment Systems Task Force
by the Office of Fair Trading

May 2005

© **Crown copyright (2005)**

This publication may be reproduced free of charge in any format or medium provided that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as crown copyright and the title of the publication specified.

FOREWORD

This is the first progress report of the Payment Systems Task Force, set up following the Chancellor's pre-Budget report of November 2003. The Task Force is chaired by the OFT, and brings together banking industry, retail, consumer and business representatives; and the Bank of England and the Treasury (acting as observers).

A lot of ground has been covered since the Task Force first met in April 2004. One report of a working group set up by the Task Force, the BPSL Innovation Working Group, is published with this report, and another is due to be published this summer. When implemented, the recommendations made by the Task Force will make a significant difference to the payment systems industry in the UK, and to the people and businesses that use them.

This report covers the first year of the Task Force's four year existence. As a result of the BPSL Innovation Working Group report noted above, the Task Force has asked the payment systems industry to introduce a form of faster electronic clearing. Currently BACS clearing takes three working days, but the report assesses the costs and benefits of a system that would make money available either the same or the next working day. The wider business case for introducing such a system shows a significant notional value accruing to the United Kingdom economy. The industry has agreed to form an 'Implementation Group' to consider how the recommendations in this report can be put into practice, but it believes that implementation of such a system could be achieved within two years from full specification.

This first Progress Report, and the report of the Working Group, has been agreed by all members of the Task Force. This is a testament to the commitment of all parties to the Task Force process. Bringing the opinions of all these groups together has been an achievement in itself, and I would like to thank all the members of the Task Force for their willingness to co-operate and support our work.

Jonathan May
Chairman, Payment Systems Task Force

EXECUTIVE SUMMARY

This Progress Report covers the first year of the Task Force. In the year, three working groups have been formed. One reports with this report, and its options for change will now be taken forward by the industry's Implementation Group. Another working group is due to report this summer, and the third will run for the duration of the Task Force as an information resource on developments within Europe.

The Task Force was established following an announcement by the Chancellor of the Exchequer in his pre-Budget report in November 2003 that the OFT would play an enhanced role in payment systems for a period of four years. The OFT subsequently announced the creation of the Payment Systems Task Force in March 2004. The work of the Task Force is based mainly, but not exclusively, on the issues raised by the Cruickshank report of 2000, *Competition in UK Banking*.¹

BPSL Innovation Working Group report

The first working group to report is the BPSL Innovation Working Group, whose report is published at Annexe C. The main conclusion of that report and the recommendation of the Task Force – supported by each member of this Task Force – is that a faster payments service be introduced for telephone banking and internet banking payments, with the ability to accept standing order payments.² The Task Force also recommends that, because the other innovations to the BACS system set out in the Working Group report have not been fully assessed or costed by the industry, they should be considered by the payments association, APACS, and by BACS Payment Schemes Limited (BPSL).

The Working Group considered the cost and demand for a faster payment service, which would allow electronic telephone banking, internet banking or standing order payments made early in the morning to be completed on the same day, and payments made late in the day to be completed by first thing the

¹ The full text of the Cruickshank report can be found at:
www.hm-treasury.gov.uk/documents/financial_services/banking

² Defined as 'instructions from customers to their bank or building society to make regular automated payments of a specified amount to a named beneficiary'

next morning. These payments are the only electronic ones which attract 'float' interest and which currently take three days to complete. Direct credits and direct debits already provide for simultaneous value transfer.

The one-off IT development costs for financial institutions that would be directly participating in such a system were initially estimated to be no more than £65m, although there would also be supplementary one-off and on-going costs. There would also be costs for other users of payments in amending their systems and procedures. Research has shown that the demand for such a system would be small compared to total BACS volumes, but significant; if the system were offered free for consumers, and at no additional cost to businesses, up to 269 million payments per year could be made. The report also assessed the willingness of consumers and businesses to pay for this service.

The analysis shows that, taking the industry as a whole, it is clear that if banks were to impose no additional charges, there is no convincing narrow cost-recovery case. The wider business case, however, shows a significant notional value accruing to the United Kingdom economy,³ as well as broader benefits such as the reduction of settlement risk through shorter clearing cycles.

The industry has agreed to form an 'Implementation Group' to consider how the recommendations of the Task Force based on the Working Group report can be put into practice. The report sets out criteria for the new system which the Task Force has asked the Implementation Group to meet. These criteria are based on access, coverage, payment types, revocability and capacity. The Implementation Group will report back to the Task Force within six months of publication of the Task Force's report. The banks have said that implementation could be achieved within two years from full specification of the requirements. The industry has agreed that, if it should prove impracticable to include regular payments in the faster payments solution, it will, within the same time frame,

³ Research has indicated that, under the assumptions made, the value to the United Kingdom economy (when expressed as the value that it is worth to consumers and businesses) could be in the range of £748 million to £1,340 million over ten years. See Appendix I of the BPSL Innovation Working Group Report for full details.

eliminate float from standing orders, will address information issues, and will seek to resolve timing issues relating to availability of funds for customers.⁴

The means by which faster clearing is achieved is, however, up to the industry Implementation Group. Although the solution costed by the Working Group involved the current provider of BACS services, Voca, the industry is also considering other solutions. The Implementation Group is not constrained by the Task Force in its choice of solution, provided the chosen solution is at least as effective as that originally examined in the Working Group report.

BACS Access and Governance Working Group progress report

The BACS Access and Governance Working Group is due to report in the summer to the Task Force. The Task Force will then publish the report. This Working Group is considering a number of key concerns from the Cruickshank report, including the mutual governance model used by BPSL (BPSL is governed by the banks that own it). As well as governance issues the report will look at whether the BACS system - and its stakeholders - would benefit from a wider variety of bodies gaining access to the scheme.

The Working Group is adopting a two-stage approach: it is examining a number of access and governance innovations, and will report its recommendations to the Task Force. The Working Group will also have identified a number of other issues that will require further research. These will be taken forward by the industry, who will report back to the Task Force in approximately 12 months.

European Working Group progress report

The European Working Group acts as a resource for the other working groups and the Task Force. It does not bring forward recommendations, but advises the other bodies of developments of significance in Europe and has prepared a paper setting out the developments for use as a resource by the Task Force and working groups.

⁴ The payer needs to have money in his or her account two working days before funds are paid to the beneficiary. If funds are not available at that time the standing order might be rejected, or any resulting overdraft might be subject to a charge.

CONTENTS

<i>Contents</i>	<i>Page</i>
Foreword	
Executive summary	
1 Introduction	1
2 BPSL Innovation Working Group: summary	5
3 BACS Access and Governance Working Group: interim summary	9
4 European Working Group	11
5 Impact and achievements of the Task Force	13
6 Next steps	15
<i>Annexes</i>	
A Membership and makeup of the Task Force	16
B Terms of Reference	17
C BPSL Payment Schemes Limited Innovation Working Group Report (see OFT789b)	19
D Members of the European Working Group	21
E Task Force Working Group timeline	22
F UK Payment Systems in perspective	23
G Reform of United Kingdom Payment Systems in perspective	27

1 INTRODUCTION

- 1.1 The establishment of the Payment Systems Task Force (the Task Force) followed an announcement by the Chancellor of the Exchequer in his pre-Budget Report of November 2003 that the OFT would play an enhanced role in payment systems for a period of four years.⁵ The establishment of the Task Force came in the context of increasing public and media interest in payment systems. The March 2000 report by Don Cruickshank to the Chancellor of the Exchequer, *Competition in UK Banking* (the Cruickshank report) covered many areas, including payment systems. The issues raised by the Cruickshank report, and the subsequent OFT report into payment systems of 2003⁶ (the OFT report) are discussed in detail in Annexe G of this report.
- 1.2 The work of the Task Force is based mainly, but not exclusively, on the issues raised by the Cruickshank report. These issues include governance, access, wholesale pricing, innovation, and price transparency of payment systems. In its report of August 2001, *Competition in payment systems: a response to consultation*, HM Treasury said that 'The Government agree with the overall thrust of [the Cruickshank report], although it does not fully accept every detail'.⁷ The OFT report noted that the industry had undertaken a number of self-regulatory reforms in addressing some of the concerns raised in the Cruickshank report. The purpose of the Task Force is to establish how much change there has been, and whether there should be more.

Membership of the Task Force

- 1.3 The Task Force is chaired by the OFT, and brings together payment systems industry, retail, consumer and business representatives to ensure decisions that are reached benefit all sectors of the UK

⁵ Chancellor of the Exchequer's pre-Budget Speech of 2003 (para 3.16)

⁶ *UK Payment Systems* May 2003 OFT658

⁷ Paragraph 2.3

economy.⁸ The Bank of England and HM Treasury sit on the Task Force, as observers.⁹ All members are aware of the critical importance of ensuring that payment systems are safe, reliable and efficient. Decisions are taken by consensus, not by a vote. In the case of a split, all views will be recorded. The recommendations of this Task Force report are supported by all members.

- 1.4 The banking industry is represented on the Task Force by the banking, building society and payment systems industry associations, by the United Kingdom's three payment clearing schemes, the only national ATM network, and the three largest card schemes. The Electronic Money Association is represented.
- 1.5 The retail industry is represented by the Federation of Small Businesses, the British Chambers of Commerce, and the British Retail Consortium. The interests of consumers are represented by Which? (formerly the Consumers' Association) and the National Consumer Council.
- 1.6 The OFT chairs the Task Force (and the working groups) and provides the secretariat. Although the OFT's role under consumer and competition law remains unchanged (and continues separately and independently from that of the Task Force), it has no specific additional powers in relation to the Task Force. The OFT's role in the Task Force is separate from its wider role in regulating competition and consumer law.

Remit of the Task Force

- 1.7 The Task Force's remit is to identify, consider, and seek to resolve competition, efficiency and incentive issues relating to payment systems, particularly looking at network effects of the existing payment mechanisms. Where appropriate, issues affecting consumers which

⁸ A full list of Task Force members is at Annexe A of this report

⁹ The Bank of England oversees the main UK payment systems from a risk - not from a competition - perspective (this role is explained in *Payment Systems Oversight Report 2004*, Bank of England, January 2005). It also has a range of operational relationships with payment systems.

derive from, or are associated with, features of payment systems will also be considered.

- 1.8 Although the issues raised by the Cruickshank report are the focus of this approach, other issues that have arisen subsequently, or as a result of research by the Task Force, will be considered where appropriate.

The approach of the Task Force

- 1.9 The Task Force meets not less than four times a year, and issues Progress Reports on its findings annually, of which this is the first. The Task Force sets up working groups to research specific issues, and to report back to the Task Force, setting out options for change. The Task Force publishes each working group report, in addition to its annual Progress Reports. The first working group looked at innovations in the BACS clearing system, and its report is published as part of this Progress Report (see chapter 2 and Annexe C). Another working group, looking at access and governance issues for BACS, is due to report to the Task Force this summer (see chapter 3). A third working group which researches relevant issues in Europe acts as a resource for the other working groups (chapter 4).
- 1.10 A working group approach allows the Task Force to focus on specific issues, and to research those issues in detail. Although many members of the Task Force choose to be represented on working groups, working groups also invite members from outside the Task Force to participate, if they have a particular interest or knowledge to contribute. Like the Task Force, each working group operates on a consensual basis, and where possible each report is supported by all working group members. There is no voting process – if there is a disagreement within the group that cannot be resolved, each view is recorded. Having said that, all members of the Task Force and working groups have worked hard to achieve reports and recommendations supported by all parties, and will continue to do so.
- 1.11 The Task Force currently plans to start working groups on other issues raised by the Cruickshank report within the remaining three year remit of the Task Force. A full projected timeline is attached at Annexe E.

Although it is possible that the order in which these issues are covered by the Task Force will change, they will all be reported on by March 2008.

- 1.12 Details of the principal payment systems in the United Kingdom are contained in Annexe F and the history of their reform is at Annexe G.

The results of the Task Force

- 1.13 The members of the Task Force are committed to the process of resolving areas in the United Kingdom payment systems industry where competition, efficiency and incentive issues remain. The government has said that it will keep the progress of the Task Force under continuous review for its remaining duration. It has also said it will introduce legislation if the Task Force approach fails to bring significant improvements.

2 BPSL INNOVATION WORKING GROUP: SUMMARY

- 2.1 The Terms of Reference of the BPSL Innovation Working Group required it to consider 'the scope for, and costs and benefits of, innovation' to the BACS clearing scheme. The Working Group interpreted this as 'The general aims of the BPSL workstream are to [...]: consider any perceived shortcomings of the payment schemes offered by BPSL; consider the reasons for these; consider what potential solutions are available; assist in resolving the shortcomings by identifying appropriate solutions; and report to the Task Force on the available options by 31 March 2005.'
- 2.2 The BPSL Innovation Working Group looked at possible changes to telephone and internet banking payments and standing orders (defined as 'instructions from customers to their bank or building society to make regular automated payments of a specified amount to a named beneficiary'). The Working Group then assessed the benefits and costs of any such changes.

Research carried out

- 2.3 The BPSL Innovation Working Group commissioned research into the demand for faster clearing, and customers' willingness to pay for such a service. The research consisted of 12 initial in-depth qualitative group discussions with consumers and SMEs to understand the issues, followed by a quantitative phase of 1,000 consumer and 900 SME interviews:
- the qualitative research showed that consumers and SMEs felt that they had sufficient payment options available to them and they were mostly broadly content with how they were working, but that there were gaps in the knowledge of both consumers and SMEs
 - the quantitative research showed that, while price sensitivity issues existed, nearly half of consumers said that they would be likely to use a next day service and 43 per cent said they would be likely to use a same day service, if it were offered for free

- over half of SMEs said that they would be likely to use the next day service and just under half would be likely to use a same day service, if offered at no additional charge to existing services, and
- up to 193 million same day or next day payments would be made by consumers if the service were free.¹⁰ Usage would drop by about half if the charge were to be 50p and by half again at £1. SMEs would make 76 million same day or next day payments if there were no additional charges, but dropping considerably more sharply with additional charges.

2.4 These results were consistent with those of similar, limited research carried out for BPSL.

2.5 The OFT consulted large corporate and other institutions ('heavy users') about any other innovations they would find helpful. The suggested innovations fell into three categories:

- those that were under the overall 'faster clearing' umbrella
- those that could be considered by APACS or BPSL, or by the existing BACS Access and Governance Working Group, and
- those where the solution to which might well exist already and that could be considered as part of an education programme about current arrangements.

2.6 The BPSL Innovation Working Group was not able to make any assessment of the potential costs and benefits of these innovations.

2.7 The BPSL Innovation Working Group also looked at how payment schemes work in Sweden, Norway, France and Spain, where retail payment schemes have similar features to those in the United Kingdom but which appeared to offer innovations not currently available in the United Kingdom. The studies showed that while payment schemes in

¹⁰ The total number of BACS direct credits and standing orders in 2004 was 1,963 million

the United Kingdom offered a service with some distinctive features, innovations introduced in the countries examined might be beneficial to United Kingdom consumers and corporate users.

Costs and benefits of changes

- 2.8 The BPSL Innovation Working Group asked the banks to provide high level estimates of the costs of implementing faster clearing in relation to telephone and internet payments and standing orders.¹¹ The banks estimated the total IT costs of introducing a faster clearing service – a hybrid same-day/next-day service – as between £48 million and £65 million. There would be other, non-IT, costs, which could not be quantified in the time available, as well as ongoing education, training and IT support costs.
- 2.9 The report quantifies how consumers and businesses might benefit from the existence of a faster clearing service by assessing the value of the (on-going) benefits against the (primarily one-off) costs of making the changes. The analysis shows that, taking the industry as a whole, it is clear that if banks were to impose no additional charges, there is no convincing narrow cost-recovery case. The wider business case, however, shows a significant notional value accruing to the UK's economy.¹² The analysis does not capture a number of potential benefits which are difficult to quantify and which may, or may not, be significant, but which include, for example, the reduction of settlement risk through shorter clearing cycles.

¹¹ Other innovations, such as those suggested by the heavy users and conclusions from the foreign comparisons, emerged only during the course of the working group's later work and were not therefore included in the costings.

¹² Research has indicated that, under the assumptions made, the value to the United Kingdom economy (when expressed as the value that it is worth to consumers and businesses) could be in the range of £748 million to £1,340 million over ten years.

- 2.10 It is unclear what prices, if any, the banks would charge for a faster clearing service: charging is a competitive matter for each bank to consider for itself, and, under competition legislation it is unlikely that the banks could lawfully collectively agree to charge, or not to charge, or to charge a particular amount, for providing such a service. The consumer organisations on the Working Group have made it clear that they would be disappointed if a charge were to be introduced for the faster service. If, due to the competitive nature of the market, individual banks decide not to introduce an additional charge for the service, they will not be able to achieve a positive business case which directly recovers the cost of developing the service. This does not necessarily mean, however, that there is not a wider case.

Next steps

- 2.11 The industry has agreed to form an 'Implementation Group' to consider how the recommendations of the Task Force based on this report can be put into practice. The report sets out criteria for the new system which the Task Force has asked the Implementation Group to meet. These criteria are based on access, coverage, payment types, revocability and capacity. The Implementation Group will report back to the Task Force within six months of publication of the Task Force's report. The banks' high-level indicators of the likely timescales for implementation of the proposals reflect the particular IT circumstances of each bank and show that implementation could be achieved within two years from full specification of the requirements.
- 2.12 The Task Force accepts the view of the BPSL Innovation Working Group that other innovations - those suggested by the 'heavy users' and observed in the international case studies - should initially, at least, be looked at by APACS or BPSL.

3 BACS ACCESS AND GOVERNANCE WORKING GROUP: INTERIM SUMMARY

3.1 The BACS Access and Governance Working Group was set up by the Task Force to examine concerns raised in both the Cruickshank report and the OFT report about restrictions on competition caused by the mutual governance of the scheme. The restrictions on access which limit direct membership to banks and building societies, and the lack of representation on the BPSL Board for non-banking stakeholders will also be considered.

3.2 BACS is split into scheme (managed by BPSL), and infrastructure (run by Voca). The BACS Access and Governance Working Group concentrates on the access and governance arrangements of BPSL. BPSL has 12 members, all of which are banks or building societies. The members both own BPSL, and sit on the BPSL Board. Members of BPSL have a number of roles; the most important are that they:

- settle payment obligations (which they choose to settle at the Bank of England)
- underwrite the Direct Debit Guarantee
- guarantee BPSL (BPSL is a company limited by guarantee)
- fund BPSL
- underwrite all risks incurred via BPSL
- direct BPSL and determine its plans, and
- use BPSL to support their customer propositions.

3.3 The BACS Access and Governance Working Group is researching a number of possible innovations to access and governance arrangements, including increased representation for non-banking stakeholders, and wider access to the scheme. Research is taking three main forms:

- other payment schemes, some from outside the UK, are being examined because they have different governance arrangements which have been revised in recent years. Both the benefits and drawbacks of these alternative systems, as well as their effects and the reasons why particular changes have been introduced, will be compared to current BACS governance arrangements
- existing research into governance models is being assessed for relevance, and
- the views of 'heavy users' (such as large corporates and government departments) of BACS will be sought on possible extensions to membership of and access to the BACS scheme.

3.4 The BACS Access and Governance Working Group will report in two stages: it will report to the Task Force on 30 June with recommendations for immediate changes to BACS access and governance arrangements. It will identify any problems caused or exacerbated by current governance arrangements and provide a rationale for any change. It will also eliminate any proposed changes to access and governance arrangements which appear at this stage to be not worth pursuing. Lastly, the Working Group will suggest a number of other possible changes to access and governance arrangements which should be considered in more detail. As part of the second stage, these other possible changes will then be assessed by BPSL and its stakeholders. A report will then be made to the Task Force on whether these other possible changes are desirable, and on the implementation of the changes suggested in the original report. This second stage will take approximately 12 months.

3.5 One of the issues that the BACS Access and Governance Working Group will report on will be greater transparency for users of the BACS scheme. One option being considered involves a scheme under which members of a new 'affiliate' class would benefit from enhanced access to BPSL-related information and briefing. Affiliates would be able to express opinions and give feedback on aspects of BPSL activity; processes would be introduced for views to be considered by the BPSL Board, and for Affiliates to raise issues with the Board.

4 EUROPEAN WORKING GROUP

- 4.1 The Task Force set up a European Working Group to provide, as necessary, relevant information on European developments to the Task Force and other working groups. The European Working Group will run for the duration of the Task Force, and will regularly report to it, but it will not make recommendations or suggest options for change to the Task Force.
- 4.2 The regular reports of the European Working Group reflect what is happening on payment systems in Europe, the legislative changes, and the banking industry's perception of those changes. The first report of the Working Group has been made to the Task Force. The members of the Working Group, each of whom has particular knowledge of European payment systems issues, are listed at Annexe D.
- 4.3 The first report of the European Working Group covers four main issues:
- the background of European legislation of relevance to payment systems
 - current European Commission initiatives and their possible effect on UK payment systems
 - the European Central Bank (ECB) vision for, and current European Payment Council (EPC) initiatives within, the euro zone, and any possible impacts on UK payment systems, and
 - the potential effect on UK payment systems should the UK decide to join the Euro.
- 4.4 The report identifies a number of initiatives, developments and matters for consideration. The Financial Services Action Plan (FSAP) is made up of a series of policy objectives and specific measures to improve the Single Market for financial services. The aim of the draft Directive on a New Legal Framework for Payments in the Internal Market is to remove all legal obstacles to the creation of an internal market for payments, and to create a new regulatory regime for previously unregulated 'payment institutions'. The report also reflects the European Commission's drive to

create a Single Euro Payments Area (SEPA). The Commission intends to publish a legislative proposal for the Payments Directive later this year, and, until it does so, the Task Force has decided to defer publication of the Europe paper because of the level of detail it contains.

5 IMPACT AND ACHIEVEMENTS OF THE TASK FORCE

- 5.1 This chapter, which will form part of each annual Task Force Progress Report, will predict and then measure the impact of changes recommended by the Task Force. It is very likely that significant changes to payment systems in the United Kingdom will take some time from conception to implementation, so this chapter will estimate the impact that those changes will have when implemented.
- 5.2 The only working group so far to have reported is the BPSL Innovation Working Group. Although the recommendations of that Working Group will take some time to implement, it is possible to make a financial estimate of the costs and benefits of implementing the main recommendation – that a form of faster clearing be introduced into the UK.
- 5.3 An inference of the potential notional net benefit can be made by weighing estimates of willingness to pay for the service (how consumers and businesses value the service) against the costs of introducing it.¹³
- 5.4 Although a cost benefit analysis of this type is useful in putting a figure to any potential changes, there are other considerations which can be taken into account when measuring the potential impact of changes. The demand research undertaken by the BPSL Innovation Working Group, for example, estimated that if a faster clearing service were introduced at no additional charge for consumers and SMEs, some 269 million such payments a year would be made, mainly substituting from the current BACS service.
- 5.5 Perhaps the major achievement of the Task Force is that the recommendation for faster clearing was supported by all members of the BPSL Innovation Working Group and of the Task Force. It is likely that the benefits it will bring to the UK economy will be shared by business,

¹³ The analysis estimates that, under the assumptions made, the notional net benefit of this service could be in the range of £748 million to £1,340 million over a ten year period. See Appendix I of the BPSL Innovation Working Group report for full details.

consumer and retail groups. It allows the industry to shape changes sought by regulators without recourse to potentially costly, and lengthy, legislation.

6 NEXT STEPS

- 6.1 This chapter covers important future dates for the Task Force. First, the Task Force will report progress annually at approximately the same time each year, until the four year time frame of the Task Force ends in the spring of 2008. These Progress Reports will, in addition to reporting on progress made by the Task Force during that year, include as annexes the reports of any working group that have been published in the course of the year. The four Task Force Progress Reports will therefore include all the reports of all the working groups.
- 6.2 As stated above, although the BPSL Innovation Working Group has published its report, the Implementation Group will inform the Task Force on how those recommendations will be implemented approximately six months after the publication date of this report. Once the Task Force has considered these plans, it will make them public. The Task Force will also give regular updates on how the industry is progressing with the implementation of the faster clearing system itself.
- 6.3 The other current Working Group considering options for change, BACS Access and Governance, will report to the Task Force in the summer of 2005. The Task Force will then publish the report. Although that report may recommend some actions that can be taken immediately to address existing access and governance concerns, it is likely also to recommend several other areas which may require further research, perhaps by the industry, or in consultation with its stakeholders. BPSL will report to the Task Force in the summer of 2006 on implementation, and on the areas that required further research.
- 6.4 The dates for the commencement and reports of the other working groups may change, but the current dates for the various workstreams are included in the timeline at Annexe E.

A MEMBERSHIP AND MAKEUP OF THE TASK FORCE

A.1 Office of Fair Trading (Chair)

Association of Payment Clearing Services

BACS Payment Schemes Limited

British Bankers' Association

British Chambers of Commerce

British Retail Consortium

Building Societies Association

Chaps Clearing Company Limited

Cheque and Credit Clearing Company

Electronic Money Association

Federation of Small Businesses

LINK

MasterCard

National Consumer Council

S2Cards

Visa

Which? (formerly Consumers' Association)

Bank of England (sitting as observers)

HM Treasury (sitting as observers)

B TERMS OF REFERENCE

- B.1 Establish and support the work of a representative committee (to be known as the Payment Systems Task Force) bringing together industry, retail, consumer, governmental and other relevant bodies with an interest in payment system issues. The Task Force will be chaired by the OFT.
- B.2 The Task Force to identify, consider and seek to resolve any competition, efficiency and incentive issues relating to payment systems, with particular, but not exclusive, emphasis on the network effects of the existing payment mechanisms. Generic subjects for discussion include issues of access, cooperation, innovation, governance, pricing and transparency but this is not an exhaustive list. Where appropriate, consumer facing issues deriving from, or associated with, features of payment systems will also be considered. The Task Force will take account of reports on payment systems, including the Cruickshank and OFT reports but will also be driven by ongoing research work (to be undertaken by the OFT with the assistance of Task Force members) consultation and market developments.
- B.3 A consensus of opinion will not necessarily be reached by the Task Force on all/any issues. Task Force participants shall have the right to request that a diverging view be noted in any meeting minutes and expressed in any annual report published by the Task Force such that the spectrum of opinions is reflected. Task Force participants shall only be named in any minutes/report with the permission of the participant.
- B.4 The Task Force will operate, at least initially, for a four year period at which time the Government will assess whether further action in this sector, including legislation, is required. The Task Force will meet on a regular basis and not less than four times a year.
- B.5 Where concerns are identified, the Task Force may establish and direct working groups to undertake detailed work on these, reporting back to the Task Force. Where such concerns are validated, the Task Force will seek to resolve these on a negotiated and voluntary basis with the industry and other interested parties.

- B.6 To report, on an annual basis, the work programme, findings, proposals and achievements of the Task Force.
- B.7 The work of the Task Force will not affect or impede existing or future enforcement activity undertaken by the OFT's enforcement divisions in this sector.

C BPSL INNOVATION WORKING GROUP REPORT

Please refer to the separate document - Annexe C

	Foreword
	Executive summary
1	Introduction
2	Pressure For Change
3	BACS Clearing
4	BACS: Existing And Planned Innovation
5	International Case Studies
6	Demands For Innovation
7	Banks' Costings
8	Cost/Benefit Analysis
9	Options For Change
10	Next Steps
A	Membership of Working Group: Organisation of members
B	Working Group terms of reference
C	Draft service framework: relevant extracts from the framework
D	Technical summary of features of BACS
E	NOP report to the Working Group

- F Further details from international case studies
- G List of bodies met/consulted
- H Full banks' costing report: text of letter from APACS to OFT dated 23 December 2004
- I Cost-benefit evaluation
- J European considerations
- K Glossary of terms

D MEMBERS OF THE EUROPEAN WORKING GROUP

D.1 Office of Fair Trading (Chair)

Association of Payment Clearing Services

BACS Payment Schemes Limited

British Bankers' Association

Chair of APACS New Legal Framework working group

Electronic Money Association

HM Treasury

Voca

F UK PAYMENT SYSTEMS IN PERSPECTIVE

Payment schemes

- F.1 Payment schemes establish the framework by which payments between parties are made. These payments can be between consumers, businesses, the government, or almost any other body. Schemes set up the rules by which payments are made, making them safe and secure. They develop an infrastructure, including telecommunications networks, information processors, and brands.
- F.2 Payment schemes allow money to be transferred between parties who do not know - or have no reason to trust - each other. By using a payment scheme, both the paying and receiving parties are committed to a common procedure which is acceptable to both, and where obligations and entitlements are clear. Without such a system, payer and receiver would have to decide on a procedure each time a payment needed to be made, where risks of payment default remains. Billions of transactions take place every year, and the importance of these common procedures is therefore clear.
- F.3 Clearly all parties must have complete trust in the system. Security and safety is paramount. The payer must be confident that his payment will be taken accurately from his account, and transferred safely and by the agreed timescales to the recipient. The recipient must be assured that the correct amount will arrive when it is expected. The Task Force appreciates that not only must payment systems be safe and reliable, but that they must also inspire confidence in those who use them. Nothing that this Task Force recommends will detract from the levels of safety and reliability provided by UK payment systems.

A summary of UK payment schemes

- F.4 The payment systems industry association is APACS, which was set up in 1985. APACS is a non-statutory body which provides a forum for institutions to discuss non-competitive issues relating to the payments industry. APACS provides a strategy and vision for the United Kingdom payments industry, facilitates change across the industry, promotes the

integrity of payment systems and represents the industry in the media. APACS is also responsible for promoting the efficiency of payment systems, and producing industry research and statistics.

- F.5 The three payment schemes discussed below (BACS, C&CCC and CHAPS) are the shared part of a payment system which allows one consumer or business to pay money to another consumer or business.

BACS

- F.6 BACS is a low-value, high-volume electronic payment system widely used in the UK economy. BACS payments can take several different forms, including direct debits (commonly used to pay bills) and direct credits (which include inter-bank standing order payments, as well as telephone and internet banking payments, and which may also be submitted in bulk form, such as for electronic wage payments). Each of these payments operates on a three day cycle: for instance, payments initiated on a Monday will be paid on the Wednesday but a payment initiated on a Friday will be paid on the following Tuesday.
- F.7 The BACS scheme is run by BACS Payment Schemes Limited (BPSL), a non-profit making membership based industry body whose role is to develop, enhance and promote the use and integrity of automated payments. The infrastructure itself is run by Voca, a profit making company with a contract to run the BACS infrastructure on behalf of BPSL. Innovation in the BACS scheme is the subject of the report of the first working group, discussed at Chapter 2 of this report, and attached in full at Annexe C above. The report of the second working group, discussed at Chapter 3 of this report, is concerned with the access and governance arrangements for BPSL.

The Cheque and Credit Clearing Company

- F.8 The Cheque and Credit Clearing Company (C&CCC) is responsible for the bulk clearing of cheques and paper credits in the UK. Like BACS, it is a non-profit making membership based industry body, and operates on a three-day payment cycle: on day 1 a cheque paid into a Member Bank (or one of its agencies) anywhere in Britain during the course of a day's

business will normally be processed by the collecting bank that evening. At the collecting bank clearing centre the cheque information is passed electronically through a secure data exchange network (the Inter Bank Data Exchange, IBDE) to the appropriate paying bank clearing centre. On day 2 the cheque is delivered to an Exchange Centre, where each Member hands over all the cheques drawn on other banks and collects cheques drawn on itself. On the morning of the next working day (day 3), bank staff review the cheques presented for payment and make decisions about whether to pay or return them. Settlement between the Members, for the net values of the cheques exchanged between them, takes place over their Bank of England settlement accounts on day 3. Cheques can sometimes take longer to clear, but that is a competitive matter between banks.

- F.9 Although the volume of cheque payments has declined since its peak in 1990, 6.5 million cheques and credits are still cleared each working day. The Task Force will start a working group looking at the cheque payment process in 2005, reporting in summer 2006.

CHAPS

- F.10 The CHAPS Clearing exists to process and settle systemically important and time dependent payments. CHAPS payments are settled in real-time with simultaneous debit and credit across settlement bank accounts at the Bank of England. The time from release from the sending settlement bank, including settlement across accounts at the Bank of England, to receipt by the receiving settlement bank is around 45 to 60 seconds.
- F.11 While CHAPS is used almost exclusively in the UK for the settlement of high value clean payment transactions, lower value, usually time-dependent payments, form the greater proportion of transactions in the clearings.
- F.12 Like BACS and C&CCC, CHAPS is a not-for-profit body owned by its members, which are from the banking industry. As well as processing transactions in Sterling, CHAPS also offers a clearing service for Euros.

Other schemes

F.13 As well as clearing schemes, there are five other significant payment schemes in operation in the UK:

- the Automated Teller Machine (ATM) network. Currently the only large United Kingdom-based inter-bank ATM network is LINK, which is run by LINK Interchange Network Limited, another membership based industry body. LINK provides the shared infrastructure which allows a customer of Bank A to withdraw his or her funds from the ATM of Bank B, or from a specialist ATM provider
- there are two significant credit card schemes in operation in the UK, Mastercard and Visa. Card-holders can purchase goods and services up to a pre-arranged financial limit. On receipt of a monthly statement, card holders can either pay off the balance in full or in part, and
- there are two significant debit card schemes in operation in the United Kingdom, Visa Debit (owned by Visa), and Switch/Maestro, run by S2 cards using Mastercard's brand Maestro. Debit cards are linked to a particular bank or building society account, and goods and services are paid for by automatically debiting the cardholders account.

G REFORM OF UNITED KINGDOM PAYMENT SYSTEMS IN PERSPECTIVE

The Cruickshank Report

- G.1 In November 1998, the Chancellor of the Exchequer commissioned a review of the United Kingdom banking sector. This culminated in the Cruickshank Report of 2000. This report examined levels of innovation, competition and efficiency among various sub-markets of the banking industry, and recommended options for change. Among the sub-markets was the payment systems market.
- G.2 The Cruickshank report found barriers to entry and anti-competitive practices in the provision of payment services, which raise prices to consumers, add to business costs, and stifle innovation. Because of their very nature, payment systems involve a degree of co-operation between organisations that would otherwise compete against each other. Cruickshank concluded that this led to a dampening of competition which was exacerbated by the way in which payment schemes were governed and run.
- G.3 The Cruickshank report noted that payment schemes in the United Kingdom were governed by the banks that owned them (mutual governance). As many of the same banks appeared on the governing boards of the various payment schemes, Cruickshank concluded that there was a reduced incentive for those schemes to compete with each other, either by entering each other's markets, or by introducing new products. Mutual governance also made competition **within** a scheme more difficult: because decisions were taken by consensus, it was impossible for one subset of banks to introduce an innovative product unless all banks supported the introduction. This led to the Cruickshank report's conclusion that 'many schemes moved at the pace of the slowest member'¹⁴.

¹⁴ Cruickshank, para 3.125

- G.4 According to Cruickshank, the result of this lack of competition could be seen in the performance of the UK's payment systems. The report gave the examples of three day clearing for electronic and paper payments, and the £750 million pounds of interchange fees paid in the UK each year.
- G.5 The Cruickshank report identified some key areas where improvements could be made in payment systems. These included price transparency, good governance, non-discriminatory access, efficient wholesale pricing and innovation.

The OFT Report

- G.6 In April 2003 the Government announced in its Budget Report that legislation would be brought forward 'to give the OFT new powers to promote effective competition in payment systems'¹⁵.
- G.7 In May 2003, however, the OFT published a report examining the extent to which the payment systems market had changed since the publication of the Cruickshank Report¹⁶. The OFT noted that some Cruickshank issues were being dealt with elsewhere in the OFT, that a number of self-regulatory changes had been carried out by the industry, and that a number of areas still remained unresolved. The report noted that Cruickshank's concerns about the multilateral interchange fee used by card schemes was now being considered by the OFT under the Competition Act 1998. This issue was not considered further in the OFT's Report, and forms no part of the Task Force's deliberations.
- G.8 The Report discussed several changes to the governance of payment schemes since the Cruickshank Report. At the time of Cruickshank there had been strong links between the three clearing schemes (BACS, C&CCC and CHAPS) and the trade body APACS. Although the three clearing schemes were legal entities in their own right, members of the

¹⁵ Budget Report – April 2003, Chapter 3; paragraph 3.25

¹⁶ *UK Payment Systems*, May 2003, OFT 658

clearing schemes also had to be members of APACS, and there were governance links to APACS within their constitutions. Since the Cruickshank report these links with APACS have been severed, which, the OFT Report concluded, could lead to more freedom for clearing scheme members in deciding their own access and governance arrangements.

- G.9 At the time of Cruickshank, BACS was formed of one body which both governed and operated the payment schemes. The banks and building societies which own BACS were therefore in control of both scheme and infrastructure. In December 2003 BACS legally separated scheme from infrastructure. Although the scheme (now called BPSL) is still mutually governed by the payments industry, the infrastructure provider (now called Voca) is run on a profit making basis. The OFT hoped that an independently owned infrastructure provider could attract investment which in turn would stimulate innovation for BACS. BPSL and Voca are, however, presently still owned and governed by the same banks that ran BACS. CHAPS and C&CCC already had separate scheme and infrastructure.
- G.10 The OFT report noted innovations in the payment systems market. BACS had begun a wide-ranging technological renewal programme – NewBACS – which would increase the capacity of the Voca payment engine, and would introduce a new internet-based delivery channel called BACSTEL-IP. In August 2001 CHAPS migrated its Sterling network to the SWIFT global messaging system already used by CHAPS Euro network which would support any eventual entry into the Euro. At the same time, it supported industry changes to the payment and securities infrastructure. Members of C&CCC have outsourced their processing to third parties to achieve greater efficiency.
- G.11 The OFT report noted changes to both the governance arrangements of card schemes and innovations to systems. The most visible innovation has been the 'Chip & Pin' project, still (at May 2005) being rolled out. Older generation cards held account details in the magnetic strip on the back of a card, and verification of the identity of the cardholder was by cardholder signature. 'Chip & Pin' cards contain a microchip which contains details of the card and the account, and are able to contain a

much wider information set than is currently available on the magnetic strip. Signatures have been replaced by a four-digit pin number, which is typed into the retailers' keypad. It is thought that this innovation will reduce the amount of credit and debit card fraud in the United Kingdom.

- G.12 Another highly visible change has been the replacement of the Switch brand by Maestro. Maestro is an international brand, and has a wider recognition than Switch. New members to the scheme now only have to obtain a Maestro licence to join the scheme, and many banks who may wish to join are already licensed to issue Mastercard credit cards. This may give wider access to new members. Although cards will be branded Maestro, the Switch scheme continues to be run by S2 Cards.
- G.13 Switch has also decided to outsource transaction processing to Mastercard (which runs the Maestro brand). This means that the series of bilateral connections run by Switch between member banks were replaced a hub and spoke system, which allows easier connections for new members.
- G.14 The OFT report also covered changes to governance arrangements. Prior to the change, Switch was a joint venture serviced by a company owned by the three founder members of the scheme. Following the change, S2 Cards was formed by all the members of the scheme, with the Board elected by those members.
- G.15 LINK has allowed membership of independent ATM providers.

The Payment Systems Task Force

- G.16 The Treasury's pre-Budget Report of November 2003 took account of these changes made by industry, but still considered that competition problems remained in UK payment systems. In the 2003 pre-Budget Report, the Government announced that the OFT would be taking an enhanced role in the payment systems industry for a period of four years. In advance of any legislation, the payment systems industry was given an opportunity to address outstanding Cruickshank concerns via a Task Force approach in advance of any legislation. The Government

made clear that legislation would be enacted if this approach failed. The remit of the Task Force is discussed in the introduction to this Report.

- G.17 On behalf of the Task Force, the OFT produced and distributed a questionnaire on payment systems, designed to assess whether any Cruickshank concerns were still to be addressed, and whether additional concerns existed. Thirty responses were received, and where significant issues were raised, follow up meetings were held.
- G.18 Several key themes emerged from the questionnaire. First, many correspondents supported the case for faster clearing for BACS-type electronic payments as long as it was clear that demand existed for such payments. There were differences of opinion over the importance of the Cruickshank concern that only major banks and building societies have direct access to payment schemes, with some regarding access restrictions as an area for improvement, and others regarding the issue as irrelevant. Some respondents pointed out that developments in Europe must be closely monitored, to ensure that changes to UK payment schemes were consistent with them. Some respondents said that the governance changes made to APACS and BACS were a step in the right direction, but that it was too early to tell whether those changes went far enough. Others were concerned that even though BACS scheme and infrastructure had split, both were still owned by the same banks and building societies, thus negating any potential competitive benefit of the split. Mutual governance was felt by some respondents to provide important safeguards for payment systems, whereas others considered mutual governance created a strong disincentive for competition.