

# **BPSL Innovation Working Group report**

**May 2005**

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

OFT789b

© **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 report of the BPSL Innovation Working Group (the Working Group) set up by the Task Force in May 2004 to consider the question 'BACS PSL Clearing: what is the scope for, and costs and benefits of, innovation'.

In order to assess the demand for change, the Working Group commissioned some research (carried out by NOP) into the demand for faster clearing of electronic payments (primarily, telephone and internet payments and standing orders, as defined in the report) which showed that there is demand for change among personal and SME customers and that a faster clearing scheme would be used by a large number of consumers but in relation to a relatively small proportion of the total number of BACS payments. The Working Group also sought the views of frequent users of BACS, 'heavy' users. While the need for faster clearing is less of an issue for those users, they identified a number of other innovations that they felt were desirable.

The report sets out demand for change, both from personal and SME customers, as evidenced by the NOP, and other, research, the heavy users, and the wider, political and Government demands for innovation. It sets out the background to the present BACS payment schemes and details of how a new, faster, payment scheme (called 'ELLE') could be established, and at what cost. While some of the benefits to a faster clearing scheme are not necessarily easily quantified - any more than are some of the costs - the report includes an analysis of the costs and benefits. This demonstrates clearly the case for introducing a faster clearing scheme.

The Working Group has concluded that the prospective benefits for the United Kingdom economy justify the creation of a faster payments service. I believe that this report reflects a sensible appreciation of the realities of the banking world today. The banking industry has agreed to establish an 'Implementation Group' to consider how the recommendations of the Task Force, based on this report, could be put into effect. In addition, the industry has agreed that the Implementation Group will make its final report to the Task Force within six months of the publication of the Task Force's recommendations.

That we have been able to reach a conclusion at all on these issues is testament to the knowledge and perceptiveness of those who have taken part in the Working Group and their enthusiasm to ensure that a successful outcome was reached. I am personally very grateful to the individuals involved for all for their

hard work and dedication to the task, and to the organisations listed in Appendix A to this report, especially to APACS, who have made available significant resources in undertaking the foreign comparison trips, in taking part in the steering group for the consumer research, and, in particular, contributing towards the cost of the research work.

I commend the report to the Task Force.

Christopher Rawlins

Director, Markets and Policy Initiatives Division, Office of Fair Trading

Chairman, BPSL Innovation Working Group

May 2005

## **EXECUTIVE SUMMARY**

### **Background**

Payment systems in the United Kingdom have been examined in the Cruickshank report *Competition in UK Banking* of 2000 and in the OFT's own report *Payment Systems in the UK* in 2003. Payment systems have also been the subject of considerable pressure for change from Government, and the media, particularly in relation to faster clearing. HM Treasury's 2003 Pre-Budget Report announced that the OFT would take on an enhanced role in relation to payment systems, for a period of four years, to resolve outstanding competition problems in advance of any legislation. The OFT subsequently announced the creation of the Payment Systems Task Force in March 2004. The Task Force set up its first working group to consider innovations to the clearing schemes offered by BACS Payment Schemes Limited (BPSL). This is the report of the Working Group.

The Terms of Reference of the Working Group required it to consider 'the scope for, and costs and benefits of, innovation' to BPSL clearing schemes. The Working Group's own scoping paper stated '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.'

The Working Group looked at possible changes to telephone and internet 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**

The 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 there were gaps in the knowledge of both consumers and SMEs. Exceptions were cheque and electronic clearing, which were thought to take longer than they should
- 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.<sup>1</sup> 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.

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

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.

---

<sup>1</sup> The total number of BACS direct credits and standing orders in 2004 was 1,963 million.

The Working Group has not been able to make any assessment of the potential costs and benefits of these innovations.

The Working Group has 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 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**

The 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.<sup>2</sup> The banks estimated the total IT costs of introducing a faster clearing service – a hybrid same-day/next-day service ('ELLE') – 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.

The report quantifies how the United Kingdom economy 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 United Kingdom economy.<sup>3</sup> 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.

---

<sup>2</sup> 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.

<sup>3</sup> 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.

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. Neither the Working Group nor the Task Force can specify or recommend whether to charge at all or the level of any charge. 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**

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 suggests criteria against which the Implementation Group could consider its proposals, based on access, coverage, payment types, revocability and capacity. The 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.

The Working Group believes that other innovations - those suggested by the 'heavy users' and observed in the international case studies - could initially, at least, be looked at by APACS or BPSL.

# CONTENTS

<i>Chapter</i>		<i>Page</i>
	Foreword	
	Executive Summary	
1	Introduction	1
2	Pressure For Change	5
3	BACS Clearing	13
4	BACS: Existing And Planned Innovation	22
5	International Case Studies	29
6	Demands For Innovation	40
7	Banks' Costings	68
8	Cost/Benefit Analysis	75
9	Options For Change	86
10	Next Steps	90
A	Membership of Working Group: Organisation of members	93
B	Working Group Terms of Reference	94
C	Service Framework: relevant extracts from the framework	96
D	Technical summary of features of BACS	147
E	NOP report to the Working Group	151
F	Further details from international case studies	169
G	List of bodies met/consulted	290

H	Full banks' costing report: text of letter from APACS to OFT dated 23 December 2004	294
I	Cost-benefit evaluation	299
J	European considerations	316
K	Glossary of terms	321

# 1 INTRODUCTION

- 1.1 Competition concerns about United Kingdom payment schemes were raised in the Cruickshank report of 2000. The report found economic characteristics of United Kingdom payment schemes that did not deliver price transparency, good governance, non-discriminatory access, efficient wholesale pricing or innovation. Furthermore, the report suggested that a new framework for competition, including licensing and regulation, was necessary to deal with the problems identified.
- 1.2 In preparation for proposed legislative changes that were to provide the Office of Fair Trading (OFT) with powers as a specialist regulator of payment schemes, the OFT examined and reviewed the payment systems market in 2003 in relation to open access, innovation, and efficient and transparent charges. The OFT report<sup>4</sup> noted that the industry had undertaken a number of self-regulatory reforms in addressing some of the concerns raised by the Cruickshank report - for example, the system changes to BACS<sup>5</sup> and governance changes to APACS.<sup>6</sup> The OFT reported, however, that a number of competition concerns remained. The proposed legislation was suspended by H M Treasury in favour of the Task Force and the payment systems industry therefore currently remains essentially self-regulatory.
- 1.3 The Payment Systems Task Force (the Task Force), chaired by the OFT, brings together industry, retail, consumer, business and government representatives (as observers) with an interest in payment systems. It was established in 2004, to identify, consider and seek to resolve competition, efficiency and incentive issues relating to payment systems over four years, particularly looking at network effects of the existing payment mechanisms. Where appropriate, issues affecting consumers

---

<sup>4</sup> OFT 658, *UK Payment Systems*, May 2003 at [www.offt.gov.uk/NR/rdonlyres/10DB2458-FBD9-4B5C-9EE7-CEB7ACA472BB/0/oft658.pdf](http://www.offt.gov.uk/NR/rdonlyres/10DB2458-FBD9-4B5C-9EE7-CEB7ACA472BB/0/oft658.pdf)

<sup>5</sup> See, for example, paragraphs 8.2 – 8.5 of the OFT report.

<sup>6</sup> See, for example, paragraphs 8.15 – 8.16 of the OFT report.

which derive from, or are associated with, features of payments systems are also considered.

- 1.4 The Task Force meets not less than four times a year, and reports on its work and findings annually. A number of working groups have been established to take forward work on various issues. The Task Force publishes a report at the conclusion of each working group. In looking at the issues and in considering any remaining competition concerns, the Task Force and the Working Group have taken account of the relevant previous work on payment systems, including the Cruickshank report and the OFT report, as well as more recent trends and developments. It particularly notes the innovations the banking industry has introduced, and is still introducing, in both systems and infrastructure, which are reflected in this report.
- 1.5 This is the report of the BPSL Innovation Working Group (the Working Group) set up by the Task Force. It sets out the findings of the Working Group and the options for change identified by the Working Group. The Working Group was set up by the Task Force at its meeting on 26 April 2004. The list of member organisations of the Working Group is at Appendix A and its terms of reference are at Appendix B. The principal aims of the Working Group are to identify the scope for, and costs and benefits of, innovation to current clearing arrangements for high volume, low value electronic payments which are currently all processed by Voca on behalf of BPSL who operate the BACS clearing schemes. The Working Group's remit is to identify, and set out for the Task Force the drivers and options for change to current arrangements, and for the Task Force to decide its recommendations in the light of those options.
- 1.6 The banking industry has agreed to establish an 'Implementation Group', which, following publication of this report by the Task Force, will consider how to put into effect the Task Force's recommendations. This group will report back on its findings within six months.
- 1.7 The Working Group has looked at potential innovation to the processing of high volume, low value electronic payments in BPSL. Its primary concern has been with speeding up telephone and internet payments, and standing orders where, in most cases, value transfer does not take

place on the same day. In considering the case for change the Working Group has focused on the existing combination of BPSL scheme management and Voca infrastructure. Concentrating on the current arrangements has facilitated high level cost estimates which would have been more complex and costly to obtain if, for example, a different infrastructure supplier or several different options had been analysed. However, there are other potential routes by which faster payments could be delivered and it is expected that the Implementation Group will examine a number of possible schemes and suppliers in order to identify any better, more efficient, or cheaper alternative. Thus no inference should be taken from this report, nor the title of the Working Group, that any change would necessarily be delivered through BPSL and/or Voca.

- 1.8 The Working Group has also considered potential innovations to direct credits and direct debits. In these cases, value transfer between parties takes place on the same day, so the focus has been on innovation other than speeding up the transaction.
- 1.9 In addition to the input from the banking industry, government, consumer, and retail and small business consumer members of the Working Group, the Working Group ascertained the views of the public through extensive consumer research and through a questionnaire sent to known interested parties. The OFT also held a forum for corporate heavy users of the current BPSL system.<sup>7</sup>
- 1.10 The banking industry, with the rest of United Kingdom industry, is subject to general competition legislation. As well as regulation of packaged investment products, mortgages and general insurance, the Financial Services Authority is the single statutory regulator responsible for the authorisation and supervision of deposit-taking by banks, and, in

---

<sup>7</sup> Held on 19 January 2005. The seminar was attended by representatives from The Association of Corporate Treasurers, AXA, Bottomline Technologies, British Gas, BT, The Department for Work and Pensions, Direct Line, Dixons, EDF Energy, JPM Chase, J Sainsbury, Legal & General, The Local Government Association, MBNA, Next, HM Paymaster General's Office, The Royal Bank of Scotland, Royal Mail, Shell, SKY, Standard Life, The UK Petrol Industries Association, Yorkshire Building Society, as well as from the Cass Business School (academics carrying out some research for the OFT), BPSL and OFT.

order to maintain confidence in United Kingdom financial services generally, for supervising exchanges, settlement houses and other market infrastructure providers. It does not, however, regulate payment systems. The Bank of England is responsible for the oversight of United Kingdom payment systems. The Bank's primary objective as overseer is to ensure sufficient attention to systemic risk reduction in the design and operation of payment systems. The Bank is not, however, a competition regulator of payment systems. The Banking Codes, which are monitored by the Banking Codes Standards Board, cover current accounts, savings and deposit accounts, cards, loans and overdrafts.

- 1.11 The stability of payment systems is an essential part of the United Kingdom economy. The recommendations suggested in this report have been made in acknowledgment of this. Any changes made to payment systems must not compromise levels of reliability or security.
- 1.12 As at May 2005, the Task Force is operating two further working groups: the BPSL Access and Governance group is examining the potential for adapting membership criteria and governance arrangements of the scheme; and the European Working Group is acting as an information source for the Task Force and for other working groups.

## **2 PRESSURE FOR CHANGE**

- 2.1 The BACS system is of vital importance to the United Kingdom economy. The great majority of the United Kingdom population make or receive BACS payments regularly, through direct debits, standing orders, online and telephone banking, and by receiving benefit or salary payments. In 2004, 4.6 billion such BACS payments were made, amounting to over £2,883 billion. Of these, 4.2 billion were payments where value transfer took place on the same day, and there were 385 million standing orders and remote banking payments. In addition, there were some 200 million non-BACS automated payments.
- 2.2 Although the BACS system is a reliable and secure way to transfer funds, areas of its performance have been criticised. Over the past few years the pressure for BACS to become a faster and more innovative system has grown, especially in relation to automated telephone and internet payments, and to standing orders, where, for most transactions, value transfer does not take place on the same day. The pressure on BPSL for faster clearing has come from many different sources, including the Government, the Bank of England, the OFT, consumer and business groups, and the media.

### **Government**

- 2.3 The Government believes it is vital that the United Kingdom payments market is efficient, innovative and, if possible, open to real competition because it is of crucial importance to both the United Kingdom's banking market and the wider economy.
- 2.4 BPSL is currently the only large scale clearing house for low value, high volume electronic payments in the United Kingdom and is subject to virtually no competition. The Cruickshank report identified a lack of competition in the money transmission market, caused by the 'underlying economic characteristics of payment systems'. The report continued that payment systems could 'be run in the interests of those

who control them rather than in the public interest'.<sup>8</sup> This lack of competition has, the Government believes, led to less incentive to innovate, and the lack of innovation has led to pressures for two main changes. The first is for faster BACS payments. The second pressure is for the BPSL system to consider more changes that some businesses want (as set out in chapter 6). There is now pressure from various sources across the United Kingdom's economy for these innovations.

2.5 H M Treasury has welcomed the banking industry's commitment to engage constructively with the Task Force on issues of mutual concern, but remains committed to legislation unless the Task Force leads to significant improvements. The Economic and Fiscal Report in the Budget Report 2005 included the following paragraphs:<sup>9</sup>

Payment systems play a crucial role in the economy. The Government continues to believe that improved competition and efficiency in these systems would deliver significant benefits to the UK. Innovation, price inefficiency, access and governance are key issues related to improving competition and efficiency in these systems. The Government welcomes the plans of the Payment Systems Task Force, chaired by the OFT, to examine these issues across all payment schemes in the UK. If successful in resolving the outstanding issues, the Government believes that the Task Force will improve competition in payment systems while being more flexible and less costly than legislation.

The Government looks forward to the conclusion of the Task Force's work on faster electronic payments in April 2005. The Government notes that progress has been made in some aspects of this work and looks forward to further progress on some outstanding issues. The Government also notes that the industry has agreed to form an implementation group that will decide by the end of 2005 how to implement the Task Force's recommendations. Unless the Task Force, and subsequent action by the industry, leads to significant improvements

---

<sup>8</sup> Cruickshank report paragraph 15, Executive Summary.

<sup>9</sup> Paragraphs 3.12 and 3.13.

in competition and efficiency, the Government will legislate to tackle these issues. The Government will consider the forthcoming conclusions of the Task Force on faster electronic payments, and the work of the implementation group, in this context.

## The Bank of England

- 2.6 The Bank of England is responsible for the oversight, but, crucially, not the competition regulation, of payment systems in the United Kingdom. Its main objective is to assess and, if necessary, seek to ensure mitigation of risks to the financial system and the wider economy – 'systemic risk'. The Bank also seeks to promote an efficient payment and settlement infrastructure when this does not conflict with its primary responsibility for systemic risk mitigation.
- 2.7 The Governor of the Bank of England has said that it is 'disappointing' that it now takes longer to clear retail payments in the United Kingdom - whether cheques or electronic payments - than in almost any other member of the G10.<sup>10</sup> In addition to any potential wider economic benefits of shorter clearing cycles, members of BACS would benefit from reduced credit exposures if clearing cycles were shortened.<sup>11</sup> Shortening inter-bank clearing cycles would reduce the number of days for which exposures exist and hence would also reduce the credit exposure to each member. The Bank reported on these issues, and the size of some of the potential benefits, in its 2004 Oversight Report.<sup>12</sup>

---

<sup>10</sup> King, M (2004) Speech to the Lord Mayor's Banquet for Bankers and Merchants at the City of London at the Mansion House, 16 June. Available at: [www.bankofengland.co.uk/speeches/speech222.pdf](http://www.bankofengland.co.uk/speeches/speech222.pdf)

<sup>11</sup> This is because payments to and from each member are netted to produce a single multilateral net amount for each member - resulting in either a claim on or obligation to the other members of the system as a group. If a member in a net debit position failed to make a pay-in, surviving members would need to fund the resulting shortfall to allow settlement to complete.

<sup>12</sup> See, for example, 'Box 5: Reducing settlement risk in retail payment systems', pages 46 and 47, *Payment Systems Oversight Report 2004*, Bank of England, January 2005.

## The Office of Fair Trading

- 2.8 The OFT's 2003 report *UK Payment Systems* (see footnote 4) considered some of the concerns raised in the Cruickshank report, including those regarding the lack of innovation in the BACS scheme. The OFT concluded that while innovation was planned and had occurred in the BACS scheme, progress in making significant changes had reflected the disincentives arising from the lack of competition faced by BACS.
- 2.9 The OFT's report noted that the NewBACS initiative (see chapter 4 below) would include a new central infrastructure and delivery channel. It was noted that the new system would have the capability to reduce the clearing cycle from the current three days to a next day cycle. The report concluded, however, that despite changes to the relationship between the BACS scheme and infrastructure, the incentives for member/owners of BACS to innovate would not improve radically. It should be noted, however, that the scope of the NewBACS infrastructure renewal programme does not include all the functionality to reduce the clearing cycle. Further expenditure would be required to achieve this.
- 2.10 The Chairman of the OFT attended the Task Force meeting on 24 June 2004 and said, among other things, that the ownership of the Task Force was with its members, and that the reports produced would be the Task Force's and not the OFT's. He said that there were pressures on the payment systems industry to change and that the industry had the opportunity, through the Task Force, to determine how these changes would occur. The OFT would not wait for four years to report to the Treasury if no progress were to be delivered.

## Float

2.11 In its 2003 report, the OFT also examined the costs to consumers of 'float'. Float occurs when money reaches the beneficiary customer's account some time after it leaves the paying customer's account. For most BACS transactions, the accounts of the customer making the payment and of the payee are updated simultaneously, in effect, as settlement occurs. For a small number of transaction types, payment leaves the final customer account at the paying clearing bank before settlement occurs. In these cases, the paying bank, rather than the final customer, earns interest (the 'float') on the money for a period before settlement. Float principally arises in connection with:

- inter-bank standing order payments, and
- internet and telephone banking transactions.

2.12 The industry has told the Working Group that in order to be sure that their customers have the money to meet their obligations when 'value' is exchanged on the third day, paying banks currently debit the customer's account at the beginning of the cycle, on day one. This means that the paying bank has the use of this money for two working days during which time it can be invested to generate float revenue. With most BACS payments, such as direct debits, float does not occur, because payments leave one account and enter the other simultaneously. With standing orders, telephone and internet banking payments, however, the payer's account is typically debited two days before payment is made. The 2003 OFT report estimated that the annual income to the banks from float (not necessarily the cost to consumers, however), based on an annual interest rate of 5 per cent, was then £30 million.<sup>13</sup> The report noted that where the monies

---

<sup>13</sup> In arriving at this figure of £30 million, the OFT based its calculations on a total estimated annual value of inter-bank standing orders of c. £52 billion and of inter-bank remote banking transactions of £25 billion. Given 260 million inter-bank standing order transaction - the figure in 2001 - and an average standing order value of £200, the value of which is available as float to the banks for an average of two working days, or 2.8 calendar days, at an average rate of interest of five per cent:  $£52bn \times 2.8/365 \times 5\% = £20m$ . Assuming that float is generated for

involved would otherwise earn similar rates of interest for final customers, the amount of float also represented an estimate of the interest income forgone by those final customers.

- 2.13 The industry has further said that float is an industry practice that does not arise as a result of the BACS system. It is a commercial decision made by individual banks, based on risk and credit management considerations, about when to debit the payer's and credit the beneficiary's accounts at their own banks, and how to treat the resulting accounting entries. Two banks, Lloyds TSB, and HSBC have made competitive decisions to adjust the interest calculations made by their accounting systems to give the benefit of the funds to their paying customers during the three day process. This eliminates float for payments made by their customers. A shorter BACS clearing cycle, however, would reduce the level of float for all banks - to zero in the event of same-day clearing in relation to relevant payments.
- 2.14 In its response to the Banking Code Review 2004,<sup>14</sup> the OFT asserted that the banking system should no longer have the benefit of the interest-free float while payments were cleared but that customers should receive the relevant interest. In February 2004, Sir John Vickers, the OFT's Chairman, said: 'Customers, not just the banks, should get some benefit from the float.'<sup>15</sup> Elaine Kempson, the independent reviewer of the Banking Code, did not include this recommendation by the OFT in the revised Code but, instead, recommended that the OFT 'explore this issue further and that the outcome [be] subsequently incorporated into the Code, if appropriate'. The sponsors of the Code said in response that 'we agree with the

---

two working days (2.8 calendar days) at 5 per cent interest on remote banking transactions of £25 billion, the value of the float available to the banks is  $\text{£}26\text{bn} \times 2.8/365 \times 5\% = \text{£}10\text{m}$ . Full details are contained in Part II, Chapter 7 of the report.

<sup>14</sup> The Banking Code is a voluntary code of practice which is owned by its subscribers and changes are organised through the sponsors - BBA, APACS and the BSA. The Code was reviewed by independent reviewer Professor Elaine Kempson.

<sup>15</sup> For further details see: <http://www.of.gov.uk/News/Press+releases/2004/30-04.htm>

recommendation and do not feel this to be a suitable matter for the Codes'. Having had the issue remitted to it, the OFT believes that the Task Force is the most appropriate vehicle to examine the issue of float. The Task Force has not considered the issue of float separately, but it is the case that reduced clearing times reduce the level of float.

## **Consumer and Business Groups**

2.15 Both consumer and business bodies believe that innovations to BACS - particularly faster clearing - would benefit the economy. The Chairman of the Federation of Small Businesses,<sup>16</sup> Carol Undy, said: 'The UK is now taking longer to clear payments than almost any other G10 country. It should, given today's technology, not take three days for a customer to clear a cheque or receive an electronic payment.' In June 2003, Which? published a report<sup>17</sup> which expressed concern that electronic payments through BACS took at least three days to process, and, depending on the bank, the total clearing period could take as many as five days. Which? was also concerned that the slow clearing process allowed float income to be earned on consumers' money. Consumer organisations have demanded a change to this practice.

## **Treasury Select Committee**

2.16 At the Treasury Select Committee (TSC) hearing on Credit Card Charges and Marketing held on 19 October 2004, the Chairman, John McFall MP, raised the issue of faster clearing. He asked the banks present (Lloyds TSB and HBOS) whether they agreed with the Governor of the Bank of England's comments on clearing times (see paragraph 2.7 above) and if this was an area for improvement. James Crosby, Chief Executive, HBOS agreed that it was. Eric Daniels, Group Chief Executive, Lloyds TSB said 'Speaking for Lloyds TSB, we believe that if we can speed electronic payments, we should.'

---

<sup>16</sup> The Federation of Small Businesses represents 185,000 of Britain's SMEs.

<sup>17</sup> *Snail's Pace*, Which?, June 2003.

## Media

- 2.17 Over the past few years the written and broadcast media has paid particular attention to the banking industry and has more often than not been critical of it. One of the areas of focus has been the time it takes for electronic payments to clear in the United Kingdom and the float arising on such payments. Articles appearing in both tabloid and broadsheet newspapers and in television and radio programmes have all expressed concern over the length of the BACS clearing cycle, and, in doing so, have raised the public's awareness of the issue.

### 3 BACS CLEARING

#### Background<sup>18</sup>

- 3.1 Bankers Automated Clearing Services (BACS) started operations under the name of Inter-Bank Computer Bureau in 1968 to automate bulk low value clearings and remove the need for sending paper-based payments through the banking network. The clearing banks were looking to replace the manual service carried out until then by the Bankers' Clearing House, which involved the movement of funds from one bank branch to another bank branch.
- 3.2 The BACS system became a central feature of the UK payment-clearing network and proved very successful in fulfilling the role for which it had been created. By 1978 the system was processing 338 million automated payments a year and over a billion a decade later. In 1985 the company changed its name to BACS Limited and expanded its membership to include building societies.
- 3.3 In the early years, banks and companies that had been sponsored by their bank produced payment data in the form of a magnetic tape or diskette. This reliance on physical media was subsequently reduced by the introduction of 'BACSTEL', a service enabling payment information to be sent to BACS via a telephone line. BACSTEL grew in popularity and by 1998 completely replaced the physical media for sending payments to the BACS system.
- 3.4 In 2003, BACS introduced Internet Protocol (IP) access using a new service known as 'BACSTEL-IP'. BACSTEL-IP will replace the BACSTEL telecoms system by the end of 2005.
- 3.5 On 1 December 2003, BACS Limited was separated into two companies to provide for a more open payments marketplace and the need to

---

<sup>18</sup> The Draft Service Framework, containing details of specific features of payment systems in the United Kingdom and used as a reference document for the Working Group members, is at Appendix C.

separate the ownership of clearing schemes from their technical infrastructure. The two companies formed at separation were:

- **BACS Payment Schemes Limited (BPSL)**, a membership-based industry body whose role is to develop, enhance and preserve the integrity of automated payment and payment-related services. BPSL is a 'not-for-profit' company limited by guarantee, and
- **Voca Limited**, initially called BACS Limited (that is, it retained the name at separation), until October 2004 when the Voca name was adopted. Voca Limited focuses on its core competency: the provision of data processing services especially in relation to payments. Voca has a commercial mandate to operate in various markets and it is anticipated that the company will evolve over time as it develops a number of new commercial initiatives. Voca is a profit-oriented company limited by shares.

3.6 BPSL has a contractual relationship with Voca for the supply of Automated Clearing House (ACH) processing services required for the 'BACS' Direct Credit and Direct Debit schemes it operates. The contract with Voca to provide these services is for a seven year period (five years plus a two year notice period) which commenced on 1 December 2003.

3.7 Inter-bank settlement takes place across accounts at the Bank of England. Settlement services provided by the Bank of England are subject to a joint contract with Cheque and Credit Clearing Company Limited.

### **BPSL's role**

3.8 BPSL's importance to the UK economy and payment infrastructure can be illustrated by the following key facts:

- up to 66 million payments are processed on a peak day, and rising
- 4.6 billion transactions were processed in 2004, 13 per cent higher than in 2003

- over 50 billion payments were processed during the last 36 years, with zero failures
- over 70 per cent of the UK population uses BACS payment schemes
- over 90 per cent of UK salary payments are paid using BACS payment schemes
- 100 per cent of the FTSE100 use BACS payment schemes, and
- over 100,000 UK businesses use BACS payment schemes, with around 40,000 of these having direct connectivity into the BACS system using BACSTEL or BACSTEL-IP.

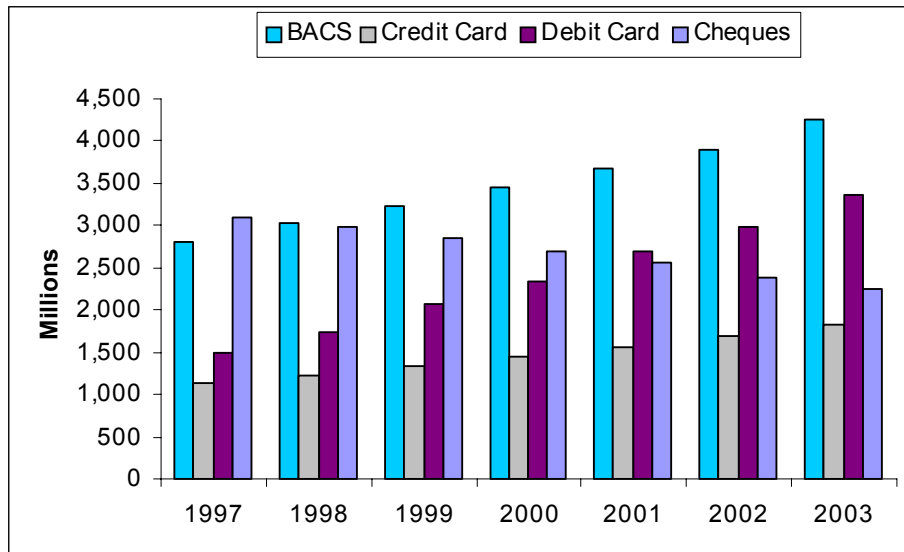
### 3.9 BPSL is responsible for:

- approving the provider(s) of ACH infrastructure services required to provide the BACS payment schemes
- administering schemes' rules and standards, and providing advice on best practice
- maintaining the overall integrity of the automated clearing system and payment settlement
- enhancing the quality of clearing, settlement and payment services
- ensuring compliance with regulatory and Bank of England oversight requirements, and
- developing new payment services to meet the needs of corporate customers and consumers.

## Payment schemes

3.10 BACS Payment Schemes are responsible for direct debits, direct credits and standing orders (see below).

**Chart 3.1 - BACS payments compared with other payments**



## Direct debit

3.11 A direct debit is an instruction from a customer to their bank or building society authorising a company to collect regular amounts from the customer's account, and, as long as the customer has been given advance notice of the collection amounts and dates, a company can vary the amounts collected at a subsequent date.

3.12 Over 17,000 organisations use direct debits for collecting a variety of regular bills including utility payments, insurance, council tax, mortgages, loans and subscriptions. In addition, consumers can pay occasional bills such as digital TV 'pay per view' services by direct debit.

**Table 3.1**

<b>Direct debit payment item volumes by main uses/sectors (millions)</b>				
	<b>1980</b>	<b>1990</b>	<b>2000</b>	<b>2004</b>
Life Insurance	100.6	310.7	414.9	402.6
Non-Life Insurance	0.0	97.6	302.1	400.0
Council Tax/NDR	9.4	79.3	108.8	131.6
Mortgages	1.1	19.5	87.4	108.4
Loans & Leasing	22.7	62.8	167.5	182.8
Electricity Billing	0.1	31.4	101.4	112.9
Gas Billing	2.3	23.0	108.4	136.9
Water Rates	2.1	30.1	81.2	101.7
Telephone Billing	0.0	17.2	127.1	205.0
Retail Sales	2.7	34.3	59.1	72.8
Business to Business: Collections	3.2	14.9	46.4	105.7
TV Billing & Licences	4.5	25.7	170.1	219.4
Subscriptions	5.8	24.1	94.7	163.8
National Insurance	3.7	13.1	17.6	20.3
<b>Total Direct Debits</b>	<b>170.5</b>	<b>836.5</b>	<b>2,000.8</b>	<b>2,572.8</b>

**Table 3.2 – Consumer attitudes towards direct debit**

	% agreeing 1991	% agreeing 2004
I prefer to use Direct Debits and use them for most bills	11	48
I am selective about my use of Direct Debits and use them for some bills and not others	34	20
I will only use Direct Debits if there is no other choice	16	9
I will not use Direct Debits	23	14
I am not able to use Direct Debits as I have no suitable account	10	6
None of these	6	3
	100	100

Source: Direct Debit long-term tracking study for BPSL, 2004 results.<sup>19</sup>

### The direct debit guarantee

3.13 All banks and building societies that take part in the direct debit scheme operate this guarantee. The efficiency and security of the scheme is monitored and protected by the customer's own bank or building society. If the amounts to be paid or the payment dates change, the company (that is, the direct debit originator) will provide notification to the debtor normally 10 working days (or as otherwise agreed) in advance of their account being debited. If the originator or the debtor's bank or building society makes an error, a full and immediate refund of the amount paid is available under the guarantee. The guarantee also makes it clear that a debtor can cancel a direct debit authority at any

---

<sup>19</sup> Sample size 1,957 adults aged 17 years plus (representative of UK adult population 17 yrs and over).

time by writing to their bank or building society. They should also send a copy of the cancellation instruction to the direct debit originator organisation.

### **Direct credit**

- 3.14 Direct credit is a service enabling large and small organisations to make automated payments directly into the bank or building society account of the beneficiary. The service is mainly used for paying wages, salaries and government benefits. In total, it is used for paying over four million wages every week and around 20 million salaries a month. The service can, however, be used for a wide variety of other applications. Consumers find internet and telephone banking services (provided by their bank) convenient - these services use direct credit - to effect inter-bank payments. In addition over 100,000 companies use BACS payments to pay suppliers, pensions, employee expenses, insurance settlements, dividends and refunds. Generally, the channels used by businesses to input payments into BACS give rise to simultaneous debiting of their account on the same day as the beneficiary account is credited. In contrast, banks' internet and telephone banking channels for personal customers often utilise bank standing order processes and result in the payer's account being debited in advance of the credit being received in the payee's account.

### **Standing orders**

- 3.15 A standing order is 'an instruction from a customer to his/her bank or building society to make regular automated payments of a specified amount to a named beneficiary'. The term is also used to refer to individual payments arising from the instruction. The beneficiary is often another person such as a relative or landlord, or can be an organisation, for example, a charity. As such, standing order services are provided by banks according to their own terms and conditions (that is, not governed by common rules). However, inter-bank standing order payments are executed between banks and building societies as a type of direct credit.

**Table 3.3**

<b>Direct Credit payment item volumes by main uses/sectors</b>				
<b>(millions)</b>				
<b>Millions</b>	<b>1980</b>	<b>1990</b>	<b>2000</b>	<b>2004</b>
Salaries	49.0	132.7	244.8	237.6
Wages	26.5	200.6	260.4	209.0
Pensions/Annuities	8.8	60.4	108.6	119.9
Card Related Credits	0.0	12.4	48.1	54.5
Business to Business Payments	2.3	18.0	84.6	196.1
Dividends	0.2	1.8	23.3	24.9
Inland Revenue Tax Credits <sup>20</sup>	0.0	0.0	8.3	262.5
Government Department – DWP	0.0	45.7	159.8	376.8
Telephone/PC Banking and standing orders	166.3	243.2	278.8	384.1
<b>Total direct credits and standing orders</b>	<b>261.1</b>	<b>754.3</b>	<b>1,310.5</b>	<b>1,962.5</b>
<b>Total BACS volumes (direct credits, standing orders and direct debits)</b>	<b>431.6</b>	<b>1,590.8</b>	<b>3,311.3</b>	<b>4,535.3</b>

## The BACS processing cycle

3.16 The process takes three working days:

- day 1 - input day: payment instructions (direct debits and direct credits/ standing orders) are received into the BACS clearing system between 07:00 and 22:30 (BACS is open Monday – Friday, 07:00 to

---

<sup>20</sup> Child Benefits volume included in Inland Revenue Tax Credits in 2004 and in DWP figures for 2000 and previous years.

22:30). These instructions are validated and various security checks are made

- day 2 - processing day: the payment instructions are sent to the relevant beneficiary bank or building society by 06:00, and
- day 3 - entry day: settlement of members' net positions takes place across accounts held at the Bank of England. Banks and building societies generally apply valid payment instructions to customer accounts on this day, although for some indirect BACS participants (that is, agency banks and building societies) it may take longer.

3.17 A diagrammatical representation of this process is shown in Appendix D.

3.18 While the whole process takes place over three working days, all direct debits and most direct credit payments are simultaneously debited and credited to payer and beneficiary customer accounts on Day 3.

### **Technology renewal programme**

3.19 The BACS technology is currently undergoing a major renewal programme called 'NewBACS', to enable it to meet predicted volume growth for BACS payment services and provide enhanced security features. Further details of NewBACS are given in Chapter 4.

## 4 BACS: EXISTING AND PLANNED INNOVATION

### Introduction

4.1 BACS (now BPSL) and its members have implemented a number of initiatives to improve existing services and develop new ones in order to meet customer demands or to deliver efficiency gains for service users, although the end-to-end timeline for BACS has remained at three working days. An explanation of the innovations and developments that have occurred is provided below, together with an indication of the main beneficiaries from each development. With few exceptions, all the examples relate to innovation since 1993. The innovations have been grouped according to whether they were primarily focused on proposition or system/ processing. The NewBACS programme and potential future developments arising from that programme are also outlined at the end of this chapter.

### Proposition enhancement

#### **One-off Direct Debits: occasional payments**

Beneficiary(ies): direct debit originators.

4.2 While the direct debit scheme offers an efficient way for organisations to collect regularly occurring payments from large numbers of customers, additional flexibility has been made available to enable direct debit originators to collect both one-off and occasional, or irregular, payments by direct debit. One-off payments enable organisations originating direct debits to maximise their use of the scheme in a convenient way for their customers. Such an approach avoids the need for cheques to be sent via the post to effect payment or for credit card details to be provided. Examples of the use of one-off direct debits include where a payer wants to make an interim payment for, say, a utility bill or credit card, or an additional payment in reduction of a debt. Within BACS, one-off direct debits require the originator to electronically lodge the Direct Debit Instruction (that is, the 'mandate') using the Automated Direct Debit Instruction Service (AUDDIS), then

subsequently send the claim for payment and finally to cancel the mandate using AUDDIS.

### **Making it easier for customers to switch banks: the 'Transfer of Direct Debits and Standing Orders' (ToDDaSO) service**

Beneficiary(ies): all customers with direct debits and/or standing orders.

- 4.3 The banking industry in the United Kingdom has been working on developing service improvements aimed at providing a more efficient way for personal and business customers to transfer direct debits, standing orders and (although not a mandatory requirement) bill payment information between financial institutions. A paper-based pilot (Phase 1) service was implemented, which involved the sending of paper transfer advices from a customer's 'New Bank' to originators, advising them of the customer's New Bank details. Phase 2 set up a pilot group of BPSL member banks – acting in the role of a New Bank – to send automated transfer advices to a pilot group of direct debit originators, followed later by the full service involving all financial institutions and originators (Phase 3). This service involved the sending of automated messages by the New Bank to originators advising them of the account transfer, including the customer's New Bank account details. Phase 4 of the ToDDaSO project automated the flow of information between the New and Old Banks.

### **Automated Recalls**

Beneficiary(ies): BPSL member banks, the Department of Work and Pensions (DWP) and potentially other large initiators of payments.

- 4.4 The BACS proposition offers an automated recall facility enabling banks to recall (or 'unwind') a payment after it has been prepared and submitted to BACS. This automated facility is used on Day 1 of the payment cycle – that is, two days prior to the date on which the payment is due to be applied to the beneficiary account. Recalls

requested after Day 1 have to be handled manually using paper advices, when the refund is settled by bank giro credit. The automated recall facility has since been extended to non-bank financial institutions (including the DWP). Other institutions that meet the eligibility criteria can apply to use the service, subject to the agreement of the sponsoring member bank.

### **Paperless Direct Debits (PDD)**

Beneficiary(ies): large direct debit originators and their customers.

- 4.5 Paperless direct debit was launched to enable organisations to sign up customers for direct debit collections without having to obtain a signed paper authority. The following sign-up channels have been developed under the PDD Rules: face-to-face, telephone, telephone keypad, internet and interactive TV. It speeds up and simplifies the sign up process, while at the same time further increasing an organisation's administrative cost savings. It is more convenient for customers, with no forms to complete and no possibility of delays. The organisation obtains the customer's bank account details and then electronically lodges the direct debit instruction with that bank using Automated Direct Debit Instruction Service (AUDDIS). PDD is therefore only available to organisations using the AUDDIS service and who can satisfy additional stringent criteria. To ensure that key measures are delivered and correct information obtained, scripts have been developed and included in the Direct Debit rules.

### **Direct Credit Euro scheme**

Beneficiary(ies): businesses wishing to make payments in Euro.

- 4.6 BACS launched its direct credit Euro service to coincide with the launch of the new currency. This service enables originators to input direct credit payments in Euro denomination; payment files can consist of either 'Euro only' transactions or a mixture of Sterling/ Euro. The receiving institution handles any required currency conversion.

## **BACS Remit**

Main beneficiary: businesses making BACS (Direct Credit) payments.

- 4.7 The BACS Remit service is an enhanced payment message format for domestic and international credit transfers. It enables electronic business-to-business supplier payments to be accompanied by extended remittance data, received either electronically or by fax. Remit international caters for electronic cross-border payments to international message standards, accompanied by the necessary transaction information as specified by the EU.

## **STEP 2 Entry Point**

Main beneficiary: small UK financial institutions.

- 4.8 The last few years has seen the development of Europe-wide Euro denominated ACH payments. Payment instructions are routed through the STEP 2 system, which has evolved as a development of the EBA STEP 1 system. STEP 2 processes high volume and commercial retail payment orders sent to the system through a secure network. Participation in STEP 2 is restricted to banks operating in the EU.
- 4.9 In the United Kingdom, HSBC bank provides an 'entry point' service, using BACS, to ensure full 'reach'. This means that 'STEP2' payments coming into the United Kingdom from overseas banks can reach the intended beneficiary regardless of whether or not their account is with one of the United Kingdom institutions that has joined the STEP2 scheme.

## **BACS Approved Bureau Service (BABS)**

Main beneficiary: SMEs.

- 4.10 BACS launched this service to extend the opportunity to originate BACS payments and direct debits to smaller companies, who might not have sufficient volume requirements to merit becoming a direct access

participant in BACS. There are now approximately 675 approved bureaux (both financial institutions and non-banks), many offering payroll management and other services in addition to effecting the actual payments on behalf of their clients. Over 60,000 businesses submit their payments and collections into BACS using the services of a bureau.

## System and processing related innovation

4.11 Between 1988 and 1995, BACS developed a range of services aimed at streamlining processing activities undertaken within member banks and/or businesses using direct debit and direct credit. A list of these services is provided in the table below. A fuller explanation of each of the services is available in Appendix D.

**Table 4.1 – BACS services developed between 1988 and 1995 re: direct debit and direct credit**

Service	Full Name of Service	Main beneficiary(ies)
ARUDD	Automated Return of Unpaid Direct Debits	large direct debit originators and paying banks
ADDACS	Automated Direct Debit Amendment and Cancellation Service	large direct debit originators and paying banks
ARUCS	Automated Return of Unapplied Credits Service	receiving banks and corporates initiating large numbers of BACS (direct credit) payments
AUDDIS	Automated Direct Debit Instruction Service	direct debit originators
AWACS	Advice of Wrong Account for Automated Credits Service	businesses making regular BACS (direct credit) payments

## The NewBACS programme

4.12 The BACS technology is currently undergoing a major renewal programme called 'NewBACS', to enable it to meet predicted volume growth for BACS payment services and provide enhanced security

features. NewBACS will also introduce the technical ability to cap debit positions in BACS, facilitating a reduction in settlement risk.

## **BACSTEL-IP**

- 4.13 BACSTEL-IP is replacing the existing BACSTEL delivery channel through which BACS submissions are currently made, including payments initiated by customers using banks' internet and telephone banking services. BACSTEL-IP allows users to:
- transmit submissions to the BACS electronic funds transfer service
  - view submission information
  - access online any messaging and processing reports from BACS, and
  - maintain organisational and user static data held in the BACS system.
- 4.14 BACSTEL-IP employs technologies such as Java and Internet Protocol (IP), and fully utilises Public Key Infrastructure (PKI) and latest cryptography methods. In addition to mitigating risks, the new technology also provides users with greater flexibility and more immediate information direct to their desktop, plus tighter control of payment transactions.

## **Connectivity Options**

- 4.15 BACSTEL-IP offers users the ability to submit payments and collect reports across three connection types: BACS Dial Extranet, the BACS Fixed Extranet or the Internet. BACSTEL-IP brings together all BACS submission information, electronic reports, messaging services and also the collection of unpaid and unapplied items into a single secure IP connection.

## **Security Improvements**

- 4.16 Public Key Infrastructure (PKI) security provides data integrity (the assurance that the data sent is the same data BACS receives).

Encrypted transmissions provide privacy (the assurance that no one is able to view payment data in transmission).

### **Tracking/Control**

- 4.17 BACSTEL-IP allows the user greater control, enabling them to monitor the progress of individual payments and access payment histories online. Input reports are electronically provided within three to four hours of submission on input day, which enables same day error resolution and an opportunity for re-submission of time critical payments. All BACSTEL-IP software will use the latest version of the Industry Sorting Code Directory (ISCD) to ensure that the sort code and account number validation checks are done at the point of submission, delivering cost savings by reducing errors and facilitating straight through processing.

### **Reporting Tools**

- 4.18 Electronic reporting is available using a web browser to access the BACS payment services web channel. This enables automation of paper-based processes, saving the user time and money. Reports can be viewed, printed and saved locally, as well as being provided in XML format, which enables information to be automatically integrated into other business applications the user may have installed. This will significantly reduce costs and increase accuracy compared to paper-based reporting which requires information to be re-keyed into applications.

## 5 INTERNATIONAL CASE STUDIES

### Introduction

- 5.1 In order to be able to assess accurately any differences between the way in which BACS-type transactions are handled in the United Kingdom and in other countries, the Working Group carried out study visits to France, Norway, Spain and Sweden in August – October 2004. These countries were chosen because they appeared to offer innovations that were not currently available in the United Kingdom but had enough similar features to make valid comparisons. This chapter briefly summarises some of the key innovations that could be relevant to the United Kingdom. The full International Comparisons study and individual country reports are available at Appendix F.
- 5.2 In carrying out this study, the Working Group has been mindful of the need to interpret the results of international comparisons carefully. Economic, regulatory and competitive factors can all determine the price and delivery of a good or service and the Working Group is aware that that these factors will never be identical in different international markets. It is also relevant that faster payments in at least some other countries have developed against a background of a number of independent factors, some of which are outlined in the individual country reports forming part of Appendix F, and not necessarily driven by competitive issues.

### The Market

- 5.3 France is similar in geographic and demographic terms to the United Kingdom. Cheque use in France is very high (70 per cent higher than in the United Kingdom). Debit cards are widely held. Cash use is the lowest of the compared countries. There are a wide variety of payment methods available in France.
- 5.4 Spain has the highest use of cash in retail payments of the four countries and total non-cash payments are comparatively lower than in all compared countries. Internet take-up is the lowest of the four countries surveyed.

- 5.5 Sweden and Norway have similar retail payment markets. Both systems are giro based (that is, payments to businesses and some payments to individuals have traditionally been made using paper or electronic credits rather than cheques) with an increasing proportion of payments being made electronically. The use of payment cards is almost universal in Norway, and at similar levels to the United Kingdom in Sweden. Cheques have virtually no presence in either country. The use of cash is at similar levels to the UK and internet banking use is high in both countries.

## Regulation

- 5.6 The nature of regulation in each market is relevant in interpreting the level of innovation and services available in each of the compared countries: legislative provisions affect what has developed and can develop.
- 5.7 The oversight of payment systems is an essential part of central banks' financial stability role. In France and Sweden the central banks have designated particular retail payment systems as being of systemic importance. In Norway the central bank is the authorising and supervisory authority for payment systems which are deemed to be of importance for financial stability. In Spain the central bank owns and manages the payment system, and is considering whether to designate it as systemically important when it moves into the private sector in 2005. The central banks in Norway and Sweden have statutory responsibility for the promotion of efficiency. Both have interpreted this in broad economic terms and in Norway the central bank has for several years conducted studies into the pricing and costs of payment systems. In the United Kingdom, the Bank of England is primarily concerned with the assessment and mitigation of systemic risks, although the Bank seeks to promote an efficient payment infrastructure when this does not conflict with its primary responsibility for systemic risk mitigation.
- 5.8 Banque de France is the only central bank which has a statutory responsibility to ensure the security of payment systems. Cheque as a payment method is guaranteed by primary legislation in France and it is illegal for a citizen to write a cheque that cannot be honoured. The

central bank in Spain regulates customer pricing: the Banco de Espana monitors the transparency of published tariffs and can reject charges which it considers do not relate to the actual service provided. The Finansinspektionen in Sweden directly supervises a retail payment system company, namely BGC.

## **Analysis of Case Studies**

### **Speed of Payments**

- 5.9 The international case studies compared typical end-to-end timings relating to the main payment methods. These timings relate to the typical situation for inter-bank payments. Payments made between accounts with the same bank may have a shorter end-to-end timescale. The end-to-end timings may be different if either the payer or payee has his or her account with an indirect participant. End-to-end timings are, however, often dependent on competitive decisions taken by direct participants regarding the availability of funds to customers, which can vary from institution to institution. The norm in the inter-bank clearing cycle is documented in the tables at the end of each country chapter in Appendix F.

**Table 5.1 - Typical end-to-end timings for inter-bank payments (in working days)**

	France	Norway	Spain	Sweden	UK
Internet/telephone banking credit	same-day to three day	ELLE <sup>21</sup>	Two day	ELLE	three day
Direct debits	five day	seven day <sup>22</sup>	Two to four day	two day	three day <sup>23</sup>
Bulk electronic credits	same-day to three day	ELLE	Two day	one to two day	three day <sup>24</sup>
Standing orders	two day	ELLE	Two day	two day	three day
Depositing cheque in branch	three day	two day	three day	two day	three to five day
Paper credit in branch <sup>25</sup>	service not available	two day	Two day	two day	three day
Paper credit /cheque in post <sup>26</sup>	two to three day	two day	three day	two day	three to five day

---

<sup>21</sup> ELLE: Early by late, late by early. Submissions made in the morning before an intra-day deadline will clear that same day. Submissions made in the afternoon window will clear the next morning. Submission windows vary from country to country.

<sup>22</sup> This timing applies to business-to-consumer direct debits. There is also a two-day business-to-business direct debit product in Norway.

<sup>23</sup> For United Kingdom direct debits, debit/credit occurs on the same day on day three.

<sup>24</sup> For United Kingdom Bulk electronic credits, debit/credit occurs on the same day on day three.

<sup>25</sup> In some countries the paper credit is a separate instrument, in others, for instance the United Kingdom, it has to be accompanied by cash or a cheque.

<sup>26</sup> The timings relate to those after the item has been received, there will be an additional delay for the payer arising from the postal service in the country concerned.

## General

5.10 The main points identified were:

- all countries have a wholesale same-day payment system. This is typically available to personal customers at a premium price
- customers in Norway and Sweden can initiate one-off same-day retail payments by internet and telephone banking up to a cut-off time, which varies from bank to bank but is typically around the middle of the day. In Spain these payments have a two-day end-to-end cycle, and in France timing is same day, two day, or three day, depending on the input time and the policy of the receiving bank
- the end-to-end cycle for direct debits is the same as for bulk credit items in Sweden. In Spain the cycle is two to four days. In France there is a five-day cycle for direct debits. In Norway the cycle for business-to-consumer direct debits is seven days, due to a statutory requirement on banks to inform their customers of direct debit transactions at least seven working days in advance
- in Spain and Sweden, bulk inter-bank electronic credit transfers (for example, business-to-business, and salaries) and standing orders are processed on a two-day end-to-end cycle. The Swedish post giro system is intra-bank and is same-day up to a cut-off time. France has the same cycle for bulk files as for internet payments. In Norway these credit transfers will be same-day if initiated early enough in the day
- standing orders have the same end-to-end cycle as bulk electronic credits in all countries
- the end-to-end times for cheques deposited in branches vary between countries. In France and Spain funds are typically available two or three days after a cheque is paid in respectively. In Norway and Sweden the use of cheques is virtually zero but funds will be available the day after pay in

- for customers using paper credits at a branch there is a two-day end-to-end process in Norway, Spain and Sweden. Paper credits are not routinely used in France, but one-off branch credits are three day
- for customers using debit cards, funds will typically be taken from accounts the day after the merchant has input the transactions to its acquirer. In most cases the debit will occur on the day after the purchase but there may be a more extended period in some circumstances
- customers using internet banking can usually forward-date payments in all countries, and business customers can submit bulk files of payments well in advance of the input deadline, and
- although the analysis has been set out in terms of days, in some of the countries surveyed the final deadline for customer input with many payment methods can be late on the first day, whereas the credits and debits for funds availability are made early on the final day. Salary payments in Spain, for example, may have an end-to-end process of under twelve hours and in the United Kingdom under 36 hours.

5.11 One component of the end-to-end process is that of inter-bank clearing and settlement. This varies from country to country and by payment method. The timings are measured in inclusive working days from the last point when transactions can be entered into the payment system to receipt of output from the system or settlement, whichever is the later. In the United Kingdom, the clearing and settlement cycle is three days for all items considered in the table in paragraph 5.9 above. In Spain it is two days, in Norway it is one or two days depending upon the input time and in France (apart from direct debits) and in Sweden it is one or two days, depending on the input time and nature of the submission. All bulk corporate input currently has a two day clearing and settlement cycle.

## Charging for personal customers

5.12 Banks in all the countries surveyed apart from the United Kingdom charge customers in some direct manner for an inter-bank payment system service, as shown in the following table (the table is not intended to indicate, however, that payments are entirely free in the United Kingdom and chargeable elsewhere. It does not include, for example, indirect charges, which also differ across the countries surveyed):

**Table 5.2 – Inter-bank payment system service**

	France	Norway	Spain	Sweden	UK
Fixed monthly/annual fees, e.g. cards, internet banking	Yes	Yes	Yes	Yes	No
Transaction charges, cheques	No	Yes	No	Yes	No
Transaction charges, paper credits	product not available	Yes	Yes	Yes	No
Transaction charges, electronic items	Yes	Yes	Yes	No	No
Transparency	Negotiation	Fixed	Negotiation	Fixed	Fixed

### General

5.13 High charges for cheques in Norway and Sweden have resulted in the virtual elimination of cheques in those countries (where they had previously been used primarily in retailers and for person-to-person payments), whereas the lack of charges is one reason why there is still substantial cheque use in France and the United Kingdom.<sup>27</sup> Charges for

---

<sup>27</sup> There are a number of other reasons for continued cheque use in UK and France, many of which applied in Norway and Sweden, such as customer habit and the existence of a cheque guarantee in effect (not a guarantee scheme in France, but legal sanctions against dishonoured cheques). Cheques remain popular with consumers in France for payments to retailers, and in the UK for payments where no electronic alternative is widely available such as those between consumers and those by consumers to small businesses.

transactions in branches have also been instrumental in helping to reduce the volume of paper credits in Norway and Sweden.

- 5.14 In Norway the central bank comments annually on bank pricing, in the context of the efficiency of those systems and their relation to the costs of providing payment services. The central bank in Sweden has recently completed a similar analysis. In Spain, there is direct regulation of customer pricing for payment services by the central bank. In all countries, bank pricing is subject to competition legislation and therefore may become subject to scrutiny by the competition authorities. In France the legal position is that banks cannot charge for the provision of cheques to personal customers.
- 5.15 In France and Spain there is more bank-customer negotiation and less transparency with regard to personal customer pricing. Personal customers in both countries may pay significantly less than the published charges.
- 5.16 Further details on charges in the four countries are given in Appendix F.

### **Other innovations**

- 5.17 The international study also examined the range of innovations in payment services in order to identify those which might be considered for the United Kingdom market. Several of the developments in other countries are already under consideration or development in the United Kingdom, or already available; others could possibly be adapted or introduced in the United Kingdom to the benefit of consumers:<sup>28</sup>
- in both Norway and Sweden there are operational bank business-to-consumer (B2C) Electronic Bill Presentment and Payment (EBPP) services where internet banking users can view and pay their utility and other bills through that channel. There have been a number of

---

<sup>28</sup> the introduction of these innovations in the United Kingdom would, however, be dependent on the net benefits of their introduction exceeding the cost of doing so.

EBPP initiatives in the United Kingdom, including one currently under development

- in the area of delivery of remittance and other payment-related information to corporate customers, the BACS REMIT service in the United Kingdom carries remittance information. The payment system operators in Norway and Sweden have both developed remittance services, which participant banks can then sell on to their corporate customers. These services form a core part of banks' corporate offerings in those countries. The United Kingdom could consider adapting the NewBACS infrastructure with a view to improving the remittance services available. Correspondence between users in the United Kingdom and the OFT has shown that many corporates would find such a service beneficial
- one-off (that is, item-authorised)<sup>29</sup> direct debits, where the customer enters into a mandate with the originator but has to initiate each individual transaction, are available in France where the payment initiation can be by paper or electronic methods. In France they were introduced to meet the needs of customers who were wary of entering into an open-ended direct debit mandate, or who wished to authorise each payment if the amount varied from period to period. Consumers in the United Kingdom could benefit from the introduction of a similar type of service if the service were cheaper for companies to run than processing by credit card and cost savings were passed on to consumers
- in Sweden the Bankgirot service issues Bankgirot numbers to corporates. These are customer IDs which are linked to bank account details held in the system. Through using the Bankgirot number on its invoices the corporate does not have to reveal its bank account details to enable payment, and possession of the ID itself is not enough to give access to the payee's account. The system facilitates account portability, but needs to be made compatible with

---

<sup>29</sup> an ongoing mandate generally used for regular bills, for which the customer authorises each payment.

the IBAN system. The Swedish system is unique among the countries surveyed. Such a service might appeal more widely to customers who were unwilling to share their account details. In the United Kingdom this could ease the burden of account switching as well as reducing customer account details exposure

- B2B EBPP: EBPP is a service where banks deliver electronic invoices between trading partners as well as handling the payment transaction. In France, Spain and Norway the banks reported that they were investigating the opportunities in this area. There are potentially cost savings and other efficiency benefits to trading partners in exchanging invoices electronically, and revenue opportunities to banks in providing the service, and
- with cheaper telecommunications and other technological changes, payment-related information has also been improved: Norway, Sweden, France and the United Kingdom introduced extended formats, and the Swedish Data Clearing is now working to extend its text field for customer use from 11 characters to 50. Extended message formats may be beneficial to consumers as they allow them to add a narrative to the payment – with payments to family or friends, for example.

5.18 At present United Kingdom customers can access a three day cycle ad-hoc payment facility only through a retail payment system. With the exception of some payments in France, this is the slowest of all the countries surveyed. A faster service is available in all countries with a retail same day service provided at some level for at least some customers in three of the compared countries. Conversely, direct debits are processed faster in the United Kingdom than in two of the other countries.

5.19 In the last ten years central clearing and settlement cycles have been cut in Sweden and France (only for cheques) and Norway. The Spanish system was established in 1990, but has not been adapted since then. In the United Kingdom, where there has been no cut in recent years, such a move could be assessed for the benefits to consumers in facilitating faster availability of funds.

5.20 The introduction of any or all of the other types of innovations acknowledged above in conjunction with a faster facility would have the potential to provide the United Kingdom with a stronger customer facing service, provided there was a real demand for each of the services. Several of the innovations described, such as EBPP, also allow for competition between the banks on the service provided, which should ultimately lead to further innovation and a better deal for consumers.

## **6 DEMANDS FOR INNOVATION**

### **Overview of the various forms of demand research undertaken by the working group**

- 6.1 Members of both the Task Force itself and of the BPSL Innovation Working Group have been anxious that the demand for faster clearing on the part of customers - whether private or SMEs - should be identified and quantified. Only then could any form of analysis of the costs of faster clearing against the benefits likely to flow from it be undertaken. The Working Group therefore concluded that, in the apparent absence of any consumer research into the perceived demand for change, it would commission its own research. After a competitive tendering procedure, NOP was awarded the contract to carry out both the qualitative and quantitative stages of the work. Full details are given in paragraphs 6.5 to 6.34 below.
- 6.2 The Working Group and the Task Force were also able to draw on some limited consumer research carried out by BPSL in January 2004 into the demand for faster clearing.
- 6.3 Apart from the type of consumer demand identified in paragraph 7.1 of the OFT's 2003 report, the Task Force, through its membership, has been able to draw on the views of the consumer organisations (the NCC and Which?) and business groups (the British Retail Consortium, the British Chambers of Commerce and the Federation of Small Businesses) representing the views of consumers and businesses of all sizes.

6.4 For context, the total number of payments made through BACS in 2004 was:

**Table 6.1 – Total number of automated payments: 2004**

<b>Automated Payment Method</b>	<b>Volumes (millions)</b>
BACS Direct Debits	2,573
BACS Direct Credits	1,579
BACS Remote Banking Credits and Standing Orders	384
<b>Total BACS</b>	<b>4,535</b>
Estimated non-BACS in-house automated payments	196
<b>Total Automated</b>	<b>4,731</b>

## **NOP Research Summary**

6.5 The key themes to emerge from the study are presented below. The qualitative research showed considerable confusion about clearing times but that both consumers and SMEs<sup>30</sup> believed that existing payment options served their needs to some extent. However, the quantitative research showed that, when given a specific proposition concerning faster clearing, there was evidence of demand from consumers and SMEs, with some of these willing to pay for this service.

6.6 The qualitative research comprised six groups of consumers and six groups of SMEs. For the quantitative stage, 1000 interviews were conducted with current account holders and 900 with SMEs with turnover up to £35 million in certain sectors. These figures have been grossed up to the current account population (43.1 million) and the SME

---

<sup>30</sup> Definition for this study: turnover up to £35m using a business bank account.

population of SMEs as defined for this survey (1.24 million). Further information about methodology is contained in Appendix 1 to the full NOP report at Appendix E.

### **Consumers - Qualitative**

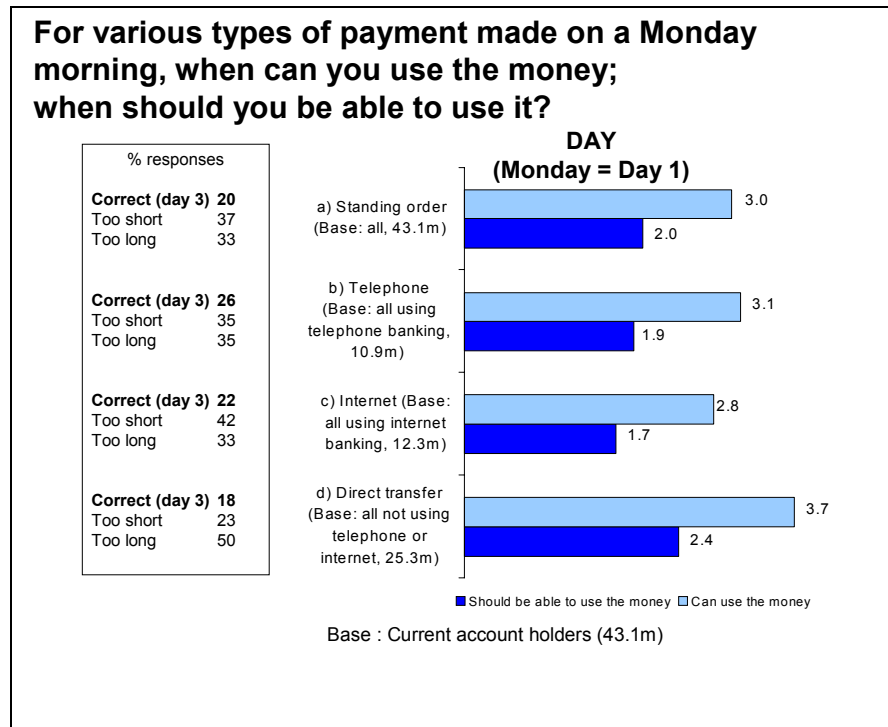
- 6.7 In general, consumers felt that there were sufficient payment options available to them, and they were mostly broadly content with how these were working. A frequent exception was cheque clearing (and to a lesser extent, electronic clearing), which was thought to take longer than it should.
- 6.8 The most obvious gap in the present payment systems would appear to be consumer knowledge, as most expected to be able to do what they needed to with existing payments systems. There was admission that in some instances consumers would need to obtain advice from their bank first. There seemed to be more need for consumer information and education to increase awareness of existing services and how they can be used, than for the development of entirely new payment systems.
- 6.9 Those areas identified by consumers in which there may be room for improvement included increased speed, ease of control and security. Specifically an improved understanding of electronic transfers - many were concerned about security and/or asking someone for or giving someone bank details. The benefit of these transfers was thought to be increased speed over cheques, but in practice, most are not using them at the moment.

### **Consumers - Quantitative**

- 6.10 A third of all current account holders said they had a need for urgent payments (this is equivalent to 13.8 million consumers). The most common needs were paying credit or store card bills, moving money between accounts held at different institutions and paying utilities bills. However, across all urgent payments, the most common payment types were cash (40 per cent) and cheques (33 per cent). Users of internet or telephone banking are less likely to use cash and cheques for urgent

payments and more likely to use electronic transfers than the total population.

**Chart 6.1 – Consumer perception of clearing times**

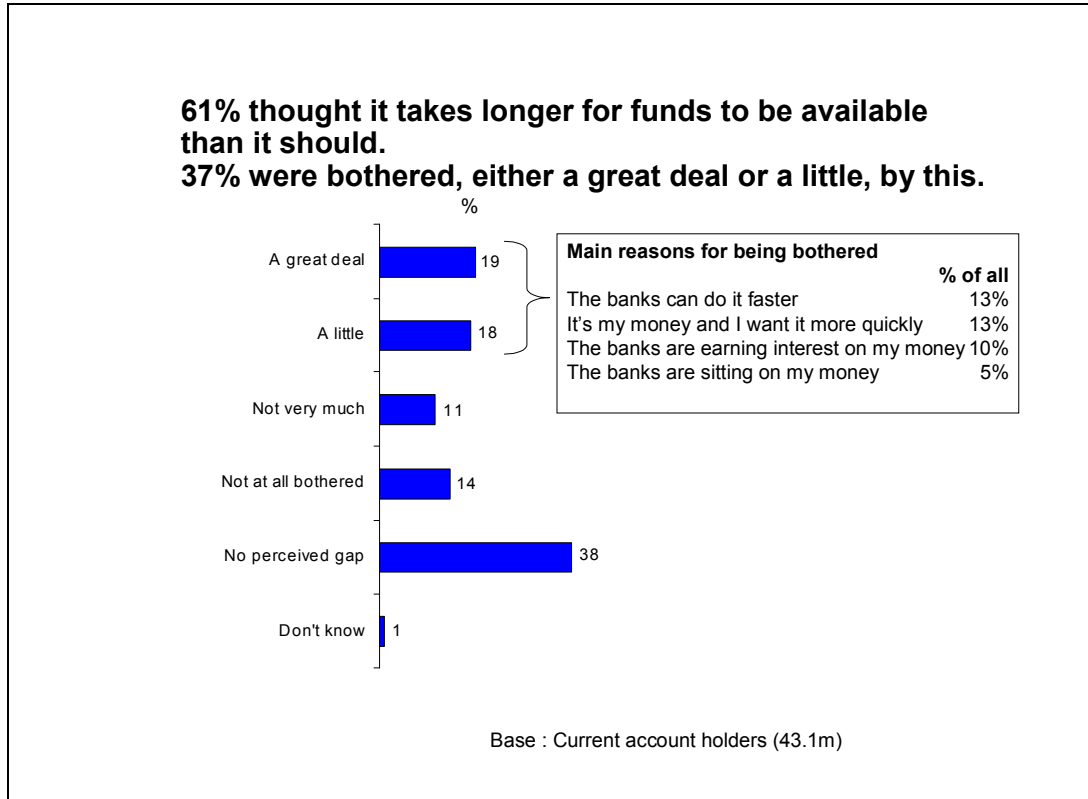


6.11 When asked to estimate clearing times for automated payments between banks, only about a fifth (between 18 per cent and 26 per cent across four payment types) actually chose the correct answer of three working days. So, although the average estimate was a clearing time of about three days, this does not signify high levels of understanding amongst consumers. When asked when the money should be available for use, the average dropped to about two days, with substantial numbers believing that the clearing time should be less than three days.

6.12 For example, over half of those asked about telephone or internet transfers felt the money should be available for use on the same day as the transfer is initiated. In total, 61 per cent thought that it took longer for funds to clear than it should for at least one of the payment types and over a third of the total (equivalent to 15.9 million current account

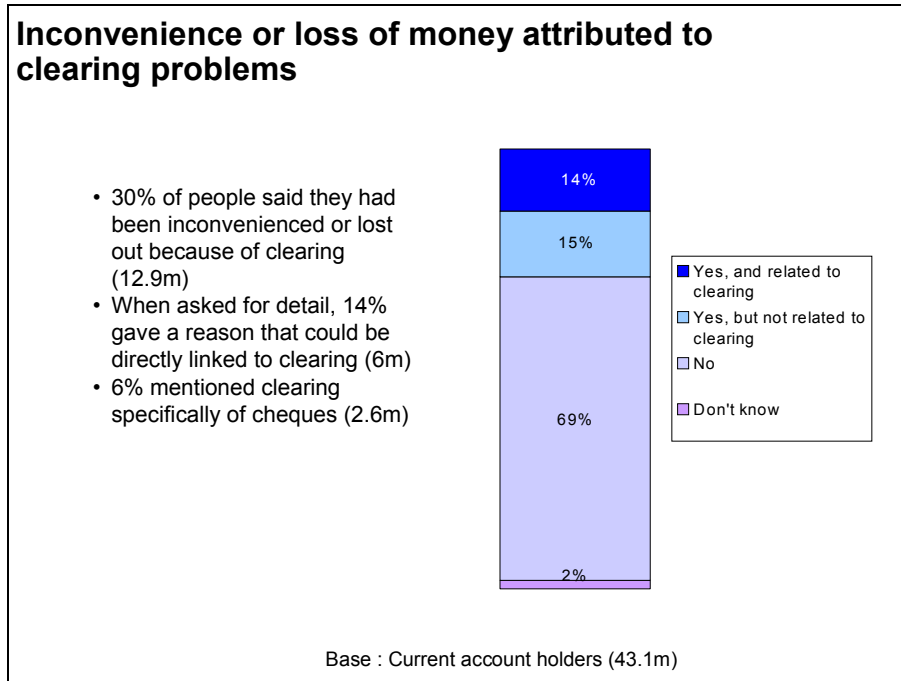
holders) were actually bothered by this gap. This tended to be because consumers felt that the banks could clear transfers faster rather than because of an expressed need for faster access to the funds.

**Chart 6.2 – Consumer attitudes to clearing times**



6.13 About 30 per cent of current account holders, equivalent to 12.9 million people, said they had ever been inconvenienced or lost out financially because of clearing times. When asked about the circumstances, half of these (around 6 million people) gave a reason that could be directly linked to clearing.

### Chart 6.3



6.14 The following concepts were read out to respondents during the research to introduce the faster payment services:

Figure 6.1 – Concepts tested during the research

**Next day**

You would be able to make a payment by internet or telephone banking up to 9 o'clock in the evening and it would be available for the person or company to use first thing the next morning. How likely would you be to use this service, assuming it was free of charge?

or

**Same day**

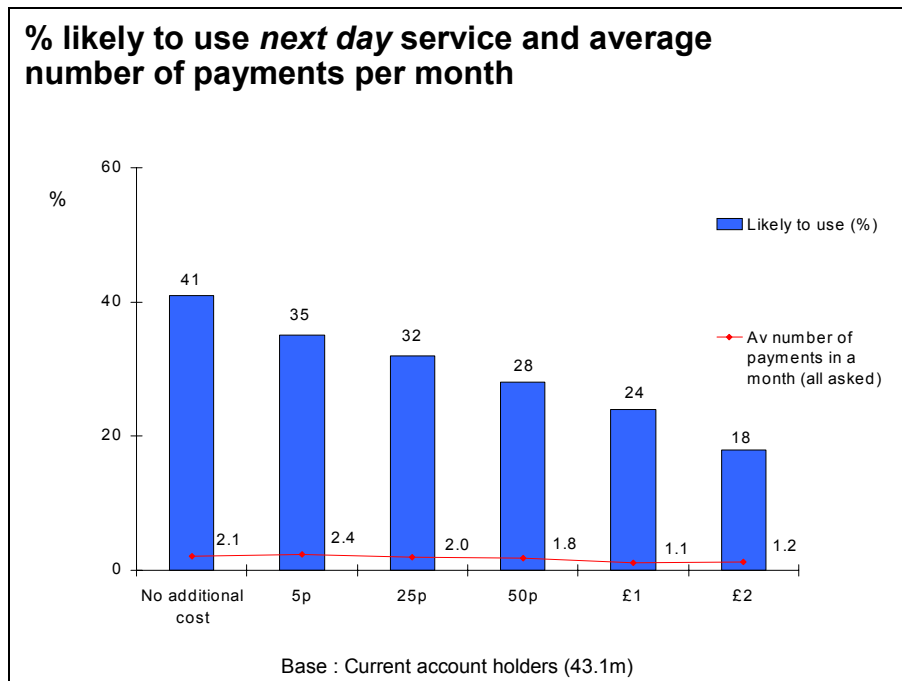
In addition to being able to make next day payments you could make a payment by telephone or Internet banking up to 12 o'clock noon, and it would be available for the person or company to use by 4 o'clock on the same day. Thinking just about payments that need to arrive the same day, how likely would you be to use this additional service, assuming it was free of charge?

(For price points) If the payment is after 12 noon, the funds will be available for the recipient to use first thing the next morning.

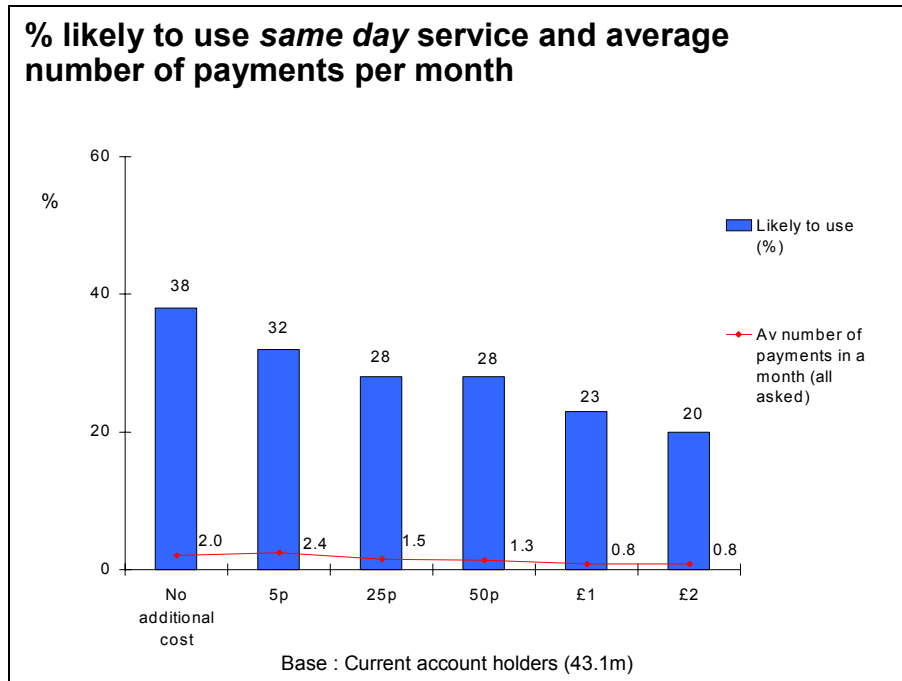
- 6.15 There was substantial interest in the faster payment concepts, with 46 per cent (20 million people) saying they would be likely to use the next day service and 43 per cent (18.3 million) likely to use the same day service. While those who currently use electronic banking (either internet or telephone) were more likely to show a strong interest in the faster payment services, however, substantial proportions of those likely to use the service do not currently use internet or telephone banking (41 per cent of those likely to use the same day and 42 per cent of those likely to use the next day service). A further barrier that will need to be overcome in practice is that a minority of those who say they are likely to use the faster services are uncomfortable asking for account details from a known person or company (30 per cent of those very likely to use next day and 32 per cent of those very likely to use the same day service say they would be uncomfortable).

6.16 In order to test further the appeal of the services, respondents were asked how likely they would be to use these services if there were a charge for each payment. While fewer people said they would use the services at different price levels, there was still interest in the services, with about one in five saying they would be willing to use the service at a charge of £2 per payment. The average number of payments per month dropped from about two per month when the service was free to about one per month at £2.

**Chart 6.4**



**Chart 6.5**



6.17 The researchers are aware from past experience that not all those respondents who claim they are likely to do something will actually do it. For example, a proportion of those who say they will use the services do not currently have access to internet or telephone banking and so are unlikely to use the service without first changing their banking arrangements. An algorithm is therefore applied which says: of those who say they are 'very likely' to use the service, 50 per cent will do so; of those who say they are 'fairly likely' to use it, 25 per cent will do so.

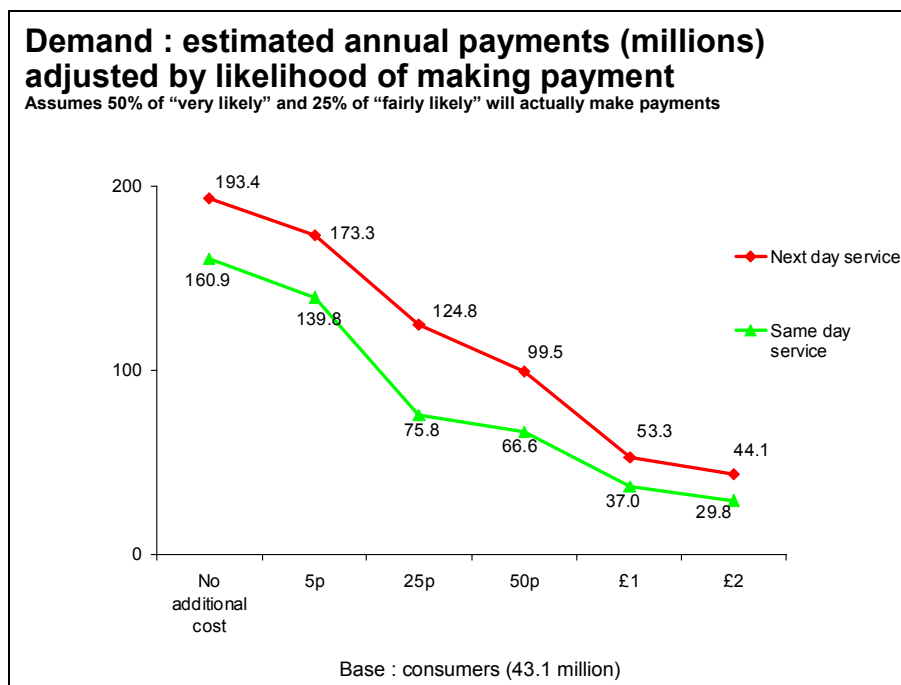
6.18 Making this adjustment gives an overall demand figure, in terms of millions of payments per year, as follows:

**Table 6.2 – Demand for next day, same day payment payments**

	NEXT DAY		SAME DAY	
	All (m)	Adjusted (m)	All (m)	Adjusted (m)
No additional cost	449.8	193.3	398.2	160.9
5p	445.2	173.2	388.7	139.8
25p	319.9	124.7	209.9	75.8
50p	255.1	99.5	183.1	66.6
£1	136.2	53.3	102.0	37.0
£2	112.3	44.1	82.5	29.8

6.19 This gives overall volumes of payments as shown below.

**Chart 6.6 – Overall volume of payments**



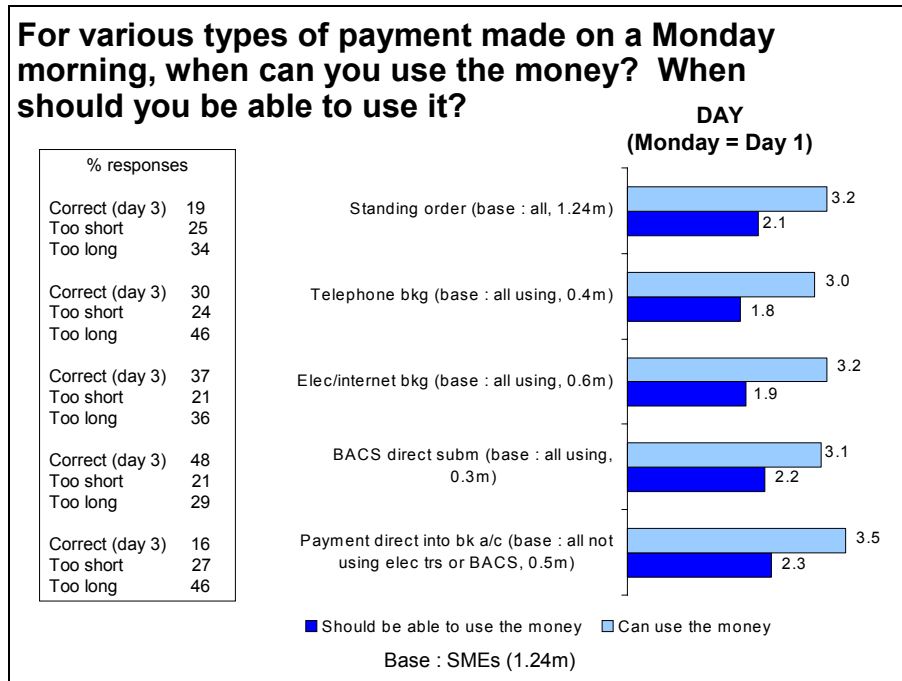
## **SMEs – Qualitative**

- 6.20 As with the consumers, SMEs generally felt that the existing payments systems catered for the vast majority of their needs. There were no major areas where payments into or out of their business accounts could be improved. One or two businesses were able to suggest improvements, but the majority were unable to do so.
- 6.21 There appeared to be little interest among SMEs, as among consumers, for any express payment options where a charge would be made, partly driven by the perception that bank charges for these would be very high, and partly because they could not envisage how they would use these types of services. The areas which did concern SMEs related to speed of clearing (and the amount of money the banks make from this), and also to bank charges.
- 6.22 As with consumers, there appears to be scope for education, as many SMEs may be able to make even more effective use of the current systems than they do currently, due to lack of understanding of options.

## **SMEs - Quantitative**

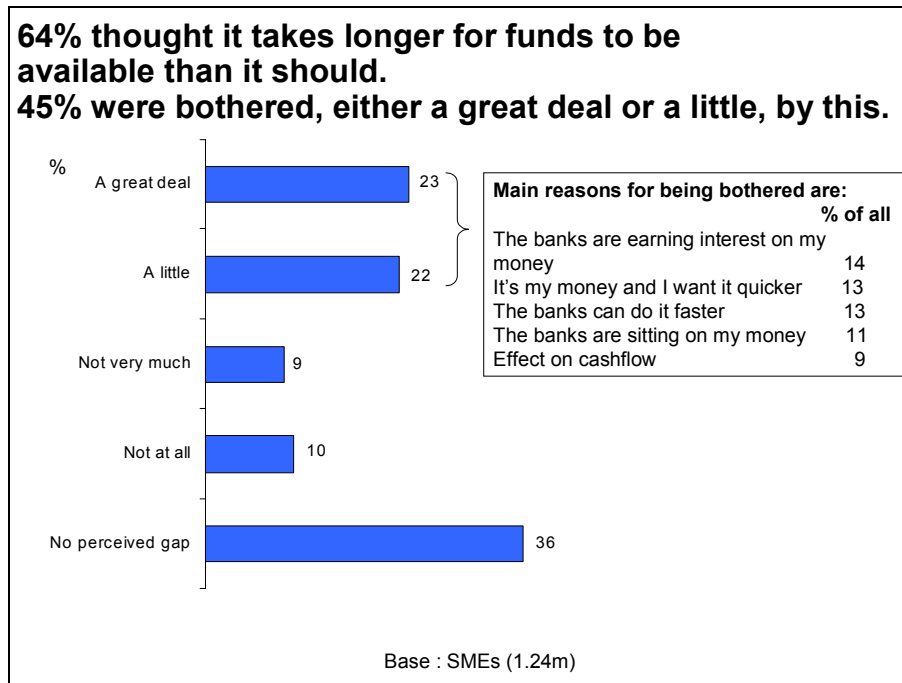
- 6.23 There is much confusion about clearing times. For each payment type asked about (for example standing orders, direct credits), there was a wide spread of opinions as to how long clearing takes, and overall only a minority were actually able to give the correct number of days that payments currently take to clear. So although on average three days was felt to be the norm, this average hides a great deal of confusion. SMEs also tended to feel that clearing should take a day less than it does.

**Chart 6.7 – SME perception of clearing times**



6.24 Forty-five percent of respondents, equating to around 558,000 SMEs, were bothered by the time it takes for funds to clear. This tended to be because the SMEs felt that the banks were earning interest on their (the SMEs') money and because they believe the banks can do it faster.

**Chart 6.8 – SME attitudes to clearing times**



6.25 Around a third of SMEs claimed to have been inconvenienced by the length of time clearing takes; however on further investigation only about half of the examples given could be directly related to clearing and, of those, a minority related to cheque clearing. A third of SMEs said that they had had goods or services withheld by a supplier until payment had been received. A quarter (23 per cent) had ever needed to make other urgent payments. Together, these accounted for just under half of the businesses in the study (46 per cent, equivalent to 533,000 SMEs). When urgent payments had to be made, cheque or credit card tended to be the payment method used.

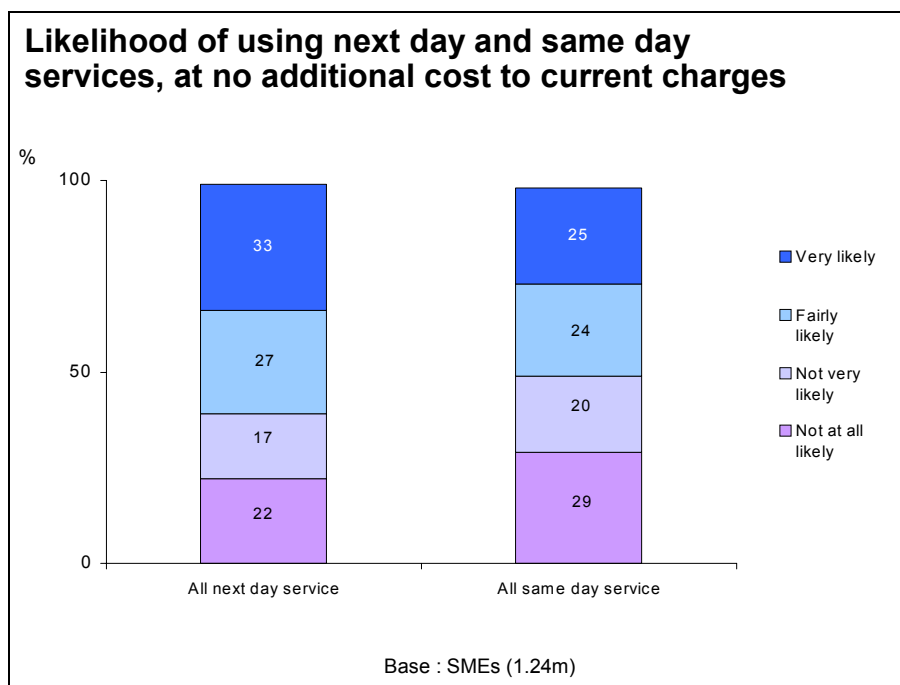
- 6.26 Only a minority of SMEs (but particularly those with the highest turnover) checked their balances or statements on a daily basis, or paid in cash or cheques every day. This indicates that most SMEs do not receive urgent payments on a daily basis. The following concepts were read out to respondents during the research to introduce the faster payment services:

**Figure 6.2 – Concepts tested during research**

<p><b>Next day</b></p> <p>You would be able to make a payment by telephone banking up to 9 o'clock in the evening, which would then be available for the recipient to use first thing the next morning. If this was at no additional cost to the current charges for one-off BACS electronic transfers, how likely would you be to use it?</p> <p>or</p> <p><b>Same day</b></p> <p>In addition to being able to make next day payments, you could make a payment by telephone banking or internet banking up to 12 noon, and it would be available for the recipient to use by 4 pm on the same day. Thinking just about payments that need to arrive the same day, how likely would you be to use this additional service, if it was at no additional cost to the current charges for one-off BACS electronic transfers?</p> <p>(For price points) If the payment is after 12 noon, the funds will be available for the recipient to use first thing the next morning.</p>
---

- 6.27 The concept of faster payment services at no additional cost was appealing to over half the SMEs interviewed, with 60 per cent overall, equating to 747,000 SMEs, likely to use the next day service and around half (49 per cent, equating to 607,000) likely to use the same day service.

**Chart 6.9**

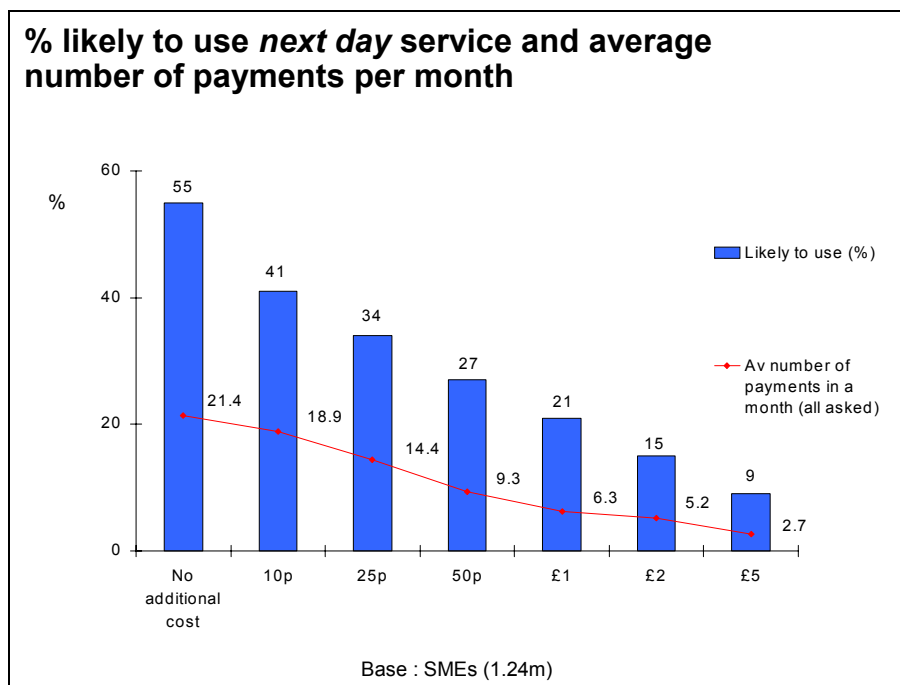


- 6.28 Just over half the sample were currently making payments by internet or telephone banking. Internet banking, and to a lesser extent telephone banking, tended to be used mostly for making inter-account transfers, with direct debits used for utility bills, insurance premiums and subscriptions. Among those SMEs already making payments by internet or telephone banking, interest in the next day and same day service rose to 72 per cent and 60 per cent from 60 per cent and 49 per cent respectively overall.
- 6.29 Around two fifths of those saying they would be likely to use either the next day service or the same day service were not currently using electronic (internet or telephone) banking, and the need to change to one of these channels in order to take advantage of faster payments systems may well deter some SMEs.
- 6.30 For those interested in either the next day or the same day service, the payments likely to be made were to regular or one-off suppliers (63 per cent and 62 per cent respectively for next day service and 58 per cent and 62 per cent same day service) and for salaries or wages (55 per cent next day, 50 per cent same day). Anticipated use was 21

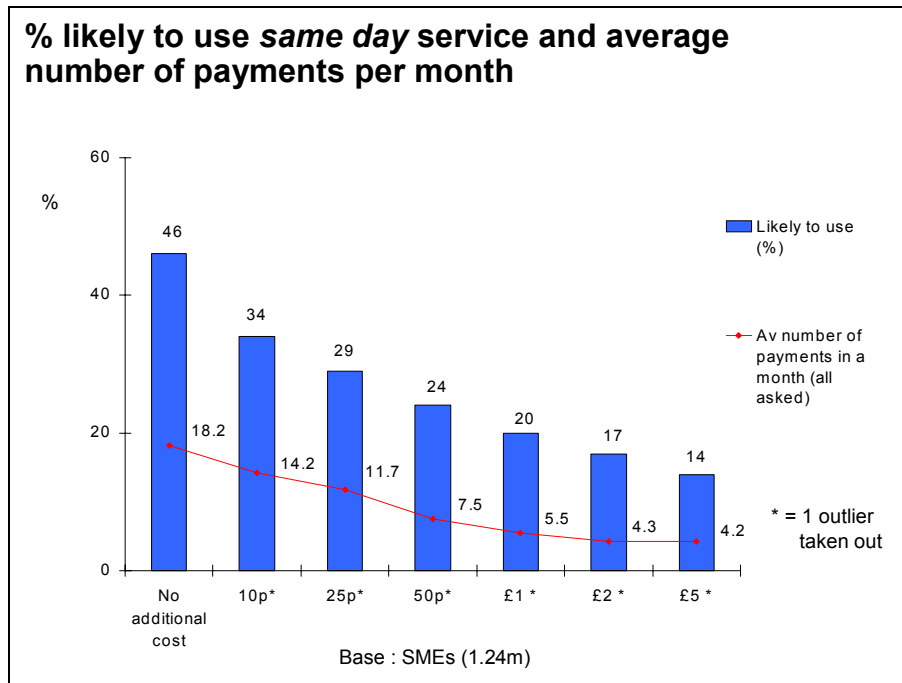
payments a month for next day and 18 payments per month for same day, at no additional cost.

6.31 A number of price levels were tested among the SMEs, ranging from 10p per payment, up to £5. These costs were positioned as being in addition to any charges the respondent was currently paying. The anticipated usage of the faster payment systems decreased to three and four payments per month, for next day and same day payments respectively, at the £5 level.

**Chart 6.10**



**Chart 6.11**



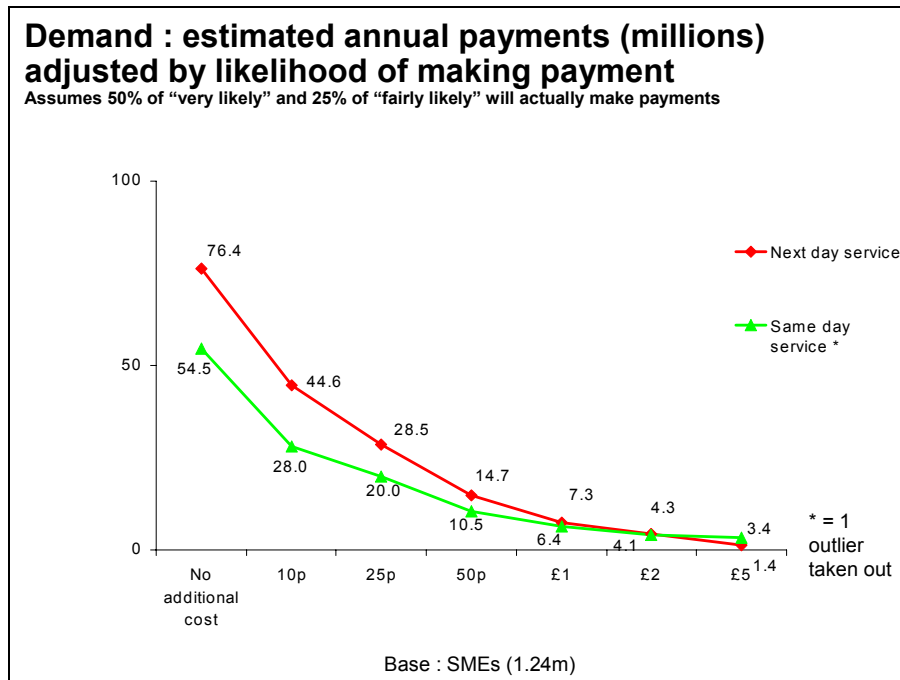
6.32 Experience has shown that not all those respondents who claim they are likely to do something will actually do it. The same algorithm is applied as was used for estimating consumer demand: of those who say they are 'very likely' to use the service, 50 per cent will do so; of those who say they are 'fairly likely' to use it, 25 per cent will do so. Making this adjustment gives us an overall demand figure, in terms of millions of payments per year, as follows:

**Table 6.3 – Demand for next day, same day payments**

	Next day service		Same day service	
	All (m)	Adjusted (m)	All (m)	Adjusted (m)
No additional cost	176.4	76.4	125.4	54.5
10p	114.1	44.6	73.2	28.0
25p	72.7	28.5	52.2	20.0
50p	37.6	14.7	27.3	10.5
£1	18.7	7.3	16.6	6.4
£2	11.0	4.3	10.8	4.1
£5	3.5	1.4	8.9	3.4

6.33 This gives overall volumes of payments as shown below:

**Chart 6.12**



6.34 In order to use these faster payment services, by electronic transfer, the SMEs would need to be happy to give out their banking details to customers. Overall, they would be comfortable with the idea of giving out this information to established customers (85 per cent) but less so

for new customers (57 per cent). The need to do this may be a deterrent to some SMEs.

## **Other non-consumer research**

### **Demand for innovation (heavy users)**

6.35 The demand research produced by NOP surveyed a sample of consumers and SMEs. It did not, therefore, aim to reflect the demands of very large businesses and government departments on the innovations to BACS that they would consider desirable. However, the views of these organisations are critical because:

- they generate a significant proportion of BACS volumes
- they input bulk payment files directly into the BACS infrastructure, and
- their concerns regarding BACS payments are likely to be quite different from the concerns of consumers and SMEs.

6.36 The following paragraphs summarise the innovations to the BACS payment system that were identified by corporates and government departments ('heavy users') as being desirable. The OFT identified these innovations through a number of routes:

- responses to a questionnaire circulated by the OFT;
- meetings held between the OFT and heavy users; and
- a heavy user forum where heavy users were invited to discuss their views on BACS innovation.<sup>31</sup>

---

<sup>31</sup> a list of attendees is provided in Appendix G. The OFT has invited the forum, as an electronic user group, to contribute to the work of other working groups to be established by the Task Force.

- 6.37 In the time available, however, the Working Group has not been able to consider the potential costs and benefits that could arise from the implementation of these innovations nor has it been able to make any attempt to quantify any of the costs and benefits. Consideration and quantification of the costs and benefits will be need to be undertaken as part of any future activity to evaluate in depth any of the innovations identified. Furthermore, the Working Group recognises that some of the suggested innovations could require changes that would not be limited to the BACS scheme and infrastructure, or, in providing benefits to heavy users, could potentially be detrimental to consumer interests.

### **Clearing cycle**

- 6.38 A faster clearing cycle for bulk payments could benefit some heavy users as it could allow for alterations to be made to payment files before these files are processed. A file may be extracted and amended before processing. However, the current three day processing cycle means that, once processing of a payment file has begun, the file cannot be amended to reflect information received between the first day of processing (day 1) and the day of settlement (day 3). This could result, for example, in a direct debit payment being drawn from the wrong account when the payer has recently changed bank. This is likely to have an impact on only a very small percentage of payments but can cause customer frustration.
- 6.39 Heavy users felt that a faster clearing cycle for ad-hoc payments could provide an attractive alternative to CHAPS as it would be expected to be cheaper and easier to initiate. Heavy users could use this payment method for urgent payroll or supplier payments. Government departments showed a desire for a faster clearing payment method for urgent benefit payments. However, they were keen that such a service would be provided by the whole industry to ensure that payees had certainty over when payment would be received.
- 6.40 The BACS clearing cycle does not currently operate on bank holidays and weekends; some heavy users saw a move to doing so as desirable. This would shorten the average clearing cycle, but it would require the banking industry to provide 7-day accounting and may require an

extension of the inter-bank settlement services provided by the Bank of England.

## **Payment process**

### Automated recalls and minimum standards for re-credits

- 6.41 As noted in paragraph 6.39 above, a payment file can be extracted for amendment after it has been submitted to BACS, but before it has been processed. If the payment is incorrect once processing has begun, the originator may recall the payment and request to be re-credited. The current process of recalling a payment is, for most users, manually intensive and, therefore, relatively expensive. The method of recrediting is not currently fully standardised. This creates great uncertainty about when recrediting will take place and in what form. Rather than receiving the recredit back through BACS, the originator may receive the recredit by a cheque through the post. Furthermore, an originator may receive an aggregate payment representing a number of recredits with no indication about which recalled payments are represented. Practices for recredits differ between banks.
- 6.42 Heavy users would therefore like an automated recall system and immediate recredit of recalled payments through BACS indicating where the recredit has come from and the account to which payment has failed to be applied. Such a service is currently available and is used by the Department of Work and Pensions, and it may be worth exploring the extent to which this service could be made available to other heavy users and at what cost. Additionally, heavy users would benefit from standardisation of recrediting practices across the banking industry.

### Modulus checking of account details

- 6.43 A BACS payment requires a sort code and account number to be validated. If mistakes are made in inputting these details, the payment will fail. It is preferable to detect such mistakes before a direct debit payment is initiated and found to fail. These details can be checked through modulus checking. All BACSTEL-IP software will have modulus checking and this will reduce the number of failed payments, but heavy

users have said that some banks do not provide the facility for their accounts to be checked. The elimination of Building Society roll numbers and other non-standard bank account numbers would be helpful as modulus checking does not apply to these account numbers, but this may have major cost implications for Building Societies and other institutions. 'Front-end' modulus checking (before the payment file has been sent to BACS) was seen as preferable to 'back-end' modulus checking (waiting to find out after a file has been sent).

## Verification of funds

- 6.44 BACS has no means of checking whether sufficient funds for a payment are held in a payer's account. Businesses may wish to provide a service immediately to a customer. Even if the business will not receive payment until the payment is fully processed and settled, three days later, the business may provide the service immediately if it can be confident that the payment will be made successfully. Businesses would need to know that a payment had been initiated, that there were sufficient funds to cover the payment and that the payment would not be revoked.<sup>32</sup> Some heavy users considered that a guarantee of the availability of funds would be a significant improvement to BACS. Authorisations on card schemes reserve funds on a bank account from the moment the transaction is completed: some heavy users considered that it would be helpful if BACS were able to provide a similar service.<sup>33</sup>
- 6.45 Verified BACS funds may cause BACS payments to become more attractive for payees and lead to some substitution to BACS from other payment methods. Furthermore, a system allowing verification of funds may make modulus checking superfluous.
- 6.46 Apart from verification of funds, there are a number of pieces of information which it would be helpful for a direct debit originator to

---

<sup>32</sup> Removing the ability to revoke a payment may make it unnecessary or no longer viable to have an easier, if any, recalls process for some payment methods.

<sup>33</sup> In some circumstances plastic cards provide a solution to this requirement.

have in real time which would allow services to be provided to the customer immediately and would mitigate fraud risk. They include information on whether a direct debit is permissible on the account, whether the account number is correct, and whether the customer is living.<sup>34</sup>

### One off direct debits

- 6.47 A one off direct debit may be a desirable proposition for heavy users because it may be cheaper to process than a card payment and be made available to those without acceptable cards.<sup>35</sup> While heavy users displayed limited awareness of the ability to create one-off direct debits, they considered that the one-off direct debit may not be well designed for their needs. They were concerned about not receiving payment and the fact that under existing timeframes they would be unaware whether the direct debit would be paid until quite some time after services had been provided to the customer. Verification of funds was identified as a way of dealing with this.
- 6.48 A further issue raised with one-off direct debits was the need to send a direct debit instruction to the payer's bank separately (and in advance) of the first payment instruction – this is linked to the 'delay' issue referred to above. If the instruction and the first payment were processed simultaneously, several days would be saved for each direct debit set up.

### Length of time for notification

- 6.49 Once a direct debit is set up a customer must be notified of the amount that they will be debited at least ten working days in advance of debiting. This can create customer dislocation from when services are purchased to when the customer is debited. This notification period can

---

<sup>34</sup> For applicable account numbers, existing modulus checking partially addresses the account number and direct debit permissibility issues.

<sup>35</sup> Although most current account holders have debit cards

be reduced with the consent of the sponsoring bank and the payer. Some heavy users felt that the ability to reduce the notification period was not made sufficiently clear to them.

## **Information**

### **Mandatory completion of reference fields**

- 6.50 One major cost of processing a payment is that of reconciliation (matching the payment received to who it is from and what it is for). The reference fields within BACS payments may often provide sufficient information to allow reconciliation, particularly fields 9 and 10 which record Account Name and Reference. Under existing BACS rules, it is not mandatory to complete these fields and so they sometimes remain blank.
- 6.51 Mandatory completion of these reference fields would oblige payers to attach some description to their payment and could thus ease reconciliation. A concern about mandatory fields is that payers would insert irrelevant information, which could make reconciliation harder rather than easier, or that otherwise straightforward payments may not be processed because of an oversight to complete reference information. For this reason it may be better to educate payers about the benefits of providing correct information in these fields rather than make them mandatory.
- 6.52 Heavy users were not united in their attitude to mandatory completion of fields. It was generally felt, however, that it would be surprising if paying companies would systematically insert information that did not relate to the payment concerned. A typically held view was that there should be mandatory completion of fields 9 and 10, combined with education about the benefits of including meaningful information, but no prescription about the specific contents of the fields until such time as BPSL had conducted sufficient work on the extent to which BACS fields align with international standards of field use.

## Customer statement information

- 6.53 A number of heavy users explained that the field for the originator's name sent in a direct debit instruction did not always get printed on the customer's bank statement as sent by the originator. Problems have arisen where originator trading names have been replaced by the originator's company name on customer bank statements. This caused customer confusion and complaints to the originator. The originator's name printed by banks on bank statements was obtained in different ways by different banks. Some used the information supplied by the originator in the direct debit record while others used their own database compiled from the original paper direct debit mandates submitted by originators. An industry-wide standard approach to determine the source of the originator's name on the public's bank statements would provide consistency and reduce the numbers of direct debits bounced back because consumers did not recognise who had taken their money.
- 6.54 The heavy users felt that it was necessary for a minimum standard for bank statements to be introduced. Such a standard would require that all bank statements clearly identified the sort code and account number to be used for direct debiting. Originators currently have to translate non-standard bank account numbers into a usable form. This procedure is time-consuming, unreliable and causes customer inconvenience. The lack of a standard makes it more difficult for consumers to set up direct debits on the internet.

## More information sent and received with payments

- 6.55 The current BACS messaging standard allows only 18 characters of information which may be insufficient for remittance purposes. A premium remittance service – REMIT - is available through BACS allowing full remittance information to be provided, but REMIT currently only makes this information available by post or fax which is less efficient than an electronic service.
- 6.56 There are a number of solutions available from software and service providers for electronic remittance advice. These solutions separate remittance advice from the payment, which is still delivered through

BACS. The advice is made available through a number of sources including the internet or email. However, even heavy users that were currently using software to send remittance information separately to payments felt that 'a comprehensive BACS package integrating payment with remit would be a strong addition to the BACS service'. In other European countries exchange of remittance information is seen as an integral part of a payment system.

## **Wider issues**

### **International payments via BACS**

- 6.57 Initiating cross-border payments via BACS (a system which originators use regularly and understand) would make such payments easier. It is not clear, however, whether sufficient volumes of cross-border payments would be generated to make it worthwhile to develop a United Kingdom domestic automated clearing house into providing pan-European payment services. The United Kingdom banking industry's response to proposals for a Single Euro Payment Area (SEPA) will impact on whether BACS will provide cross-border payment services.

### **Customer identification number**

- 6.58 When changing banks, companies have to inform all of their commercial counterparts and often make changes to contracts as a result of changing their account details. This makes switching bank more costly and less attractive. The introduction of a standard customer identifier number which would relate uniquely to the corporate customer, rather than to the particular account, could lie above its bank accounts. This could have a number of benefits including allowing the corporate to switch banks with greater ease. A similar system, UPICs (Universal Payment Identifier Codes), was introduced by the Bank of New York Clearing House.

### **Payment message standards**

- 6.59 Having clearly defined and interoperable standards across payment methods, countries and systems could have significant effects on the

end-to-end processing of payments. The issue of standardisation concerns not only the format of data used in a payment system but also the interoperability of that data and of the connection channels available. Heavy users would benefit from the implementation of a standard which allowed integration of invoice, order, payment and reconciliation systems across banks, ACHs and corporates, both nationally and internationally. The Working Group recognises that achievement of such a goal would be a complex issue and would require the agreement of many national and international organisations.

### **Conclusions from the heavy users' discussions**

- 6.60 Heavy users generally consider that BACS is a robust, efficient and cheap service. They appreciate the service but would like to see a more innovative service. On the other hand, they would inevitably be concerned about investment in innovations which caused the service to become significantly more expensive. There would also be a concern about innovations that were not designed to meet their needs. Some of the issues may be dealt with through an extension of the governance arrangements of BACS which are currently being considered by the BACS Access and Governance Working Group. Other 'innovations' may, in fact, require no more than an education programme about what is already available.

### **Demand for innovation (other demand evidence)**

#### **BPSL research**

- 6.61 As noted in paragraph 6.2 above, in January 2004 BPSL commissioned BACS Limited (as it then was) to carry out some consumer research into the demand for faster clearing. The research was delivered to BPSL in March 2004. The objectives of the research were to seek to quantify the level of consumer demand for same day and next day clearing, and to establish the broad target market for those options. The research was carried out as part of a quantitative consumer omnibus survey, nationally representative of the Great Britain adult population (Northern Ireland was not included) and consisted of 1,500 face to face in-home interviews of adults who held a current bank or building society account

and excluded anyone with media, banking or journalist occupations. A total of 388 business interviews were carried out: 225 'small' businesses with a turnover of £50,000 – £1 million, and 163 with turnover above £1 million. The survey excluded FTSE Top 100 companies.

6.62 The 'headline' results of the research showed that:

- there was a 'significant' level of demand for a faster payment service: 45 per cent of consumers and 46 per cent of businesses considered that it was either 'critical', 'very important' or 'important' that banks should offer a new faster payments service
- but that, in terms of day to day banking improvements, only 3 per cent mentioned faster clearing as the 'number one' improvement needed
- 40 per cent of current account holders said that they would use a same day or next day service if one were available at a price level of 50p to £1, and would do so approximately once a month
- 38 per cent of businesses would use a same day or next day clearing service if one were available at a price level of £5 to £10 approximately eight times a month, and
- overall, that would equate to approximately 45 million payments per year, or one per cent of existing total BACS volumes.

6.63 The results of this research are similar to those obtained through the wider NOP research commissioned by the Working Group. To the extent that the results are similar, it is helpful to have the corroborative effect of the two quite distinct pieces of research.

## 7 BANKS' COSTINGS

### Costs

- 7.1 Any assessment of the economic rationale of introducing a particular innovation should include looking at the costs that such an innovation would create and who would incur these costs. These costs can then be balanced against the perceived benefits. This chapter therefore looks at the costs of innovation to BACS. It has not been possible to assess the costs of every innovation identified in chapter 6 above. This is because it is difficult to assess robustly the costs of a particular innovation when the details of the proposition remain unclear. While it might be possible to identify some of the main factors that would drive costs for other innovations, any results would inevitably be inexact and consequently of doubtful value. The only innovation for which the Working Group has quantified the costs, therefore, is for a faster clearing payment service.
- 7.2 The costings figure below is an aggregate produced from individual costs provided by eleven of the twelve BPSL member banks<sup>36</sup> and Voca. This costing exercise provides a broadly indicative range of high-level costs for a particular solution of a new, additional, but faster, service. The cost range provided is for core IT development costs, expected to account for the majority of costs incurred. A number of substantial expected costs are, however, not included in the range. These are identified but not quantified.

### Costs of faster clearing service proposition

- 7.3 The core industry IT development cost of introducing a Voca-based faster payment service is estimated by Voca and the banks to be at least £48 million (£38 million for members and £10 million for Voca). BPSL member banks felt that this figure was likely to be an understatement, as initial estimates for IT projects are often

---

<sup>36</sup> these eleven banks account for 99 per cent of output volume.

underestimated. In making their assessments not all members were able to consider, for example, the cost impact on all their interfacing delivery channels. A range of £48 million to £65 million was therefore seen as being a more realistic estimate of the IT development cost.

### **Caveats to costing exercise**

- 7.4 There may be a number of ways through which a faster clearing service could be provided. Different solutions may provide different functionalities, benefits and costs and will depend on which payment methods form part of a faster clearing service. The costs have been assessed for a faster clearing service that would be provided using Voca central infrastructure for remotely initiated payments (automated telephone and internet payments) and standing orders. It is, however, possible that other payment systems could be developed which would not use Voca as the central infrastructure provider. The Implementation Group, in looking at the recommendations of the Task Force, will not, therefore, be limited to this one scheme and the analysis does not therefore imply that any faster clearing service introduced would necessarily share the same specifications as that costed above. Nor does it imply that a faster clearing service would necessarily be provided through the Voca clearing house infrastructure or be governed through the BPSL scheme. The information does, however, provide indicative high-level costs for a robust, faster, service: the Implementation Group will consider the actual costs implications and whether any alternative non Voca-based infrastructure could more efficient or cost effective.

### **The faster clearing service proposition: Early by Later today: Later by Early tomorrow (ELLE)**

- 7.5 The service proposition that was costed is as follows. In the early part of the day - before a cut-off time of, say, 12 noon - a paying customer instructs his or her bank to transfer funds to the beneficiary's account. The funds are available for use before the end of the working day, say, by 4pm. Where a payment instruction is too late for the cut-off in the middle of the day, but is made before, say, 9pm, then funds are available to the beneficiary early on the next working day. As this proposition will mean either same day or next day clearing, depending

on when the payment is initiated, it has been called ELLE, 'Early by Later today: Later by Early tomorrow'. The exact timing of the posting to customers' accounts could be subject to competition between the banks, with some minimum standard.

7.6 A feature of this service proposition costed here is that once the instruction is given, the payer could not revoke the transaction. Individual banks may, therefore, wish to set their own maximum transaction values and daily limits so as to mitigate fraud risk. This limit is an area where the banks could be expected to compete and the limits would be likely to depend on the customer, the method of payment initiation and the fraud prevention techniques of the banks. It is also possible that individual banks may decide to introduce a charge for this service. Any such price of the service and how the delivery channels (for example, internet or telephone banking) are used are also areas where banks have scope to compete individually.

7.7 The service has been scoped on capacity for internet and telephone initiated payments and standing orders<sup>37</sup>. Any benefits of a faster clearing cycle for other payment methods<sup>38</sup> are likely to be relatively small, but the eventually agreed scheme may, in fact, have wider coverage than internet and telephone payments and standing orders. The main service gaps relate, however, to internet and telephone payments, while standing orders give rise to float and some customer uncertainty regarding value dates.

### **Variation in banks' costs**

7.8 The costs supplied by individual banks showed significant variation. There are a number of potential causes for such variation, including:

---

<sup>37</sup> these account for about eight per cent of current BACS payments, approximately 384 million payments per annum.

<sup>38</sup> these benefits are briefly outlined in chapter 7.

- banks are at different stages in their IT development programmes. Some banks who have more recently invested in their payment processing systems have greater functionality and flexibility than other banks
- some banks have one payment platform for SME and personal customers and another for corporate customers, and
- some banks have different payment platforms for different brands due to past mergers.

7.9 The figures supplied by the banks are high-level and could alter in the light of any more detailed cost analyses carried out. On behalf of the Working Group (in the light of the confidential nature of the data provided), the OFT met with a number of banks individually to ensure that the costings produced by the individual banks arose from the same set of assumptions about the service proposition and what cost drivers should be scoped in. This was particularly necessary in the light of the quite large variations in the banks' estimated costs. The OFT has also met the banks collectively, with APACS, to discuss the assumptions underlying the costings exercise. It is apparent from these meetings that the banks have, indeed, used similar assumptions.

### **Cost drivers not quantified in costing exercise**

7.10 In addition to IT development, a number of other cost factors, as set out below, would need to be taken into account if a faster payment system were to be implemented. While core IT development costs would be expected to account for the majority of costs incurred, many of these factors could have sizeable cost implications in their own right, although costs have not been estimated.

### **Fraud and money laundering risks**

7.11 The recent, on-going, rapid growth of internet banking fraud has highlighted the ability of fraudsters to exploit fast payment methods, because it is harder to identify and stop fraudulent dealings within the time-frame of a same-day irrevocable payment service than within a

longer time-frame. Other things being equal, the risks of fraud would inevitably be likely to increase even further if faster clearing were introduced, particularly in relation to the internet. It is not possible, at this stage, to quantify in absolute terms the increased risk, nor to cost any solutions to mitigate the increased risks. It is, however, possible that members may want to impose value thresholds on individual faster payment transactions and daily limits as a means of limiting fraud exposure.

## **A large increase in volumes using a faster payments service**

- 7.12 The costings have been prepared on the basis that faster payments are offered as a separate service from standard BACS direct credits and direct debits, and will account for no more than seven per cent of existing Voca payment volumes. For some banks, a large increase in volumes past this point would require significant further systems development and investment in hardware, but it is far from this seven per cent of total current volume threshold. It is, therefore, unlikely to be met in the short to medium term unless there is a radical change of payment method usage, particularly by corporates which send files directly to Voca.

## **Times for submission windows**

- 7.13 The timing and size of the processing window is an unknown element which may have a major impact on the costs. The shorter the window, the greater the processing capacity required. Timing is important because of the possibility of processing being required at an already peak processing time for other processes (for example, ATMs). The exact timing of the payment flows and the processing window could have a major impact on volumes, for example, if there is an overlap with CHAPS peak traffic and processing time.

## **Customer costs**

- 7.14 There may be internal costs for some large customers. These may arise for those who choose to submit payments directly to BACS through a faster clearing service. Costs for corporates arising from changing

internal processes may also arise where a faster clearing service is used to pay bills on the final due date. Credit card companies and utilities receiving such payments may have systems that do not register payment as soon as funds enter their accounts and may therefore require investment to allow acceptance of same day clearing payments.

### **Agency bank costs**

- 7.15 Banks and other financial institutions that access BACS services on an agency basis have not provided estimates of the costs of changing their systems to access payments. Around 500 financial institutions currently access BACS on an agency basis and may require their own system changes. Although agency banks account for only around three per cent of Voca volumes, each may incur substantial one-off costs in amending their systems if they wish to offer faster payments to their customers.

### **Non-IT costs**

- 7.16 Costs will be incurred on customer education and staff training relating to any new service proposition. There will also be costs incurred by BPSL in developing the rules and other aspects relating to the set-up of a new payment scheme, including managing the delivery of the infrastructure.

### **Ongoing costs**

- 7.17 The total cost range estimates the one-off development cost for introducing a faster payment service. It does not include customer education, staff training and IT support costs. Voca has suggested that a faster clearing payment scheme, additional to the current scheme, would have ongoing costs of 10 per cent. Although the banks have not estimated figures for ongoing costs nor indicated what the main costs drivers would be, current systems do have ongoing costs, but it has not been possible to assess the level of these or the differences.

## Updating customer account so that payment information is recorded

7.18 There is a potential issue regarding the difference between funds being available for withdrawal, and the customers being aware that a specific transaction has been received. For instance, for some banks, there could be a period of time when the received funds would typically be on the customer's account balance (and thus part of the balance shown if the customer made a balance enquiry), but the transaction detail would not be visible to the customer. On the sending side - the bill payment and credit card payment, for example - the remote banking service will show the transaction details to the payer. For emergency payments, the payee will have access to the funds, via an ATM, for example, even if there is no line item detail on the statement. This is likely to be particularly important in emergency payments, bill payment and credit card payment. Not all members had looked at the customer notification aspect. Integrating the new system with banks' real time accounting systems was a potentially material cost, but whether transaction details are visible to the customer or not, irrespective of whether the account balance shows the funds as available, depends on the particular IT system of any individual bank. There appears to be no universal answer to the question.

## Implementation timescales

7.19 Only four BPSL member banks have provided any commentary on the likely implementation timescales. These range from 12 to 22 months from the requirements being fully specified. The Voca-based solutions are crucially dependent on the estimated timetable for NewBACS and the delivery of the new central infrastructure<sup>39</sup>.

---

<sup>39</sup> see chapter 4 above for a description of the NewBACS infrastructure development.

## 8 COST/BENEFIT ANALYSIS

### Introduction

8.1 This chapter describes the various costs and benefits that may be expected to arise from the introduction of a faster clearing payment service. While it is possible to identify these costs and benefits, it is not always possible to quantify all the potential impacts of these factors. This chapter does not, then, attempt to weight these various factors and more detail is provided in the preceding chapters. Where quantitative information is available, it has been analysed in Appendix I.

### Possible service gaps

8.2 It is generally true that people benefit from having increased choice. Benefits could normally therefore be shown to arise from a faster clearing payment service. Part of the answer to this, however, lies with when a faster clearing payment service might be used. The start of a cost-benefit analysis can be the identification of where the current service may not meet users' requirements. This chapter focuses on the possible service gaps for direct credits:

- regular Business to Person (B2P) and Business to Business (B2B) payments - businesses may want a faster clearing payment service for weekly wages, for payroll 'leavers and joiners' and for payment of expenses, to reflect last-minute information or to correct mistakes. Some trade payments may also be made through such a service
- state benefit payments - a faster payment service would enable state benefit agencies to make ad-hoc urgent payments to reflect last-minute information or to correct mistakes
- bill payments - customers paying bills at the last minute, perhaps because they forgot to do so earlier, might like a faster service. Last-minute payment of credit card bills to avoid interest accruing is often cited in the media. Share traders might like a faster service,

particularly day traders who want to turn their money around rapidly, and

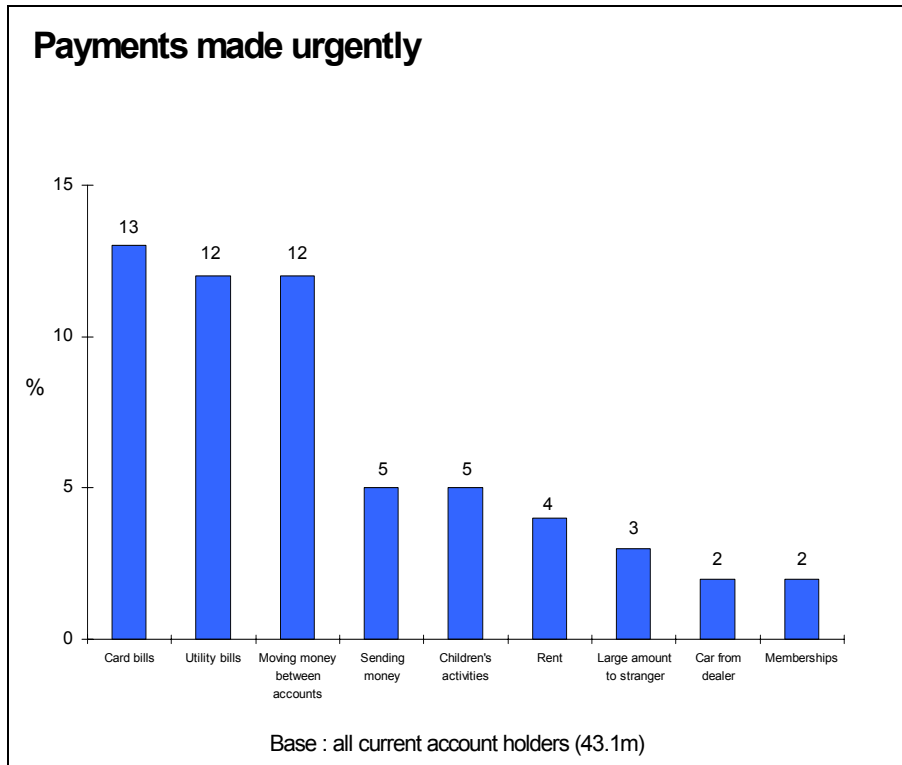
- Person to Person (P2P) - moving funds between a customer's accounts at different banks, typically a current account and a savings account, and typically via internet banking. Also, emergency P2P transfers, for instance where a parent wants to transfer funds urgently to a child at university.

### **Identified service gaps**

8.3 The market research detailed in chapter 6 and Appendix E, carried out by NOP, sought to identify the kinds of payments that consumers and SMEs might wish to make via a faster payment service:

- payments made by consumers - consumers were asked what kinds of payments they ever need to make urgently. Three types of payment were quoted by more consumers than any other: paying credit and charge card bills, paying utility bills and moving money between accounts. The chart below shows when an urgent payment might need to be made and the percentage of current account holders who have ever needed to make an urgent payment in these circumstances, and

**Chart 8.1**



- payments made by SMEs - SMEs who demonstrated an interest in a faster clearing payment service were asked to specify what kinds of payments they would be likely to make. The payments identified as most likely to be made with the new service were B2B payments to regular and one-off suppliers, as well as salary and tax payments. The table below shows the percentage of SMEs who would be likely to make each type of payment using the next day service (the responses for using a same day service were nearly identical).

**Table 8.1 – Payments made by SMEs using the next day service**

	<i>% likely to use next day service</i>
Regular suppliers	63
One-off suppliers	62
Salaries or wages	55
Corporation tax or VAT	45
Insurance premiums	39
Utility bills	33
Subscriptions	23
Moving money between accounts at different banks	21
Emergencies	8

### **Removal of float**

8.4 As noted in chapter 2 above, float has grown out of the three day clearing cycle. It is not, however, a necessary outcome of the clearing cycle but rather arises out of when banks choose to deduct funds from the payer's account and, therefore, not apply interest to these funds. The banking industry has argued that float is a matter for competition between the banks rather than a matter arising out of the mutual interdependence of payment systems. Float remains a controversial issue: while banks may compete on float, and at least two do, they tend not to. In addition, there appears to be public confusion and displeasure about float due to a lack of transparency about why funds are deducted before settlement and what happens to these funds. A faster cycle for standing orders and remote banking payments would be expected to reduce float. This would redistribute income from the banks to their customers and would mitigate criticism of the banks.

### **Reputation effects for banks**

8.5 The Cruickshank report and the OFT's report into Payment Systems explored the lack of incentives to innovate in payment systems.

Chapter 2 above notes the criticisms of the banking industry that have arisen due to the lack of innovation, particularly in light of the large profits that the industry generates. There is a potential, but intangible, benefit of innovation to the banks in helping them to be seen as innovative and responsive to consumer demands.

### **Cost reductions due to substitution from other payment methods**

8.6 A faster clearing remote banking payment method may cause people to switch to using this payment method rather than cheques, CHAPS or card payments. There may be significant benefits to society if a faster clearing payment method induced substitution away from less efficient payment methods, such as cheques, to more efficient electronic payment methods (although there may be a need to operate a legacy system for less efficient methods, which would have associated costs). The incentives to substitute between different payment methods will depend on the relative prices of these methods.

### **Impact on fraud**

8.7 A faster clearing service is likely to make remote banking fraud easier by facilitating the extraction of funds from compromised accounts. The availability of a faster clearing payment service may, however, have a second order effect inducing substitution from other payment methods which are susceptible to fraud, such as cheques.

### **Heavy user demand**

8.8 Chapter 6 above identifies a number of changes heavy users of BACS services have said they would like to see to the BACS scheme. The costs and benefits of these have not been quantified but the Task Force may wish to consider whether to require APACS and BPSL to consider them separately. Heavy users are also likely to have demands for a faster clearing payment service. This demand has not been captured in the NOP research so some assumptions about its likely magnitude have to be made.

## **Cash Management**

- 8.9 Substantial problems of cash flow uncertainty for smaller companies can be created by the practice of delaying invoice payments, often well beyond due dates. Any reduction in the payment period may prove to be important for avoiding financial distress when a payment is made immediately upon being chased rather than in the next payment run. Delay in invoice payments by customers is the most important factor but in instances when a payment is made immediately, clearing delays can contribute to the difficulties faced. Hence faster clearing could play some role in reducing financial distress among smaller businesses.

## **Inventory Management**

- 8.10 Delays in payments clearing might have an impact on inventory management. This would seem to apply most obviously to perishable goods where inventory holding costs are especially high. A business with good access to trade credit would not suffer from additional costs from slow clearing times relative to other firms, but, where trade credit is not available, maintaining low inventory levels may depend on having a short re-ordering lag, which may be helped by faster payments processing.

## **Straight through processing (STP)**

- 8.11 STP is the process of seamlessly passing financial information to all parties involved in the transaction process around the exchange of payment for goods and services. The process aims to remove manual handling or redundant processing and spans from ordering and invoicing through to reconciliation and statement production. The purpose of pursuing STP is to promote operational efficiency, reduce labour costs, enable greater transaction volumes and improve data quality.
- 8.12 The shift to STP is not a clearing time issue of itself, but standardisation and a shift to STP may be a second order effect of a re-engineering of a payment system and, particularly, a shorter clearing cycle.

- 8.13 Business customers may themselves respond to a faster clearing payment service to move more of their payments away from cheques to electronic payment methods. Electronic payment methods provide the necessary environment for STP of invoicing and reconciliation.

### **Reduction in settlement risk**

- 8.14 As a result of the three-day BACS interbank clearing cycle, there are currently up to three days worth of exposures between members open at any one time. The Bank of England noted, in its *Payment Systems Oversight Report 2004*, that shortening the length of the clearing cycle, for all BACS payments, by one day would lead to a significant and quantifiable reduction in exposures among participant banks in the BACS payment scheme.
- 8.15 A *Liquidity Funding and Collateralisation Agreement* has been developed by the BACS and C&CCC members. Its purpose is to mitigate settlement risk by establishing agreed procedures for surviving members to provide liquidity to meet any shortfall arising from a member default and share any resulting losses. This “liquidity funding” would subsequently be repaid as far as possible from collateral pledged by the defaulting member. All members would contribute collateral to the pool in advance. The size of both the aggregate liquidity funding commitment and aggregate collateral that the banks are required to provide will be related to peak end-of-day exposures across the three-day clearing cycle. The Bank of England therefore notes that it is also possible that shortening the interbank clearing cycle would reduce the peak exposure to any member - and hence, the size of the funding commitment and collateral pool required under the Agreement.
- 8.16 The actual level of reduction in peak exposures will depend on the volume of payments put through a faster clearing cycle. The ELLE proposition covers only remotely initiated payments and standing orders and this is the only proposition costed by the Working Group. Faster clearing for all BACS payments would reduce peak exposures significantly more than a faster cycle for only internet and telephone banking payments and standing orders.

## **International comparisons**

8.17 Chapter 5 above noted that, while innovation in some areas has happened in the United Kingdom, clearing times are slower than for the four countries compared. The chapter also considered a number of other innovations to the payment systems the introduction of which might benefit customers in the United Kingdom.

## **Network effects**

8.18 The Cruickshank report and the OFT's report discussed the network effects inherent in payment systems. A clearing system is a network established between the banks. An innovation to the payment system generally needs to be introduced by all members of the network to be attractive to end customers. The incentive to introduce a particular innovation will differ across the member banks, however. This means that innovation may be at the pace of the slowest and that even if it is profitable for a number of banks to innovate, such an innovation may not occur if it is not profitable for all banks.

8.19 The reduced incentive for innovation due to the interdependence of network members would be mitigated where the payment system faces effective competition from other payment systems. Similar banks currently govern the UK's clearing systems and the OFT's report said that this may reduce the incentives for payment systems to compete with each other. The Task Force will be considering these issues over its lifetime.

## **Dynamic competition**

8.20 Increased competition in a sector as important as the banking sector would be expected to have a material impact on the UK economy. If a faster clearing payment service spurred increased competition between banks and incentivised further innovation then there would be benefits to the economy. A faster clearing payment method could bring benefits through opening up new markets<sup>40</sup> by reducing uncertainty about when payments would be received. In particular, faster clearing and a shift from cheque payments to direct credits may help make 'pure click' current account banking on the internet a viable competitor to existing branch networks. Faster clearing could also make it more attractive to hold separate savings and current accounts with different financial institutions which could increase competition in the market for savings accounts.

## **Quantified demand research**

8.21 Chapter 6 discussed the market research the Working Group commissioned into the demand for a faster clearing payment service from personal customers and SMEs. This appears to indicate that there is a small (relative to total BACS volumes) but nevertheless significant demand for faster clearing as reflected in how respondents said they would value such a service. The value that people derive from a service should be reflected in their willingness to pay for the service.

## **Quantified costs**

8.22 The Working Group has access to 11 BPSL members' costs and central infrastructure costs (from Voca). These costs total £48 million in core IT development costs. As IT projects are usually under-costed this estimate has been adjusted to a range of £48 - 65 million. The assumptions behind these costs were considered in Chapter 7 above,

---

<sup>40</sup> An example of new markets being opened up due to innovation in payment methods is specialised online payment services such as PayPal.

which also noted a number of expected cost drivers for which the costs have not been quantified.

- 8.23 It is unclear what prices, if any, would be set for a faster clearing payment service. Competitive market pressures could make it difficult for banks to sustain positive prices for such a service. The NOP research suggests there would still be an interest if the service were charged for, but it is not clear that this could be transformed into a source of revenue. Consumer groups have said that they would be disappointed if a positive price were charged for this service. If, due to the competitive nature of the market, individual banks decide not to introduce an additional charge for this 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.

### **Potential value to the United Kingdom economy**

- 8.24 In order to try and quantify the benefits that may accrue from the existence of a faster clearing payment service, estimates of willingness to pay can be weighed against any costs incurred. This allows the comparison to be made of how society economically values such a service against the costs of introducing it and a consequent inference as to the potential net benefit of the service.<sup>41</sup> The estimate of this net benefit will depend on the assumptions underlying the analysis. The analysis is also limited in that there are a number of costs and benefits, as described in this chapter, on which quantified information is not available. The analysis is therefore a partial one and the non-quantified costs and benefits should be remembered when reading the analysis in the Appendix. The assumptions and data underlying the analysis and a number of scenarios are explored in Appendix I. The analysis shows

---

<sup>41</sup> The actual net benefit (the benefits minus the costs) realized by society will depend on whether, and how much, the banks ultimately charge for this service. A price charged above the cost of providing a service would lead to a deadweight loss (potential value which is not attained by consumers or the banks). The Working Group has not considered what prices may be charged and the impact of different prices.

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 to £1,340 million over 10 years.

## 9 OPTIONS FOR CHANGE

9.1 The Working Group has primarily focused on assessing the case for a faster payment service. Banking members of the group have been concerned to stress that for change to happen, there must be demonstrable net benefits that are greater than the net costs for that change. It is, of course, important that the solution chosen has the appropriate degree of availability, resilience, and integrity. One of the overriding considerations of the Working Group has been that the security of the present clearing systems should not be imperilled and that only changes that would retain the present security should be considered.

### No change

9.2 A recommendation that no changes should be made at all to the current arrangements could be sustained only in two particular sets of circumstances: first, that any change at all would threaten the stability of the present arrangements, or, secondly, that there was insufficient demand for any change relative to the cost of implementing the change. In the first instance, the present system has never failed, and, if it were to, the results would clearly be catastrophic for business and for consumers in the United Kingdom, in both domestic and overseas dealings. Clearly any change that may be introduced must not threaten that absolute reliability. In the case of the second (and, again, in the light of the cost benefit analysis), insufficient demand for change from consumers, businesses or Government would lead to a conclusion that change was unnecessary. In the event, the economic cost-benefit case shows that there is a case for introducing a faster payment service for telephone and internet payments and standing orders from the perspective of the economy at large. To that extent, the consideration is therefore whether any recommended change will threaten the reliability of the system. The Working Group is not aware of any insuperable obstacles to retaining the present reliability of the system.

9.3 The demand for change relates mainly to automated telephone and internet payments, and to standing orders, where, in each case, value transfer is typically not on the same day. There are a number of options to be considered concerning automated telephone and internet payments and standing orders, all of which have been introduced, in one form or another, in at least one of the foreign countries used as case studies, and appear to be technically feasible in the United Kingdom. The options are:

- ELLE clearing (Early by Later today, Late by Early tomorrow)<sup>42</sup>
- next day clearing, and
- same day clearing.

### **ELLE clearing**

9.4 The costs to the banks of introducing an ELLE-type service via Voca systems under BPSL rules (see chapter 7 above) have been assessed at a high level by the banks to be in the region of £48 - 65 million for IT costs alone (that is, the central Voca costs plus the costs to individual banks of changing their own systems). In addition, there would be the further non-IT and on-going costs referred to in chapter 7 above. The banks did not identify significant differences in cost between the three options of same day, next day or ELLE, and the costs provided are those for the ELLE proposition. The feasibility and cost of other potential non-Voca solutions, for example using SWIFT or LINK, have not yet been evaluated. The ELLE option would entail the new service sitting alongside the existing BACS debit and credit clearings. Once the instruction was given, the payer would not be able to revoke the transaction. The industry believes that it would be necessary to mitigate the fraud risk (given that a payment would not be revocable),

---

<sup>42</sup> where a payment instruction is before, say, 12 noon then funds are available to the beneficiary before the end of the working day; where the payment instruction is too late for the cut-off in the middle of the day, but is made before, say, 9pm, then funds are available to the beneficiary early on the next working day.

and that a value cap (or a daily limit on transactions by any one customer) would need to be considered. The price of the service, and the delivery channels customers could use (for example, internet or telephone banking) are areas where banks would compete individually.

- 9.5 From the end-user's point of view, it is likely that the ELLE solution is at least as beneficial as same day or next day clearing, as it combines the desirable elements of a same day and next day service proposition. Customers who require clearance of a payment and availability of funds to the recipient on the day of payment would need to ensure that payment instructions are received by his or her bank by, say, mid-day on the day the transaction is required to be completed. ELLE does, in fact, have advantages over a once-a-day same day clearing scheme which would almost certainly involve a cut-off time at, say, noon: any payment instruction made after that cut-off time would not be available to the recipient until the end of the next day. The same disadvantages would not, of course, apply to a same day clearing scheme where, as in Sweden, for example, clearings occurred more than once a day.
- 9.6 It will be for individual banks to decide whether, and how much, to charge customers for the service. 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.<sup>43</sup>
- 9.7 In carrying out the costing exercise, the banks have estimated that implementation of an ELLE scheme could be achieved within two years from the point at which a detailed specification for the service was agreed.

---

<sup>43</sup> any such agreement would fall for consideration under the Chapter I Prohibition of the Competition Act 1998 and under Article 81 of the EC Treaty. The Chapter I prohibition prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which have the object or effect of preventing, restricting or distorting competition in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom. Article 81 of the EC Treaty sets out an equivalent EC prohibition which would apply if any agreement had an effect on trade between Member States.

- 9.8 As noted above, the costings in chapter 7 relate only to one possible solution to a recommendation for faster clearing: a service using the Voca infrastructure. There are undoubtedly other potential solutions which, if the Task Force recommends faster clearing in one form or another, might well meet the criteria set down. If the Task Force does recommend faster clearing as a result of this report, the implementation Group will, no doubt, consider a range of possible solutions.

### **Same day or next day clearing**

- 9.9 There are obvious advantages to clearing occurring on the same day as the instruction is made; some overseas administrations have introduced clearing on more than one occasion each working day, although only a small number of customers are likely to receive significant additional value from that facility.
- 9.10 Even more clearly, there are disadvantages to next day clearing insofar as instructions made at any time before the cut-off point on the first day will not be effected until the next day. Instructions made after the cut-off point on the first day will not be effected until the third day.
- 9.11 On balance, therefore, it is clear that a system which offers the combined facilities of ELLE is likely to offer the most attractions for customers.

## 10 NEXT STEPS

- 10.1 When this report has been published by the Task Force together with its recommendations, the banking industry will consider how to implement the recommendations. The industry has agreed to return to the Task Force with its proposals for implementation within six months of publication of the report.
- 10.2 In considering the available options, the Implementation Group is likely to consider whether any options using service providers other than Voca might be appropriate. It may, for example, consider that the existing CHAPS scheme could be altered to provide for the level of high volume, low value telephone, internet and standing order transactions currently handled through BACS to be dealt with in the timescale anticipated, or that other providers might be able to offer an effective service. It is not for the Working Group, nor the Task Force, however, to be prescriptive as to what service provider might, or might not, be in a position to offer the required level of service, nor how that service should be provided. That is the role of the Implementation Group.
- 10.3 The key requirements of a new faster payments service for telephone and internet payments and standing orders are likely to include that it has broad reach, both in terms of customer access and scheme membership and that there is sufficient scope for innovations and future enhancements. In setting criteria against which the Implementation Group will consider its proposals (in addition to taking account of fraud prevention and ongoing developments in payment systems in Europe), the Task Force may, therefore, wish to consider the following:
- **access:** that all banks and building societies which presently use BACS should have access, if they so wish. If, exceptionally, they do not wish to have access, there would be no obligation to offer ELLE services
  - **coverage:** if a bank or building society has decided to offer ELLE clearing, its coverage of the scheme should be such that it is available on all those accounts on which it currently offers BACS clearing

- **payment channels at a generic level (that is, in relation to telephone and internet payments):** for each such account, ELLE must be available via existing channels for the account which can be used to make BACS credits
- **standing orders:** for banks and building societies participating in ELLE, standing orders will be routed through a faster payments service, or, if it proves impracticable to include regular payments in the faster payments solution, the industry will, within the same time frame, eliminate float from standing orders, will address information issues, and will seek to resolve timing issues relating to availability of funds for customers<sup>44</sup>
- **continuity of service:** if a bank or building society does not elect to join the new scheme, the industry will ensure that transfers via telephone, internet or standing order will still be able to reach accounts at those institutions, as a minimum, on the same basis as currently
- **other functionality:** whether there is, in fact, any scope for payments to be revoked and recalled, and
- **capacity:** that the scheme should have the capacity for further expansion at any stage in the future, if required.

## Other innovations

10.4 The Task Force has noted the points in paragraph 5.17 that are already under consideration in the United Kingdom, or which could be adapted or introduced and which might benefit consumers. The Task Force has also noted the points in 6.36 – 6.60 which the heavy users perceive to be desirable changes to the present service. These further innovations have not been considered in any depth by the Working Group and are

---

<sup>44</sup> 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.

not, in any event, directly related to the new scheme. They will thus not be considered by the Implementation Group. The Task Force may, therefore, wish to consider whether to ask APACS and BPSL to consider them separately. It may be appropriate as part of the process for APACS to look initially at all the issues and pass on, as appropriate, to BPSL those which they consider could usefully be considered in relation to the current payment service. The Task Force may wish to ask APACS and/or BPSL to report back on progress after 12 months.