

# **BACS Access and Governance Working Group report**

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

**March 2006**

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## FOREWORD

This is the report of the BACS Access and Governance Working Group (the Working Group) set up by the Payment Systems Task Force in October 2004 to consider any issues involving access restrictions to the BACS scheme and the governance of the body responsible for the BACS scheme, BACS Payment Schemes Limited (BPSL).

The Working Group initially considered whether there were, in fact, any problems with the existing arrangements. In order to make that assessment, and to be able to assess the level of any demand for change, the Working Group looked at the issues raised by the Cruickshank report of 2000 and the OFT's report of 2003, *UK Payment Systems*, and how things had changed since those reports. It then looked at how similar issues had been addressed in Canada and Australia, in the LINK ATM network in the United Kingdom, and at Euroclear, a settlement system for securities transactions.

The Working Group recommends three areas for immediate change, and some other areas where further work appears to be required. The Task Force is currently considering proposals put forward by APACS which, if implemented, would have a significant effect on the governance arrangements of a number of payment schemes, including BPSL. The deliberations of this Working Group have contributed to that process.

The Task Force is currently considering proposals put forward by APACS which, if implemented, would have a significant effect on the governance arrangements of a number of payment schemes, and could well apply to BPSL. The deliberations of this Working Group are contributing to that process.

I am very grateful to all the individuals involved in the Working Group for their enthusiastic and pragmatic approach to the issues raised and for their tolerance and forbearing in the process of agreeing the draft report, and to the organisations listed in Annexe A, especially to APACS and BPSL, for the provision of the time and resources of their staff members.

I commend the report to the Task Force.

Gover James

Head, Payment Systems Team, Office of Fair Trading  
Chairman, BACS Access and Governance Working Group

February 2006

## EXECUTIVE SUMMARY

### Background

This is the report of the BACS Access and Governance Working Group, the second Working Group to be set up by the Payment Systems Task Force (the Task Force).

The Working Group was set up to look at issues of access and governance raised by the Cruickshank report of 2000 and the OFT's report of 2003, *UK Payment Systems*, about restrictions on access to the BACS scheme, and the governance of the body responsible for the scheme, BPSL. The Working Group was required to report on the issues and options available, with recommendations, to remedy any perceived detriments.

The key issues were perceived to be:

- that only major banks and building societies had direct membership of BACS and other payment schemes
- while governance changes already made to APACS and BACS were a step in the right direction, they may not have gone far enough
- that common ownership of payment scheme and infrastructure negated possible benefits of the split
- mutual governance might provide important safeguards, but might also create a strong disincentive for competition, and
- that innovation was still 'at the pace of the slowest'.

The Working Group's first task was to assess whether there were, in fact, any problems with the existing access and governance arrangements, and, if so, whether changes were necessary or desirable. Where there appeared to be no cause for concern, the Working Group has suggested that no action need be taken.

## Research carried out

Reference sources included:

- existing research into governance models
- the views on possible extensions to membership of, and access to, the BACS schemes of:
  - heavy users of the system (such as large corporates and government departments who make or receive large volumes of payments)
  - banks not currently members of BACS, and
- the access and governance arrangements of:
  - particular payment schemes in Canada and Australia
  - the LINK ATM network in the United Kingdom, and
  - Euroclear, a clearance and settlement system for internationally traded securities.

## Key recommended changes

The Working Group has made three key recommendations for immediate change and has identified a number of other areas where further work may be required.

### 1. Affiliates Interest Group

BACS users have expressed a desire for more active influence in BPSL. To address this and other user representation and transparency issues, BPSL has recently established an 'Affiliates Interest Group' (AIG):<sup>1</sup>

- membership is open to all users of BACS
- it acts as a forum for BPSL to brief Affiliates on current and forthcoming issues and to raise issues of interest or concern

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<sup>1</sup> See [www.bacs.co.uk/bpsl/corporate/affiliates](http://www.bacs.co.uk/bpsl/corporate/affiliates)

- Affiliates are able to raise issues with the BPSL Board, and
- the Chair of the AIG (elected from and by the Affiliates) is invited to attend appropriate meetings or parts of meetings of the Direct Debit and Direct Credit Steering Groups.

## **2. Consultation process**

In the course of the work of the Working Group, the OFT established a forum for 'heavy users' of the BACS system. While that forum was, and is, an effective source of views, it is essential that the views of the heavy users should not totally outweigh the views of other users of BACS, such as businesses that input lower volumes (typically small and medium-sized enterprises - SMEs), agency banks (who gain access to the system through a contractual arrangement with a member bank) and consumers.

While the AIG will, of itself, ensure wider consultation, these other users are unlikely to have the resources to be able to contribute fully to all AIG discussions. The Working Group therefore recommends that a consultation process should be developed, targeted to ensure that the views of these other sectors are taken into account in the decision-making process and to allow interested parties time to consider, and comment on, proposals made, or to be discussed, by members of the AIG and BPSL.

## **3. The BPSL objectives**

BPSL is a membership body whose responsibility is to own, develop and enhance the integrity of automated payment and payment-related services. In the light of the issues set out above and taking account of comparisons with overseas schemes, the Working Group considered that a broader objective for BPSL,

'to promote efficiency and innovation in payments, responding to user and market needs in an efficient and cost-effective manner',

was desirable. The Working Group recommends that this objective should be implemented as soon as possible.

## Other issues

The Working Group also looked at:

- the corporate governance of BPSL (whether, for example, the appointment of independent directors to the BPSL Board should be considered), and
- whether non-financial institutions and government departments should be able to become members (currently there appears to be little enthusiasm for this, but that may change over time).

The Payment Systems Task Force is currently considering proposals put forward by APACS which, if implemented, would have a significant effect on the governance arrangements of a number of payment schemes, and could well apply to BPSL. The deliberations of this Working Group recorded in this report are contributing to that process.

The Working Group also concluded that BPSL should report to the Task Force on progress against the three Recommendations, and any developments that may have taken place on the other issues identified above, no later than twelve months from the date of publication of this report by the Task Force. The report by BPSL will include the views of the Affiliates and the wider consultees.

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# 1 INTRODUCTION

- 1.1 The Payment Systems Task Force (the Task Force), chaired by the Office of Fair Trading (OFT), brings together industry, retail, consumer, and 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 which derive from, or are associated with, features of payments systems are also considered. The circumstances which led to the formation of the Task Force are set out in Chapter 2.
- 1.2 This is the report of the BACS Access and Governance Working Group (the Working Group), the second working group to be established by the Task Force to examine and, if necessary, to take forward work on various issues. The first such group, the BPSL Innovation Working Group, has already reported, and the industry is currently working towards implementation of the recommendations contained in that report.
- 1.3 The Working Group was set up by the Task Force at its meeting of 9 September 2004 to examine concerns raised in both the Cruickshank<sup>2</sup> and 2003 OFT Reports<sup>3</sup> about restrictions on competition caused by the mutual governance of the body responsible for the BACS scheme, BPSL, and the access restrictions to the BACS scheme. The Working Group looked at whether the BACS system - and its stakeholders - would benefit from a wider variety of bodies being able to gain direct access to the scheme, and being able to participate in BPSL's decision making process.

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<sup>2</sup> Cruickshank, *Competition in UK Banking*  
[www.hm-treasury.gov.uk/documents/financial\\_services/banking](http://www.hm-treasury.gov.uk/documents/financial_services/banking)

<sup>3</sup> *UK Payment Systems*, OFT 658, May 2003.

- 1.4 BPSL is a membership-based industry body whose responsibility is to own, develop, and enhance the integrity of automated payment and payment-related services. It promotes best practice among those companies who offer payment services, and it is responsible for the associated payment clearing and settlement services.
- 1.5 The BACS payment scheme handled 5,111 million payments in 2005, an increase of 12.75 per cent on the year before. The value of these payments was £3,113 billion,<sup>4</sup> an increase of 8.9 per cent from the year before. Ninety per cent of United Kingdom salaries are paid via BACS; 100,000 business users, and 70 per cent of the population, use BACS. The BACS payment scheme is a crucial part of the United Kingdom's infrastructure. Moreover, because of the time-criticality of its payments and the relative lack of immediate substitutes, BACS is important in ensuring the smooth functioning of the real economy.
- 1.6 A full explanation of the current BPSL governance and BACS access arrangements are contained in Chapter 4. BPSL currently has 14 members, all of which are banks or building societies. The BPSL Board comprises directors appointed by members, and the BPSL Managing Director.<sup>5</sup> While Cruickshank said that this mutual governance model, also used by other United Kingdom payment schemes, dampened competition between schemes, and stifled innovation, the mutual governance model can have some advantages including the potential to prevent abuse of market power on the part of individual members.

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<sup>4</sup> A small fraction of these payments were in €, not £.

<sup>5</sup> The 14 members are: Abbey, Bank of England, Bank of Scotland, Barclays Bank, Clydesdale Bank, Alliance and Leicester, HSBC Bank, Lloyds TSB Bank, National Westminster Bank, Coutts & Company, Nationwide Building Society, Northern Rock, The Co-operative Bank, The Royal Bank of Scotland, and, from 13 March 2006, Danske Bank of Denmark. The BPSL Board is made up of the Managing Director of BPSL, and representatives of these 14 members, other than National Westminster Bank and Coutts & Company, which are represented through their parent body, The Royal Bank of Scotland Group.

1.7 The Working Group researched and assessed whether changes could be made to the access and governance arrangements that would bring about greater access, competition and innovation, without affecting the integrity and reliability of the scheme. The Working Group looked at:

- other payment schemes, some from outside the United Kingdom, which have different governance arrangements and which have been revised in recent years. Both the benefits and drawbacks of these alternative arrangements were compared with current BPSL governance arrangements, bearing in mind that, while such comparisons may offer some interesting insights, they do not all necessarily translate easily to the United Kingdom
- the relevance of existing research into governance models, and
- the views of 'heavy users' of BACS on possible extensions to membership of, and access to, the BACS scheme.

1.8 This report includes recommendations for immediate changes. It also eliminates a number of possible changes which appear at this stage to be not worth pursuing further, primarily because of a current lack of demand.

1.9 The Working Group also considered issues that arose in the BPSL Innovation Working Group and the European Working Group. The work of the European Working Group is important in the context of access and governance, as it looks at European legislation, European Commission initiatives, European Payment Council initiatives within the eurozone and the potential effect on United Kingdom payment systems should the United Kingdom decide to join the Euro. These areas may influence any recommendations that the industry decides to implement. The development of a Single Euro Payments Area (SEPA) and the possible impact on access and governance arrangements in the United Kingdom is therefore also considered in this report.

1.10 Underlying the work of the Working Group is the recognition that the stability of payment systems is essential to the United Kingdom financial sector and wider economy. The recommendations suggested here acknowledge this and that any changes made to BACS must not adversely affect levels of reliability or integrity.

## 2 CRUICKSHANK AND SUBSEQUENT DEVELOPMENTS

- 2.1 The Cruickshank report, initiated by the Chancellor in November 1998 and published in 2000, raised competition concerns about United Kingdom payment schemes. The report found economic characteristics that did not deliver price transparency, good governance, non-discriminatory access, efficient wholesale pricing or innovation. The report suggested that a new framework for competition, including licensing and regulation, was necessary to deal with the problems identified.
- 2.2 Cruickshank's key finding was that competition was not working well in the payment systems market. Because of their very nature, payment systems must involve a degree of co-operation between organisations that otherwise compete against each other. This is symptomatic of a market where network effects are present - when the value to a participant of access to a network depends on the number of other users with access to the same network. Network effects also mean that the competitive pressure that existing payment systems face from alternative systems, or the threat of new networks forming, can be limited. Once a network is established, it may be extremely difficult for a new competing network to gain the critical mass needed to function effectively on a standalone basis.<sup>6</sup> Cruickshank concluded that these factors led to a dampening of competition exacerbated by the way in which payment schemes were governed and run.
- 2.3 Cruickshank noted that payment systems in the United Kingdom were governed by the banks that owned the schemes (mutual governance). Because many of the same banks appeared on the governing boards of the various payment schemes, Cruickshank concluded that there was a reduced incentive for those schemes to compete with each other, either by entering each other's markets, or by introducing new products. Mutual governance also made competition within a scheme more difficult. Because decisions were taken by consensus, it was impossible

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<sup>6</sup> For a fuller discussion see *UK Payment Systems*, OFT 658, May 2003.

for one subset of banks to introduce an innovative product unless all banks supported the introduction. Cruickshank observed that 'mutual governance means that many schemes move at the pace of the slowest member'.<sup>7</sup> Voting arrangements at BPSL do, however, prevent a single blocking vote.

- 2.4 Cruickshank acknowledged that there were legitimate reasons for restricting access to payment schemes (such as high credit and liquidity risks), especially in high value systems. The report concluded, however, that the mutually owned schemes had anticompetitive restrictions on access - for example, the right of existing members to approve or decline new entrants. Since Cruickshank this process has changed and BPSL membership applications are assessed by the Managing Director against preset criteria.
- 2.5 Cruickshank was particularly concerned that schemes required full members to be regulated deposit takers or credit institutions. Cruickshank did not believe this was justified for low value schemes like BACS, where the credit and operational risks involved were not significant enough to justify the exclusion, and the requirement did not by itself reduce the risks of fraud.<sup>8</sup>

## **The OFT report**

- 2.6 In 2003 the OFT examined and reviewed the payment systems market in relation to the five competition issues in Cruickshank's report, noted in paragraph 2.1 above.<sup>9</sup> The subsequent report noted that some of the issues were being dealt with elsewhere in the OFT, that a number of self-regulatory changes had been carried out by the industry, and that a number of areas still remained unresolved.

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<sup>7</sup> paragraph 3.125.

<sup>8</sup> paragraph 3.74.

<sup>9</sup> paragraph 4.6.

- 2.7 The report discussed several changes to the governance of payment schemes introduced following the Cruickshank report. At the time of Cruickshank there had been strong links between the three clearing schemes (BACS, C&CCC and CHAPS) and the trade body APACS; members of each of the clearing schemes had to be members of APACS. Post-Cruickshank, the clearing schemes legally separated from APACS, which, the OFT report concluded, could lead to more freedom for clearing scheme members in deciding what to join, and therefore how best to commit their resource and time.
- 2.8 At the time of Cruickshank, BACS Limited was one body which both governed and operated the scheme. The banks which owned BACS Limited were therefore in control of both scheme and infrastructure. In December 2003 BACS Limited legally separated the scheme from the infrastructure. The body responsible for the BACS scheme (now called BPSL) is still mutually governed by the banking industry, run on a non-profit making basis and is responsible for setting the scheme rules. The infrastructure provider (now called Voca) is run on a profit making basis.
- 2.9 The potential benefits from a separation of scheme and infrastructure include:
- the ability to attract investment into the infrastructure from sources other than the current owners, the scheme members
  - the incentive for the independent infrastructure to seek profitable business opportunities which may be outside the services provided to the payment scheme
  - removal of the conflict of interest that may arise when the infrastructure wishes to provide a service which may compete with a service provided by a scheme member bank
  - membership of BPSL is less expensive as it no longer requires ownership of a share in the infrastructure, and
  - the ability of the scheme to choose an infrastructure provider other than Voca if it improved the service to users and/or reduced the cost.

- 2.10 Voca has been engaging in new business initiatives, such as electronic bill presentment and payment (EBPP), which is not sponsored by all the BPSL members. This indicates that separation has helped to spur innovation and competition. A more recent innovation is the announcement that Voca and LINK are the appointed suppliers who will jointly develop and provide a new system for faster payments. However, the only shareholders of Voca are still the BPSL members. This is not surprising, given that the separation between scheme and infrastructure was implemented only in December 2003, and may change in time. While the ownership of Voca remains solely with BPSL members, it may be that delivery of the full benefits from the separation of scheme and infrastructure is less likely.
- 2.11 The OFT report also noted innovations that had taken place in the payment systems market since Cruickshank. BACS had begun a wide-ranging technological renewal programme – NewBACS – which would increase the capacity of the BACS payment engine, offer additional risk-reducing functionality, and would also introduce a new internet-based delivery channel called BACSTEL-IP.

### **The Payment Systems Task Force**

- 2.12 In the Government's Pre-Budget Report of November 2003 it was announced that the OFT would be taking an enhanced role in the payment systems industry for a period of four years. In advance of any legislation, the payment systems industry was given an opportunity to address outstanding Cruickshank concerns via a Task Force approach. The Government made clear that legislation would be enacted if this approach failed. The remit of the Task Force is discussed in the introduction of this report.

2.13 In its first progress report in May 2005,<sup>10</sup> the Task Force concluded that the prospective benefits for the United Kingdom economy justified the creation of a faster payments service for telephone and internet payments and standing orders. APACS announced on 16 December 2005<sup>11</sup> that, by the end of 2007, banks would be able to offer a new faster payments system enabling a payment to reach the recipient's bank account 'on the same day within a few hours on any day of the week'.

### **The Payment Systems Task Force questionnaire**

2.14 The creation of the Task Force put the OFT's role in a different context. The 2003 report had been written in the light of expected legislation.<sup>12</sup> Subsequently, the OFT felt it necessary to revisit many of the issues that had been identified, and, on behalf of the Task Force, produced and distributed a questionnaire on payment systems. This was designed to assess whether outstanding Cruickshank concerns still prevailed, and whether additional concerns existed. Thirty responses were received, and where significant issues were raised, follow up meetings were held between the OFT and the organisation responding.

2.15 Many respondents made it clear that Cruickshank's concern that only major banks and building societies had direct membership of payment schemes was still a pressing issue. However, several respondents felt that this was not the case and detailed the risks that such membership could induce.

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<sup>10</sup> *First annual progress report of the Payment Systems Task Force*, OFT 789a, May 2005.

<sup>11</sup> [www.apacs.org.uk/media\\_centre/press/05\\_12\\_16.html](http://www.apacs.org.uk/media_centre/press/05_12_16.html)

<sup>12</sup> 'The Government proposes to legislate to give OFT powers as a specialist regulator of payment systems' OFT report, paragraph 1.5.

2.16 Some respondents felt that the governance changes made to APACS and BACS were a step in the right direction, but that it was too early to tell whether the changes went far enough. Others were concerned that even though the BACS scheme and infrastructure had split, both were still owned by the same banks and building societies, thus negating any potential competitive benefit of the split. Mutual governance was felt by some respondents to provide important safeguards for payment systems, whereas others considered that it created a strong disincentive for competition and that 'innovation at the pace of the slowest' was still a problem.

### **Future developments: the potential impact of SEPA**

2.17 When setting up the working group regime, the Task Force was conscious that it could not work in total isolation from developments within Europe. One of the working groups established was therefore charged with looking at European issues. The Working Group drew on the work of the European Working Group and noted, among other things, the likely effects on the access and governance arrangements within the United Kingdom if a SEPA were to be established.

2.18 A fundamental aim of the EU is the development of the internal market. In seeking this goal, the European Commission and European Central Bank have launched a considerable drive to develop a single payment area within the EU, especially for Euro payments. SEPA payment schemes will be developed; this means a common set of rules and practices for the provision and operation of SEPA payment instruments. This is believed to be crucial for the success of the single market in the EU.

2.19 The Commission published the draft Payment Services Directive in December 2005, which is now being considered by the European Parliament and which provides the legislative support needed for SEPA. Its provisions will not be finalised for some months, at least, but seem likely to touch on aspects of the BPSL service and, potentially, on measures to access BPSL. On access and governance, the Directive is eventually likely to include provisions stating that access to, and

operation of, schemes should not discriminate between payment service providers, and that any restrictions must not inhibit competition any more than is necessary for the financial safety of the system. Recently the Commission has also looked to become more heavily involved in industry arrangements for the SEPA schemes and has suggested that it may make industry agreement on SEPA standards mandatory.

- 2.20 The European banking industry is co-operating to deliver SEPA through the European Payments Council (EPC). The EPC's objective is to deliver fully functional SEPA schemes for credits and debits by 2008.
- 2.21 Both of these initiatives are evolving and the likely impact on the United Kingdom is unclear. The timetable for SEPA differs from that of the Task Force. However, the Task Force will want to take into account developments at a European level when making its recommendations. It is possible that, if SEPA standards are adopted by the United Kingdom and the BACS scheme is superseded by a pan-European scheme, implemented recommendations of the Task Force will prove short-lived or irrelevant. While SEPA is not in the scope of the Working Group, the recommendations of this report do not appear to be in conflict with activities at a European level in the area of access and governance. The Working Group believes that its work here would be beneficial in any consultation process covering the access and governance arrangements for SEPA schemes. It would be disappointed if its analysis and conclusions were not taken into account.

### **Future developments: the European Commission's sector inquiry into retail banking**

- 2.22 On 13 June 2005, the European Commission announced that it had launched an inquiry into competition in financial services, pursuant to Article 17 of Regulation (EC) No 1/2003. The Commission has said that it intends to 'maintain an open dialogue with representatives from industry and consumer associations, and will inform market players and consumers about the progress'. The main results of the inquiries will be published from 2006. The main concern of the Commission is to ensure that consumers in the EU benefit from a competitive and integrated financial market. The inquiry will start with payment cards but will then

move on to other areas. At this point, the Commission says, 'no specific retail banking product or/and service has been excluded', and 'Issues to be investigated include conditions for market entry, state of competition between payment networks, and the degree of effective choice for consumers and SMEs'.

### **3 ROLE OF REGULATION, COMPETITION AND GOVERNANCE IN PAYMENT SYSTEMS**

#### **Introduction**

- 3.1 The previous chapter noted the analyses of the Cruickshank and OFT reports and the identified potential competition problems due to network effects that arise in payment systems and the common ownership of payment schemes in the United Kingdom. These factors were felt to dampen the incentive for competition between payment schemes and limit the rate at which schemes innovated. These potential competition problems apply to United Kingdom payment schemes other than BPSL and to payment systems in other countries.
- 3.2 Where market forces and incentives to innovate are weak, providers in the market may not respond to the demands of consumers. Potential solutions to this problem are to introduce greater competition in the market or to use regulation to ensure that users' needs are met. The alternative of increased regulation has been used in a number of countries and was recommended in the Cruickshank report. While not necessarily any less effective, it is generally the case that the regulatory influence on payment systems in the United Kingdom has been lighter than elsewhere. The Task Force has been developed as an alternative to regulation but HM Treasury has stated that there will be direct regulation should the Task Force prove to be ineffective.
- 3.3 A further solution to the perceived lack of response to consumer demands would be to devise governance arrangements which would allow users to be consulted, and their feedback and needs to be taken into account. It should be the aim of the Board to consider the needs and requirements of all its users, including consumers and businesses of all sizes, as well those of as BPSL members.
- 3.4 This chapter explores in more detail these issues and concerns, how they have been addressed in some overseas administrations, and how they might be addressed in the United Kingdom.

3.5 First, in general terms, the factors that the Cruickshank report identified as those which might lead to a lack of competition and innovation were:

- lack of competitive advantage in innovation at payment scheme level
- lack of user representation or participation in scheme governance
- restriction of membership and governance of schemes to financial institutions
- payment schemes having no objective to serve users' needs other than those of scheme members
- lack of independent directors
- different payment schemes all being owned by generally the same group of banks which may lead to a lack of competition between schemes
- ownership of infrastructure and scheme by the same banks, and
- cross-subsidisation of payment methods and services to personal customers – free in-credit banking.

### **Role of the central bank and other regulatory authorities in payment systems**

3.6 Central banks have a public policy role in payment systems due to the systemic risk that arises in such systems – the aggregate risk facing the network is greater than the sum of the risks of each participant were they to operate in isolation. Individual participants may have neither the ability nor the incentive to mitigate fully these systemic risks. In consequence, there is a clear rationale for some third party to provide directly, or secure indirectly, the public good of systemic stability in payment systems. This third party is usually the central bank.

## The role of the Bank of England

- 3.7 The 1997 tri-partite Memorandum of Understanding between the Bank of England (the Bank), HM Treasury and the FSA formalised the responsibilities of the Bank in respect of the oversight of UK payment systems.<sup>13</sup> The Bank has some limited statutory oversight responsibilities under the Financial Markets and Insolvency (Settlement Finality) Regulations (1999),<sup>14</sup> which implemented the EU Settlement Finality Directive (1998) in the United Kingdom.<sup>15</sup> The Regulations are intended to reduce the systemic risks arising from uncertainties surrounding the legal enforceability of systems' arrangements for dealing with the insolvency of a participant.
- 3.8 Specifically, the Regulations provide additional certainty regarding the finality of payments in designated systems, with the Bank being the authority responsible for designating payment systems under the Regulations (and for revoking designation).<sup>16</sup> As designating authority, the Bank must consider, among other things, any changes to a designated system's default arrangements or changes to that system's participants, on which the Bank is required to comment. In December 2005, BPSL became 'designated' under these Regulations.
- 3.9 BPSL members govern the BACS payment scheme, working to maintain its integrity and improve its efficiency, develop new payment services and ensure regulatory compliance. As with other payment systems in the United Kingdom, the Bank has oversight responsibilities in respect of

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<sup>13</sup> *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority*, available at: [www.bankofengland.co.uk/financialstability/fs\\_more.htm](http://www.bankofengland.co.uk/financialstability/fs_more.htm)

<sup>14</sup> Financial Markets and Insolvency (Settlement Finality) Regulations (1999). Available at: [www.opsi.gov.uk/si/si1999/19992979.htm](http://www.opsi.gov.uk/si/si1999/19992979.htm)

<sup>15</sup> Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (1998).

<sup>16</sup> The FSA is responsible for designating securities settlement systems and recognised clearing houses but must consult the Bank in all cases about whether the system has embedded payment arrangements for settling cash obligations.

BACS. The objective of such oversight is to assess risks to the wider economy – 'systemic risk' - arising through BACS and, if necessary, ensure their mitigation.

- 3.10 Furthermore, the Bank is a member of BPSL and, in reflection of the importance of BACS to the wider economy, acts as its settlement agent. This is reflected in the requirement that existing BPSL members hold settlement accounts at the Bank, with settlement in central bank money delivering wider risk-reduction benefits.
- 3.11 Reflecting the absence of statutory powers of oversight, however, the Bank itself does not determine BPSL's membership criteria or governance arrangements. For example, although BPSL requires members to be credit institutions, the Bank will make settlement accounts available to both credit and non-credit institutions alike. Among other things, however, the Bank assesses BPSL's access and governance arrangements against the minimum standards set out in the CPSS Core Principles for Systemically Important Payment Systems, which provide an internationally recognised benchmark. A detailed assessment of BACS against these principles is set out in the Bank's *Payment Systems Oversight Report*.<sup>17</sup>
- 3.12 Two of the ten Core Principles are relevant to this report in that they relate to the need to meet users' requirements and the payment scheme's access and governance regime. In particular, they suggest that:
- the system should have objective and publicly disclosed criteria for participation, which permit fair and open access (Core Principle IX), and
  - the system's governance arrangements should be effective, accountable and transparent (Core Principle X).

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<sup>17</sup> Bank of England (2006) *Payment Systems Oversight Report 2005*. The report is available at [www.bankofengland.co.uk/publications/psor/psor2005.pdf](http://www.bankofengland.co.uk/publications/psor/psor2005.pdf) [check ref before publication].

3.13 In its 2005 *Payment Systems Oversight Report* the Bank deemed BACS to be 'broadly observant' of both Core Principle IX and of Core Principle X. In revising upwards the assessment of BACS under Core Principle IX from 'partly observant' in 2004 to 'broadly observant' in 2005, the Bank noted the introduction of the Affiliate class of membership and of the AIG. In maintaining the 'broadly observant' assessment under Core Principle X, the bank noted that the introduction of independent directors may help deliver greater observance in the future.

### **The role of the central bank, and of legislation, in other countries**

3.14 Central Banks or Finance Ministries in other countries often have far greater formal influence in the country's payment systems, particularly in the access and governance regime, than is the case in the United Kingdom (see paragraphs 3.16 – 3.20 below for the position in Canada and Australia). This often arises due to the central bank owning and operating the payment system infrastructure or it may arise through statute setting out the central bank's role. The Bank of England does not own any of the United Kingdom payment schemes and, as the Bank itself has noted, 'The UK regime is to some extent unusual as neither responsibilities nor powers for payment systems oversight are defined in statute.'<sup>18</sup>

3.15 In addition to enforcement powers (which may or may not include fines, civil or criminal sanctions), the statutory powers of oversight of central banks in other countries may include that:

- systems are obliged to provide information to the central bank
- system participants are obliged to provide information to the central bank

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<sup>18</sup> Payment Systems Oversight Report 2004, Bank of England, January 2005, Issue No. 1. The 1997 Tri-Partite Memorandum of Understanding between the Bank, HMT and the FSA sets out responsibilities for the oversight of United Kingdom payment systems.  
[www.bankofengland.co.uk/legislation/main.htm](http://www.bankofengland.co.uk/legislation/main.htm)

- payment systems must be licensed or authorised by the central bank
- the central bank must approve, or can impose, operational rules on payment systems, and
- the central bank can set conditions for membership of payment systems.

## Canada

- 3.16 The security role of the Bank of Canada is set out in the Payment Clearing and Settlement Act 1996. The Act gives the Governor of the Bank of Canada specific powers. If, for example, any action by a payment system (or member of a payment system) is likely to cause systemic risk, the Governor has the power to direct them to stop that action.
- 3.17 Clearing houses must also give the Bank of Canada 'reasonable' notice of any significant changes to the system. The Bank of Canada can carry out audits and inspections of each clearing house and the clearing house must assist in this process. The power has never been used. The Bank of Canada can impose a fee on the payment scheme for the administration of the duties above. Additionally, the Bank of Canada chairs the Canadian Payments Association (CPA). The Canadian Act provides for certain Government oversight powers over the Canadian payments system and the CPA in particular. The Minister of Finance, for example, has the authority to review all new rules or rule amendments and, if appropriate, to disallow the whole or part of a rule that is deemed not to be in the public interest. The Minister also has the power to issue a directive to the CPA to make, amend or repeal a by-law, rule or standard.

## Australia

- 3.18 The Reserve Bank Act confers a mandate on the Board of the Reserve Bank of Australia (RBA) regarding the efficiency, competitiveness and stability of the Australian payment systems.

- 3.19 The Payment Systems Board Act, through the creation of the Payment Systems Board, gives the RBA the power to 'designate' a payment system which then gives the RBA the power to impose both pricing standards (for example, Multilateral Interchange Fees (MIF), the 'no surcharging' rule and prohibiting the 'honour-all-cards' rule) and technical standards. The RBA has used the power in respect of the three credit card schemes and Visa Debit in 2001 and more recently the EFTPOS system. The RBA could also set technical standards but it is unsure that it would want to do so. It also has the power to draw up an access regime, as it has done for credit card systems.
- 3.20 In order to designate a system the Payment Systems Act requires the Payment Systems Board to form the opinion that it is in the public interest to do so (in terms of efficiency, competition and systemic stability).

### **Incentives for innovation and competition in payment schemes**

- 3.21 Many of the issues raised in the Cruickshank and OFT reports relate to perceived competition problems due to network effects, mutual governance and the necessarily cooperative nature of payment schemes. If payment systems competed vigorously, issues such as the blunted incentive to invest in innovations to a payment system, access and governance are likely to interest regulators far less than is currently the case. However, payment schemes are similar to natural monopolies in that it may make little economic sense to have two competing providers of the same service. Competition happens principally at payment system provider level (that is, at the retail level): end consumers choose their bank, rather than scheme or ACH provider.
- 3.22 Some of these factors relate to potential competition problems while others relate to access and governance issues. While potential competition problems still exist, the factors above should be read in the context of the significant changes already instituted by BPSL, as summarised in Chapter 4 below.

3.23 In payment systems greater competition may be introduced through:

- lowering or removing barriers to entry to joining a scheme
- splitting the payment scheme from the infrastructure provider
- incentivising competition between payment schemes, and
- the development of a SEPA.

### **Governance, representation and access**

3.24 More open access to scheme membership and a wider, more independent and more responsive governance regime may replace the need for market forces, or regulatory intervention, or both, to ensure that users' demands are met. Factors that could achieve this include:

- membership by non-banks
- representation of users and consumers
- wider objectives to facilitate responsiveness to demands of users, potential users and market needs
- the appointment of independent directors, and
- transparency of a scheme's rules, aims and strategy.

3.25 Chapter 5 below looks at the extent to which more open access to the BACS scheme and a wider governance structure would be beneficial to BPSL and its users.

## **4 BACS ACCESS AND BPSL GOVERNANCE CURRENT POSITION**

### **Introduction**

4.1 This chapter sets out the current position regarding access to and governance of BACS Payment Schemes Limited. It does not cover the position of operational access for 100,000 business users to the infrastructure operated for BPSL by Voca.

### **BPSL's payments**

4.2 A payment handled by BPSL has a number of features that together distinguish it from other payment types:

- a BPSL payment is an electronic message
- the purpose of the message is that a defined value is transferred from one defined account to another defined account
- the format of the message and the arrangements for its handling are defined by BPSL standards
- the value within the message is transferred between the sending and receiving BPSL members by transferring the value between the settlement accounts which those two members have at the Bank of England
- accounts to be debited or credited do not need to be held at a BPSL member bank. BPSL members provide access to non members through agency arrangements
- payments do not have to be submitted to Voca through a BPSL member. Some 100,000 authorised companies are able to send payment data either directly to Voca, or via an accredited computer bureau.

## Membership of BPSL

4.3 Each member of BPSL is required to meet defined minimum criteria on a continuous basis:

- to have an account at the Bank of England for settling BPSL transactions<sup>19</sup>
- to be based within the European Economic Area (though BPSL's main focus is payments in £ sterling, a restriction to being based in the United Kingdom is not justifiable under European law)
- to meet the BACS scheme's technical and operational requirements (this is essential, so that the integrity and efficiency of the system can be sustained)
- to be a bank or building society (that is, a credit institution). This means that all BPSL members have the credit standing and the liquidity available to ensure timely settlement of transactions, and of any other obligations arising from BPSL business, and that they are strictly and effectively regulated to ensure this
- to comply with BPSL's rules and to sign the documents that enforce this, to ensure that the integrity of the BACS scheme can be upheld and that all those involved have a clear understanding of their obligations, and

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<sup>19</sup> In common with a number of other United Kingdom payment schemes (CHAPS, Cheque & Credit, LINK), the BACS Payment Schemes are settled across the books of the Bank of England. This is in compliance with the BIS Core Principles for Systemically Important Payment Systems - Core Principle VI states that 'assets used for settlement should preferably be a claim on the central bank'. The Bank of England has published its policy on the granting of settlements accounts, available at: [www.bankofengland.co.uk/financialstability/paymentssettlementsystems/pdf/boesettleaccs021128.pdf](http://www.bankofengland.co.uk/financialstability/paymentssettlementsystems/pdf/boesettleaccs021128.pdf)

- to pay a fair share of BPSL's costs - BPSL is a self-financing, not-for-profit organisation and receives no grants or subsidies.

4.4 Other obligations are set out in rules and supporting documents. For example, a new member from outside the United Kingdom would provide a legal opinion that there was, in its home country, no legislation that would have an impact on its ability to comply with BPSL rules. BPSL members also provide forecasts of volumes to assist with capacity planning.

4.5 In recent years there have been some changes to the criteria for the BACS scheme: BPSL members no longer have to own a part of the infrastructure that BPSL uses; nor do they have to be members of APACS; nor do they have to handle a minimum volume of payments.

### **Current governance of BPSL**

4.6 BPSL is a company incorporated under English law and is subject to English company law. Its memorandum and articles of association define how the company is operated, and its annual report is filed with Companies House. BPSL describes itself in some detail on its website ([www.bacs.co.uk](http://www.bacs.co.uk)) but does not issue a printed annual report: it believes that everybody with any interest in using BACS will have access to the internet. There is some coverage of BPSL in the APACS publication '*The UK Payments Industry – A Review of 2004*'.

4.7 BPSL is a company limited by guarantee and directed by its Board of directors. BPSL has set a limit of 20 on the number of directors to be appointed directly by members, although currently only twelve members have appointed a director to the Board.<sup>20</sup> Though the members appoint the directors, the directors are required, under company law, to promote the interests of BPSL, not of the member that appointed them.

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<sup>20</sup> Generally each member has the right to appoint a director, except where members come from within the same group of companies. Currently the Royal Bank of Scotland, National Westminster Bank and Coutts & Company are members of BPSL, but, as they are all from the same corporate group, a single director is nominated by them.

- 4.8 The Board comprises the directors appointed by the members and the BPSL Managing Director, that is, one executive director and 12 non-executive directors. The Chairman is selected by the directors from one of the members but is neither appointed by, nor represents, that member. Any of the members could provide an individual to be the BPSL Chairman. There is no fixed rota, nor is it linked to volumes of BPSL traffic.
- 4.9 Decision-taking at the BPSL Board is often by consensus but when a vote is taken, the number of votes that a director can cast reflects the number of BPSL payments handled by the member<sup>21</sup> that appointed that director.<sup>22</sup> For most resolutions to be passed, not less than 75 per cent of eligible votes are to be in favour (the votes of an individual director are capped at 22.5 per cent, so it is not possible for a single director to prevent a resolution from being passed). The BPSL Managing Director has a single vote; the Chairman has no vote. The BPSL Board frequently addresses matters of commercial sensitivity and of importance to the security of the BACS scheme, so its minutes are circulated only to members; they are not published (though the Bank of England, as Overseer, may see any documentation it requires).
- 4.10 The Board has set up committees reporting to it to attend to specialist matters. Decisions outside of a committee's remit are recommended to the Board for a decision. The deliberations of these committees are managed as matters within BPSL:
- the Audit and Risk Committee reports to the Board and comprises nominated Board directors

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<sup>21</sup> Or group of members.

<sup>22</sup> 1001 votes can be cast at a BPSL Board meeting.

- a Disciplinary Committee and an Appeals Committee have been provided for, but neither has yet needed to meet. A Chairman has been appointed for each of them, but not the other committee members
- the Rules Committee is open to representatives from each member (or corporate group)
- the Member Programme Steering Committee oversees the implementation of NewBACS from a BPSL perspective. Normally representatives from Voca attend for any relevant part of a meeting, and
- the Operations and Development Committee has representatives from each member (or corporate group). Decisions within its remit and its budget are decided by consensus or, if necessary, by voting. Wider issues would be referred to the Board for determination.

4.11 As well as the Security Committee, two committees, on which all<sup>23</sup> members are represented, report to the Operations and Development Committee:

- the Direct Debit Scheme Steering Group, and
- the Direct Credit Scheme Steering Group.

4.12 BPSL invites interested persons to attend meetings of committees when there is advantage in their doing so. There is no fixed list of consultees but a pragmatic approach is used, according to circumstances, as seen in two contrasting examples:

- there have been some significant changes regarding the underpinning of the Bank of England settlement mechanisms involving the adoption of new procedures for posting collateral. Although the organisations affected were consulted, in practice this was limited to

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<sup>23</sup> Although members from the same corporate group send only a single representative.

the BPSL members, the Bank of England as Settlement Agent, and the Cheque & Credit Clearing Company (which was using the same approach to collateralisation), and

- the on-going programme regarding the installation of BACSTEL-IP<sup>24</sup> will impact on all those who input directly to Voca. Members put considerable effort into ensuring that the programme took careful account of customers while not unduly jeopardising the commercial ties of the bank-customer relationship, and software providers participated in several meetings regarding BACSTEL-IP.

4.13 In the course of its work, BPSL outlined a proposal to the Working Group for an Affiliate member category, which has now been established. An Affiliates Interest Group (AIG) has been formed, on which only Affiliates are represented. Affiliates are entitled to raise questions to put before the Board, but the AIG is not accountable to the Board, nor is it directed by the Board.

## **Relationship with APACS**

4.14 APACS is the United Kingdom payments association, a trade association of institutions delivering payment services to end customers. It provides a forum to address co-operative aspects of payment services and other payment-related developments. All payment types are within the scope of APACS but it maintains a pan-scheme focus to avoid duplication with scheme-specific activities. All BPSL members are currently also APACS members, although this is by choice - APACS membership is not a requirement of BPSL membership. Not all APACS members are BPSL members.

4.15 Generally the relationship between APACS and BPSL is at arm's length. APACS has no power to direct BPSL's business or plans, and vice versa. APACS has no power of appointment over BPSL's directors, nor over

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<sup>24</sup> BACSTEL-IP is a recently introduced secure system for submitting payment data which was rolled out to all business users and bureaux during 2005.

admission to BPSL membership (nor expulsion from BPSL membership). APACS has no power to audit or inspect BPSL, whether from a financial, operational, technical, risk or security aspect.

4.16 However APACS and BPSL have informal links, mostly for mutual information exchange. The relationship can be summarised as:

- APACS provides information and advice to BPSL. For example, the APACS Chief Executive attends the BPSL Board in a non-voting capacity
- APACS has granted BPSL permission to use some of the APACS brands, and
- BPSL may provide information and advice to APACS for the collective benefit of their mutual members, and contribute to APACS debates on payments industry strategy, risk management, trends in the market etc.

4.17 BPSL does not make any annual report to APACS but BPSL does address some specific projects with APACS. For example:

- the APACS Council is initiating a strategic planning process for the payments industry. This work is being shared with BPSL to provide a strategic context for its own planning activities
- BPSL is invited to participate in some APACS groups and projects, or to use information and guidelines developed by APACS, where this is of mutual benefit, and
- the work to control and reduce settlement risk, where many of the BPSL issues are similar to those at Cheque & Credit Clearing Company (C&CCC), and APACS has, to date, taken the lead in managing this project for both schemes.

4.18 BPSL does engage in aspects of the consultations regarding the development of a potential Pan-European Direct Debit, and other issues arising from the move to establish a SEPA. Apart from this, and from consulting C&CCC on some settlement issues, BPSL does not generally engage in routine discussions with other payments bodies.

### **BPSL's influence over non-members**

4.19 BPSL's members provide access to the BACS Scheme to many hundreds of banks and building societies and many thousands of other businesses. These commercial relationships are regulated, in part, by BPSL rules, to assure the integrity of the BPSL scheme. Each member is responsible for ensuring that the relevant parts of the BPSL rules are known to its customers; any change in rules that impacts on customers must be drawn to their attention.

4.20 While the general principle is that the member involved is the one with responsibility for keeping its customers aware of the rules, and of any changes, there are pragmatic alternatives in place to handle specific situations. For example, customers inputting direct to the central infrastructure (owned by Voca) have access to a helpdesk at BACS. The migration to BACSTEL-IP involved a range of direct and indirect communications with customers, ranging from advertisements in the IT press to alert them to the importance of the changeover, to direct mailshots on specific matters. Any query regarding enforcement of BPSL rules is handled in the first instance by a BPSL member and – if necessary – later by BPSL's enforcement procedures.

### **Non-members' influence over BPSL**

4.21 Each member is empowered to take up with BPSL and/or other members any issues raised by its customers, seeking amelioration or redress through the usual BPSL channels. In addition, non-members are occasionally invited to contribute to specific aspects of BPSL's work.

## 5 RECOMMENDED CHANGES

- 5.1 Chapter 3 above noted that intense competition between providers will generally cause consumers of a service to be served well. A number of concerns about the intensity of competition between payment schemes, as identified in the Cruickshank and OFT reports, mean that market forces may be insufficient to ensure that users are served as well as they could be. This has led to efforts to increase competition in these markets (through, for example, easing access conditions to payment schemes or separating the scheme from the infrastructure). In some countries, it has led to increased regulation (see, for example, the powers of regulators in Canada and Australia, noted in paragraphs 3.16 to 3.20 above). Another way of ensuring that users are well served by payment systems is by ensuring that their views are heard and taken on board by those that operate the scheme.
- 5.2 The Working Group has made three key recommendations, and identified a number of other areas where further work may be required. The recommendations in this chapter aim to extend the representation of users in BPSL. These recommendations should be read in the context of:
- recent changes that have been made to the access and governance arrangements of BPSL (see Chapter 4 above on the separation of the scheme and the infrastructure and independence of BPSL from APACS)
  - the possibility of introducing BPSL Clearing Membership and membership by government departments (discussed later in this chapter)
  - the analysis of competition in the market that was undertaken by the OFT, and which concluded that there appeared to be intense competition between BPSL members to provide services to banks and to non-financial institutions that were not members of BPSL. That analysis also noted that most competition in payments did not take place at the scheme level, but rather at the level of the banks, where it was likely to be intense

- the expected development of a SEPA and the fundamental impact this may have on payment schemes in the United Kingdom
- the likely finalisation of the Payment Services Directive, and
- the critical importance to the United Kingdom economy of maintaining the robustness and integrity of the payment schemes managed by BPSL.

5.3 Taking the findings of Cruickshank as its start, the Working Group examined aspects of BPSL's access and governance arrangements which appeared to give rise to concerns and has made recommendations for change only where it found room for improvement. Where further consideration is required, the Working Group has flagged issues to be revisited.

5.4 This chapter summarises the discussion of the Working Group, and concentrates on the key areas where change is recommended. A fuller explanation of the research carried out, and the reasoning behind the Working Group's recommendations, is in Annexe D.

## **Key recommended changes**

### **Affiliate Interest Group**

5.5 The first key recommendation addresses the issue of greater representation for users of BACS.

5.6 The Working Group endorses the introduction of the AIG to address many of the user representation and transparency concerns raised. The AIG is seen as a forum for discussion of pertinent topics. BPSL will use it to brief Affiliates on current and future developments. In addition, each Affiliate may recommend items for discussion and the AIG can request BPSL to provide briefings on topics which are not commercially sensitive (topics barred for reasons of commercial sensitivity would include, for example, the terms of business of BPSL members, and other matters which are purely competitive).

- 5.7 The AIG is also able to raise an issue with the BPSL Board; if it does so, it will receive a report on the BPSL Board's consideration of the matter. The Chair of the AIG (elected by the Affiliates) or their representative will be invited to attend appropriate meetings (or appropriate parts of meetings, if sensitive issues are to be discussed) of the Direct Debit Steering Group and the Direct Credit Steering Group.
- 5.8 The AIG will have access to the minutes of the BPSL Board, subject to prior deletion by BPSL of any commercially sensitive information, or issues of security. Information which may have an anti-competitive effect will not be made available. Principally this would mean, for example, that information about prices charged to, or charged by, Affiliates will not be supplied or supported by BPSL. It is also probable that certain information regarding integrity, security or disciplinary aspects will be limited to a need-to-know basis. Following discussion at the Working Group, it is recommended that Affiliates should be able to see the minutes of BPSL Board meetings, although for reasons of security or commercial confidentiality, some parts of the minutes may be deleted or blanked out.
- 5.9 Additionally, the BPSL Board will provide Affiliates with a comprehensive summary of Board meetings. It is thought that a summary of the Board meetings will provide additional context to the minutes. This could be complemented with a detailed response from the Board on specific issues that the AIG has raised.
- 5.10 A number of attendees at the Heavy User Forum expressed interest in becoming Affiliates, subject to finding out more about the extent of information that was available, and the potential costs involved. Some have already signed up as Affiliates.

### **Consultation process**

- 5.11 The Working Group considered ways to ensure that the different (and sometimes competing) interests of diverse stakeholder groups could be given appropriate weighting for their respective needs. There appear to be five categories of user of the BACS system:

- the BPSL Settlement members who provide BACS payment services to their customers and to agency banks. The 14 settlement members account for the vast majority of BACS traffic
- heavy users, such as big corporations or public bodies that make or receive large volumes of direct debit and direct credit payments
- agency banks that offer payment services to their customers but who settle through a settlement member bank
- light users such as SMEs that submit only small volumes of payments through the system, and
- individual customers of banks who make or receive payments through the BACS system.

5.12 Of these categories, it is likely that some heavy users and agency banks will have the expertise and the desire to contribute to a wide range of issues to be discussed by the Affiliates. It is less likely that representatives of consumers and light users will have either the desire or the ability to contribute to that extent. Therefore a mechanism is necessary to ensure that the views of Affiliates do not give a distorted picture.

5.13 In Canada, the Canadian Payments Association addresses the issue of stakeholder representation by assigning a certain number of seats on its Stakeholder Advisory Council to different groups. Following this approach would, however, mean limiting the number of interested parties that could become Affiliates, which would be contrary to BPSL's proposal to accept as many Affiliates as want to join. In addition, bodies that represent consumers and small businesses have said that they have limited resources to participate.

5.14 The Working Group therefore recommends that a form of targeted consultation is put in place to ensure that the views of consumers, small businesses and other groups are considered when decisions are being contemplated which are likely to affect these groups materially. The Working Group suggests that proposals made by Affiliates or BPSL be

sent to relevant consumer, business and other groups who have declared an interest, with a specified time for comments. If proposals are controversial, the bodies may then wish to join the debate.

- 5.15 The recommendation on consultation will deal with those issues which are specific to BPSL and which BPSL feels would interest consumer or business representatives. However, these representatives have also indicated that it would be helpful to have a forum, meeting occasionally, to facilitate consultation on high-level payment issues across the different payment schemes. This would not require significant resources from those representative groups. Such a forum would allow the industry to engage with stakeholders that have an interest in payment systems issues, but not a great deal of specialist knowledge on specific payment schemes.
- 5.16 The Working Group does not consider itself competent to decide on the appropriate structure of this forum: rather, it recommends that APACS meet with the appropriate stakeholders to design a forum which would be of mutual benefit. The Payment System Task Force is currently considering proposals put forward by APACS which will, among other things, be covering wider stakeholder consultation.

### **BPSL's objectives**

- 5.17 A system such as BACS has a number of similarities to a utility, in that it faces little direct competition, has widespread use, and is essential to the United Kingdom economy. Cruickshank was concerned that, due to the mutual and common ownership of payment systems and the network effects in the market, payment systems did not have the same incentives to react to customer demands as would be expected in a normal market, potentially leading to a lack of innovation.
- 5.18 The Working Group considered whether BPSL should have broader objectives than those described in Chapter 4. There are examples of this from some of the cross-scheme comparisons undertaken by the Working Group. The Canadian Payments Act identifies public policy objectives for

the CPA: promoting the efficiency, safety and soundness of the clearing and settlement systems and taking into account the interests of users.<sup>25</sup> This is supported by the consultation process used by the CPA on potential rule changes discussed above.

- 5.19 Euroclear, a provider of settlement services in equities and fixed income securities, explicitly states that it aims to set new standards for customer-focussed corporate governance.<sup>26</sup> Its Statement of Principles sets out how it will provide a wide range of customer focused services, while being committed to strong user ownership and governance and operating for the benefit of its customers. More specifically, Euroclear has stated that market consultation and validation will be used extensively as a standard approach to defining investment priorities and that it is determined to be responsive to the needs and interests of all its customers, large and small.
- 5.20 Euroclear has established a Market Advisory Committee (MAC) in each of the markets in which it operates, consisting of Euroclear users. These MACs have been given a formal status under the Articles of Euroclear Bank with defined rights and responsibilities. The MACs are seen as a primary source of feedback and interaction between Euroclear and the user community. The MAC has the right to address directly the Chairman and the Board if it is considered necessary to do so. The MACs also monitor compliance by Euroclear with its Statement of Principles. Each MAC has the power to publish an annual report on compliance. This power has been exercised twice by the United Kingdom MAC.<sup>27</sup>

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<sup>25</sup> Canadian Payments Act 5(2).

<sup>26</sup> *Delivering a Domestic Market for Europe*, July 2002.

<sup>27</sup> *UK Market Advisory Committee Second Annual Report*, September 2004.

- 5.21 The Working Group discussed some of the issues that could be included in BPSL's broader objective. The broader objectives would be particularly valuable when considered in conjunction with the AIG and increased transparency.
- 5.22 The Working Group considered that broader objectives for BPSL, which would cover innovation, efficiency, risk mitigation and meeting users' needs, were desirable. The objectives could require BPSL proactively to assess demand for innovations from stakeholders (perhaps through the AIG) and to report back to Affiliates on practicalities. As stated above, these objectives could be publicised and progress against them reported upon by the BPSL Board and, if they felt it appropriate and feasible to do so, by the AIG itself.
- 5.23 The Working Group therefore recommends that the objectives of BPSL should include the following:

'BPSL will promote efficiency and innovation in payments, responding to user and market needs in an efficient and cost-effective manner.'

The Working Group also recommends that BPSL's aims, objectives and strategies should be published in its annual report, together with progress against these aims. Such transparent objectives would lead to clear and robust decision making by the BPSL Board.

## **Other issues considered**

### **Corporate governance**

- 5.24 The Working Group considered to what extent BPSL should conform to governance best practice guidelines, in particular the case for independent directors on the BPSL Board. Currently BPSL does not have any independent directors in the sense that its directors are non-executive and appointed by the BPSL members, except for one executive director from the BPSL Company.

- 5.25 BPSL Board members have a fiduciary duty to act in the interests of the company and not the institution that employs them. It could be argued that a potential conflict of interest would arise between the interests of the scheme and the interests of a particular member in the event that the scheme should consider moving into services provided by some of its Members. The working group considered whether the appointment of an independent director would help to alleviate such a conflict from occurring.
- 5.26 In considering this issue it is first important to define what the term independent director means in the context of payment schemes and how the *UK Combined Code on Corporate Governance* might be applied. While specifically aimed at public listed companies, the Code sets out standards of good practice in relation to corporate governance more generally. It is the decision of a company to decide how to interpret these guidelines. They may either comply or explain their different approach. Scheme companies are not public listed companies, rather they are special purpose companies that are in effect system user groups that have been incorporated.
- 5.27 In the case of BPSL, an independent director is not seen to represent the BPSL members. Rather the key benefits of appointing independent directors could be to bring a wider perspective and specific expertise to the Board. The appointment of independent directors is supported by the Bank of England<sup>28</sup> who consider that this would place BPSL in greater observance of the CPSS Core Principles requirements (see paragraph 3.13), which calls for payment systems to have effective, accountable and transparent governance arrangements.
- 5.28 In the light of these points, the Working Group originally recommended, first, that the case for appointing independent directors should be deferred until the recommendations concerning wider stakeholder consultation and the affiliate proposition had been fully implemented; and, secondly, that BPSL should report back to the Task Force within 12

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<sup>28</sup> See Bank of England (2005) *Payment Systems Oversight Report 2004*.

months on the progress made following publication of this report. The Bank of England, as an observer, remained in favour of the appointment of independent directors from the outset, however, and believed that the issue required more urgent consideration. The Payment Systems Task Force is, however, currently considering proposals put forward by APACS which would, if implemented, have a significant effect on the governance arrangements of a number of payment schemes, including BPSL. These proposals could potentially have the effect of superseding the proposals put forward in this report. The deliberations of this Working Group have contributed to that process.

### **Transaction weighted voting**

- 5.29 As noted in Chapter 4 above, BPSL often makes decisions by consensus. If a vote were necessary, and so as to ensure that those members with the most to lose from 'wrong' decisions get a greater say in the running of the scheme (and to encourage prudent decision making by the Board), the weight of a Board member's vote is proportional to the amount of business the bank puts through BACS. As also noted in Chapter 4, BPSL guards against one member being able to block the will of all the other Board members by capping voting shares of any one member at 22.5 per cent (a 75 per cent majority is required for a motion to succeed). It is not clear, however, that this form of 'transaction-weighted' voting is strictly necessary when the Board directors consider only the interests of the BPSL company and not the BPSL member institutions by which they are employed.
- 5.30 Instead of transaction weighted voting, a system employing a single vote per Board member could be introduced. This system is used in Canada, where it allows a balance between banking members and other members of the Board. If independent board members were introduced to the BPSL Board, it may be appropriate to consider also introducing such a voting system.

- 5.31 As well as removing the need to decide the weight to be attributed to independent directors, the 'one member, one vote' system would give each Board member an equal say in the running of the scheme. This may be seen to be more consistent with each Board member representing the best interests of the scheme.
- 5.32 The Working Group has concluded, and recommends, that the issue of voting shares and the linked pro-rated financial contribution required to meet BPSL costs should be re-considered if or when the Board structure is changed.

## **Transparency**

- 5.33 The Working Group concluded that BPSL would benefit from some increased transparency of its decision making. The Working Group agreed that:
- Affiliates would have access to the minutes of the BPSL Board, subject to prior deletion by BPSL of any commercially sensitive information, or issues of security, and
  - BPSL should report on its progress against its aims and objectives taking account of the views of Affiliates and wider consultees.

The Affiliates may also wish to produce their own independent report with their assessment of BPSL's progress, if they consider it appropriate and feasible to do so.

## **Access to settlement membership for non-financial institutions**

- 5.34 The potential benefits to membership would include access to the wholesale tariff, membership of the Board, and better provision of information. It may also lead to greater competition, if non-financial institutions were able to offer enhanced services through their membership of BACS. The existence of clearing membership may also intensify competition for providing payment services to non-financial institutions as these could choose, alternatively, to become clearing members, taking a number of services in-house. There would be

potentially significant costs to clearing membership. Furthermore, a clearing member would still have to settle through a settlement member. It would also have to put procedures in place to deal with the underwriting of the direct debit guarantee by a settlement member.

- 5.35 The OFT arranged a forum for corporates and banks who clear large volumes (heavy users), where clearing membership was introduced as a concept. Heavy users interested in the concept were then asked to attend a follow up meeting with BPSL. Although the forum was well attended, there was little interest among attendees in becoming clearing members at this stage. The Working Group considers that clearing membership should remain an option, but should be considered further only if there is firm interest shown in it in the future. The Working Group therefore recommends that the AIG should provide a mechanism under which it can check periodically whether there is any such renewed interest. At the same time, the AIG should be briefed on the membership and access provisions within the draft Payment Services Directive, and be invited to comment on them.

### **Access to settlement membership by government departments**

- 5.36 Cruickshank called on the government to play a more active role in payment systems, by becoming a more intelligent consumer of payment services. Certain government departments have sufficient liquidity and public trust to allow them to meet any settlement or other risk they would introduce if they were to become full settlement members of BPSL.
- 5.37 BPSL brought forward proposals to allow government departments to become full settlement members of the scheme, subject to complying with all the rules. There is, however, currently only limited interest in the proposals from government departments, so, as with the proposals for clearing membership, the issue could be considered by the AIG for renewed interest.

## Other barriers to entry

5.38 Cruickshank listed a number of other potential barriers to access to payment schemes. These included the scheme rules, and the requirement to hold an account at the Bank of England. The Working Group found that neither of these was a concern; the Bank of England has said that where it 'has decided to act as a settlement agent [for a payment system], it will normally be prepared to open settlement accounts for all members of that system'.<sup>29</sup> There was no evidence that the other scheme rules appear to cause any significant or unreasonable barriers to entry.

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<sup>29</sup> *Bank of England Settlement Accounts: A Policy Document (November 2002) para 2.*

## 6 NEXT STEPS

- 6.1 When this report has been published by the Task Force together with its recommendations, BPSL and the banking industry will instigate changes to meet the three key recommendations which follow. The Working Group recommends that BPSL, in consultation with stakeholders, should report to the Task Force, no later than twelve months from the date this report is adopted by the Task Force, with a review of these changes and an evaluation of the other issues considered in this report and summarised below.

### Implementation of the three key recommendations

- 6.2 The three key recommendations are:

- first, BPSL to maintain the AIG. The key features of the AIG include an open and transparent membership process and a two-way mechanism for communicating with BPSL. In considering the detail of the AIG proposal and in evaluating the changes enacted, BPSL and the Task Force, respectively, will wish to take into account:
  - membership should be open to all interested BACS users
  - the AIG should have access to relevant information (for example, access to BPSL Board minutes), subject to competitive and commercial considerations
  - the AIG should be able to raise issues of concern with BPSL and create a two-way communication channel, and
  - to provide transparency of decision making, BPSL should communicate clearly to the AIG how AIG suggestions are being dealt with. The AIG may wish to report on how it feels BPSL is meeting its objectives and users' needs
- secondly, BPSL should adopt a broader objective. The Working Group recommends that this should at least include the following:

'BPSL will promote efficiency and innovation in payments, responding to user and market needs in an efficient and cost-effective manner', and

- thirdly BPSL will consider how to consult with those interested parties that are unlikely to see sufficient value in becoming Affiliates.

6.3 For the mechanisms for incorporating the views of non-AIG stakeholders, such as consumer and business groups, the requirements are likely to include ways for ensuring such views are sought out and considered by BPSL and the Affiliates. It should also include a way of ensuring feedback is given to those consulted.

### **Reporting to the Task Force**

6.4 BPSL will report back to the Task Force within 12 months of the date this report is adopted by the Task Force on developments with the AIG, its consultation process and how it has met its objectives. BPSL will also report to the Task Force on any developments that may have taken place in relation to other issues considered in this report, including whether there is demand for non-financial institutions and government departments to be able to become full settlement members. The Working Group concluded that that issue should remain in abeyance for the time being, at least until the AIG has had the opportunity to consider them or there appears to be firm interest in developing new membership classes. The recommendation relating to the possibility of appointing independent directors to the BPSL Board is also being held in abeyance while the discussions referred to in paragraph 5.28 above continue.

6.5 BPSL's report to the Task Force should:

- include the views of the AIG, banking industry and the other stakeholders (consumer and business associations) where appropriate
- detail the changes introduced in response to the three key recommendations and assess their impact and effectiveness

- discuss each of the other issues considered in this report, highlighting any further evaluation or developments
- report on which issues require more time for their impact to be assessed
- detail any future work that will be done and the timetable for reporting back to the Task Force on this work, and
- if necessary, make recommendations for any Task Force action required.

6.6 The Working Group offers one further general conclusion. The spirit of cooperation, genuine consultation and listening to the views of users is often more important, and more mutually beneficial to all stakeholders, than the specific recommendations of mechanisms to encourage better governance. The Working Group recommends that the Task Force should, in considering BPSL's report in due course, bear in mind the spirit of co-operation from BPSL and its behaviour in this respect.

6.7 It is worth noting here that governance best practice has been, and is, an evolving area. Any governance arrangements instituted should not therefore be expected to be definitive, and should be updated and revisited from time to time.

# ANNEXES

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## A MEMBERSHIP OF THE WORKING GROUP

Office of Fair Trading (Chair)

Association for Payment Clearing Services

Association of Corporate Treasurers

BACS Payment Schemes Limited

Barclays Bank

British Bankers' Association

British Retail Consortium

BT

Cheque and Credit Clearing Company

HBOS

HSBC

JP Morgan

Lloyds TSB

MBNA Bank

Nationwide Building Society

The Royal Bank of Scotland Group

Which? (formerly Consumers' Association)

Bank of England (sitting as observers)

HM Treasury (sitting as observers)

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# PAYMENT SYSTEMS TASK FORCE

Paper 01/04

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### WORKING GROUPS: structure and operations

1. The OFT expects that the Task Force will meet no more frequently than every quarter, avoiding July and August. The frequency must, of course, remain subject to review in the light of experience: if it becomes clear that there is a need for more frequent meetings and that members are able to commit more time to such meetings, then, with the Task Force's agreement, we will increase the frequency accordingly.
2. The terms of reference of the Task Force contain provision for the Task Force to 'establish and direct' working groups to carry out detailed work on particular subjects between formal Task Force meetings. We envisage, subject to discussion within the Task Force, that a subsidiary 'working group' will be set up for each workstream the Task Force considers. Membership of the working groups would consist of Task Force members, but the working group should, we believe, be able to co-opt members from outside the Task Force who may have particular expertise or knowledge relevant to the work in hand.
3. We believe that, for logistical reasons, each working group should be chaired by an OFT official from the Payment Systems team. The groups would meet as often as resources and other commitments permitted, consistent with achieving the aims of the working group, and will clearly vary from group to group. It is likely that some work outside of the meetings of working groups will also be needed from time to time. It is therefore difficult to say in advance what level of commitment may be asked of members of each working group. The working group should report back to every Task Force meeting.

4. The Task Force will wish to consider whether formal terms of reference should, or could, be set for the working groups, including reference to membership and frequency of meetings.

5. Draft terms of reference are annexed to this paper.

Payment Systems Team

OFT

16 April 2004

## Annexe

1. A working group may be established at any time by the Task Force to undertake such detailed work into any issue relating to payment systems as the Task Force may direct, and within such time limit as the Task Force may direct.
2. Membership of a working group shall be taken initially from among Task Force members. Working groups shall have the right to co-opt other members from outside the Task Force. The working group shall be chaired by an OFT official from the Payment Systems team.
3. Working groups shall meet as often as is deemed necessary by the Chairperson and members of the working group to achieve the work allotted to it by the Task Force within any time constraints imposed by the Task Force.
4. Working groups shall report to the Task Force in such manner as the Task Force may direct, or, in the absence of any such direction, in such a manner as the working group shall itself consider appropriate.
5. A consensus of opinion will not necessarily be reached by a working group on any/all issues. Working group members shall have the right to report a diverging view to the Task Force. Working group members shall be named in any minutes or reports only with the permission of the participant.
6. The Chairperson of a working group shall provide, on the request of the Chairman of the Task Force, a report of the work of the working group for inclusion in the Task Force's annual report.
7. The work of a working group will not affect or impede existing or future enforcement activity undertaken by the OFT's enforcement divisions in this sector.

## **C LIST OF BACS OPERATIONAL DOCUMENTS**

### **Technical Standards and Messaging**

- APACS Service Definition
- APACS Standard 10: Standard Procedure for handling claims for unpaid cheques through BACS
- APACS Standard 18: BACS Interchange Standards
- BACS Security Code of Conduct
- Messaging Originator's Guide
- Messaging Submission Guide
- CSG Procedures Manual
- DDO Service Definition

### **Operations**

- How to Ensure Your Payments are Applied Correctly
- Industry Procedures for the Reversal of Erroneous Credits via BACS
- Crediting and Debiting Building Society Guide
- BACS User Manual - Telecommunication Link Transmission Specification
- BACS High Speed Transmission Service User Guide
- BACS High Speed Transmission Code of Conduct
- The EFT Service – A best practice guide for trouble free processing

### **BACSTEL-IP**

- BACSTEL-IP Rules
- Service User Guide – BACSTEL-IP
- Trust Service Code of Conduct

## **Direct Debit Rules & Guidelines**

- The Member Rules of the Direct Debiting Scheme
- The Originator's Guide and Rules to the Direct Debit Scheme
- The Paying Banks Guide and Rules to the Direct Debit Scheme
- Direct Debit Sub-Scheme Rules
- AUDDIS Service Definition
- AUDDIS – A migration guide
- APACS Standard 39: Automated Return of Unpaid Direct Debits

## **Direct Credit/ Standing Order Guidelines**

- Direct Credit Best Practice Guidelines
- APACS Standard 14: Guidelines for the Content of Standing Order Mandates
- APACS Standard 36: Automated Recall of Standing Orders and Direct Credit Payments
- APACS Standard 37: Recall of BACS Direct Credits and Manual Recall of Standing Orders
- APACS Standard 44: Bank-to-Bank Credit Payments via BACS
- APACS Standard 45: Automated Return of Unapplied Credits Service (ARUCS)
- APACS Standard 54: Standing Order File Amendment Facility (Member Procedures)
- Guide to Standing Order File Amendment (SOFA) Database

## **The BACS Remit service**

- Remit Domestic Service Definition and Message Processing Guidelines
- Extended Formats Service - Member User Guide
- Remit International Service - Member User Guide

## D EXTENDED DISCUSSION OF CHANGES CONSIDERED

D.1 This annexe shows a number of potential changes to the access and governance arrangements of BPSL that were considered by the Working Group, discusses the issue the potential changes seek to address, outlines the positives and negatives of each potential change and concludes whether any changes are desirable. It covers:

Research Undertaken

Governance and representation:

- independent directors
- transaction weighted voting
- transparency
- BPSL's objectives
- Affiliate proposal
- advisory bodies in Canada, Australia and in Euroclear
- consultation
- recommendations on governance and representation

Access:

- restricting settlement membership to credit institutions
- clearing membership
- settlement membership by government departments

## Research undertaken

- D.2 Research undertaken by the Working Group into these potential changes has taken three distinct forms. First, 'heavy users' of the BACS system, such as large corporates, banks which are not currently members of BACS and government departments, were asked whether greater access to the BACS scheme would be of benefit to them. This was done through a questionnaire, a forum, and subsequently a meeting with BPSL.
- D.3 Secondly, OFT and APACS jointly undertook a series of meetings and telephone conferences with four diverse entities to see what solutions to access and governance issues were in place elsewhere. These were the Canadian Payments Association (CPA), the Australian Payments Clearing Association (APCA), the United Kingdom's national ATM network LINK, and Euroclear, a clearance and settlement system for internationally traded securities (of which CREST, the United Kingdom's securities settlement system, is a subsidiary). For each entity a list of access and governance issues (grouped under the headings of Governance, Access, Representation and Transparency) were put together to build up an understanding and insight as to how these issues have been tackled. All four had recently examined their governance structures and access arrangements. Although comparing governance arrangements offers some interesting insight and lessons as to how these issues have been tackled, it is not necessarily the case that they can be directly translated to the United Kingdom market.
- D.4 Thirdly, existing published research into corporate governance issues was examined and, where relevant, included in the Working Group's deliberations.

## Governance and representation

### Independent directors

- D.5 One of Cruickshank's key concerns was that the boards of payment systems such as BPSL consisted entirely of banks and building societies, with no board representation from any other type of organisation. Cruickshank believed that having a wider variety of interests represented would lead to more innovation in payment systems, and a greater understanding of other stakeholders' needs. Additionally, the *UK Combined Code on Corporate Governance* sets out the standards of good practice in relation to corporate governance.<sup>30</sup> These guidelines advocate the use of independent board directors among other good corporate governance principles. It is the decision of a company to decide how to interpret these guidelines. They may either comply or explain their different approach. The Working Group therefore considered whether BPSL and its stakeholders would, in its view, benefit from having independent directors on the BPSL Board.
- D.6 An executive director of BPSL is employed by BPSL, and holds a senior position in that company. Currently BPSL has one executive director, its Managing Director.
- D.7 A non-executive director of BPSL is appointed by the BPSL members. Under United Kingdom company law, these directors have a fiduciary duty to act in the interests of BPSL and not in the interests of the body that has appointed them. There are 12 directors on the BPSL Board, all senior figures in the bank or building society that has appointed them. It could be argued that a potential conflict of interest could arise between the interests of a scheme and the interests of a particular member in the event that the scheme should consider moving into services provided by

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<sup>30</sup> 'The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision making', *The Combined Code on Corporate Governance*, July 2003.

some of its Members. It could also be argued that a potential conflict of interest could arise between two payment schemes, who both had Board members elected by the same bank, in the event that one scheme considered competing more actively with the other. These potential conflicts of interest would be made more acute if a wider BPSL objective, including users of the scheme, were introduced. The Working Group considered whether the appointment of an independent director would help to alleviate such a conflict from occurring.

- D.8 In the case of BPSL there would be no potential conflict of interest between an independent director and BPSL Members. Rather, the key benefits could be to bring a wider perspective and specific expertise to the Board. They are also less likely to have any potential conflicts of interest.
- D.9 The appointment of independent directors is advocated by the Bank of England in its role as an overseer of BACS. This is consistent with the Bank's assessment of BACS against the CPSS Core Principles.
- D.10 The Bank of England, in its *Payment Systems Oversight Report 2005*, assessed BACS against the CPSS Core Principles for Systemically Important Payment Systems. Against Core Principle X, requiring payment systems to have governance arrangements that are 'effective, accountable and transparent', the Bank assessed BACS as being 'broadly observant'. The Bank noted that the introduction of independent directors may help deliver greater observance in the future.
- D.11 The Working Group examined two payment systems that have recently introduced independent directors, and found some positives and negatives to their introduction. Both the Canadian and Australian payment systems have independent directors. The Australian system has introduced an independent Board Chairman. The Canadian system does not have an independent Chairman, but it does have three independent directors.
- D.12 The Australian Payments Clearing Association (APCA) introduced an independent Chairman to meet corporate governance best practice. The chairman is a non-voting director and holds office for two years from the

date of appointment. Previously, the Board had been chaired by the Reserve Bank of Australia. Some felt the introduction of an independent chairman has had a marginal impact on the effective working of the Board, although it had brought a different perspective to the table. Because payment systems can be a specialised area, there are a limited number of people to draw on with the right knowledge and these generally come from the banking industry. The current chair of APCA previously worked in the industry but it was felt that sufficient time had passed to ensure independence.

- D.13 The Canadian Payments Association (CPA) introduced independent directors in 2001 to counter criticism that the make-up of the Board was too narrow. Independent directors must act in the best interests of the CPA (like other CPA Board members), but are thought to provide a wider perspective than banking Board members.
- D.14 Views of participants in the CPA were mixed as to how successful the introduction of independent Board members had been. Some Board members found that their independent colleagues were less able to contribute to discussions knowledgeably, because they were removed from day to day dealings with payment systems. As a result, votes taken by the Board sometimes resulted in abstentions by the independent directors. This must be put in the context that the role of independent directors was still relatively new, and that expertise was still being gained.
- D.15 Other CPA participants were more positive. Some Board members could point to concrete examples of where the independent directors had added value to the decision making of the Board. Two particular examples were given: in one case independent directors were able to put forward the likely concerns of stakeholders to potential innovations so those concerns could be addressed early in the process, and in another instance, an independent legal view sometimes gave a different perspective from that of an 'in-house' legal team. This was found to be very valuable.

- D.16 It was universally agreed that the presence of independent directors added credibility to the CPA, and that the concerns of consumers and businesses were now taken more seriously.
- D.17 On balance, members of the CPA were positive about the introduction of independent directors. It was felt that they added value, although it was stressed that the importance was not in having independent directors, but in having the *appropriate people* as independent directors.
- D.18 The Working Group acknowledge the potential benefits of independent directors, but is of the opinion that alternative mechanisms can be put in place to achieve the aims of effective, accountable and transparent governance arrangements. The rationale for this conclusion is that the mutual governance of the scheme already ensures that all BPSL members are represented on the Board. In addition BPSL has already established the creation of an Affiliates Interest Group so that BPSL can benefit from specific expertise and a broader perspective. The range of expertise to be provided by the Affiliates is potentially wider than an independent director could provide. There is also a recommendation on the need to pursue stakeholder involvement across the payment industry at an APACS level. Input by these mechanisms has the potential to be as effective as formal membership of a Board whose role is largely operational. Further, subsequent, discussion has, however, taken place in the Task Force on this issue, as noted in paragraph 5.28 above.

## **Transparency**

- D.19 Cruickshank was concerned by the apparent lack of transparency in the decision making of payment systems boards.<sup>31</sup> A lack of transparency in the aims, strategies and decisions of a payment systems board may lead to uncertainty among stakeholders. Furthermore, a system may subsequently have to be changed to incorporate stakeholders' views if they were not kept informed about potential changes to the system.

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<sup>31</sup> See, for example, paragraph 3.146 of the Cruickshank report.

- D.20 The Working Group discussed a number of ways in which transparency of BPSL's decision making process could be improved. For example, the Canadian CPA uses a number of mechanisms to ensure transparency of decisions made by its Board. Although Board minutes are not made publicly available, they are made available to the CPA's Stakeholder Advisory Council (SAC). Additionally, one of the CPA's independent directors is currently the chair of the SAC, ensuring a two-way flow of information between the bodies.
- D.21 The CPA also has a well-defined consultation process for changes to its rules. Consultation papers are sent to bodies with a known interest in payment systems, but are also available on the CPA website. There was some support for this level of consultation among the CPA stakeholders. It allowed potential concerns to be aired early on in the consultation process. This ensured that solutions could be found to potential problems before a course of action was decided. Some CPA stakeholders found, however, that the consultation process slowed down decision making, and the implementation of innovations.
- D.22 The Working Group also considered whether the BPSL Board should publish an annual report, including a statement describing the operation of the Board. The number of Board and established committee meetings could be given, together with the attendance of individual directors.
- D.23 The Working Group also recommended the publication of aims, objectives and strategies in the BPSL annual report. The annual report should cover progress against these aims. Such transparent objectives would lead to clear and robust decision making by the BPSL Board. BPSL should also report to the Task Force on its progress in meeting its objectives. Furthermore, the AIG may wish to publish its own independent report, assessing how BPSL had met its objectives and the demands of the AIG.

## **Affiliate proposal**

- D.24 Payment systems such as BPSL may not have the same incentives to respond to users' demands as would be expected in a 'normal' market. For instance, at the BPSL Heavy Users' Forum hosted by the OFT, a number of potential innovations to the BACS scheme were discussed. Such a forum was thought by both BPSL and its users to be beneficial in allowing users' demands to be brought forward. The Working Group considered a number of ways to ensure that users' concerns were taken into account in the future.
- D.25 The Board of BPSL currently consists of the owners of the scheme, which are thirteen banks and one building society. All these bodies are settlement members of BPSL. To expand ownership (and therefore perhaps access to the Board) any interested party would have to become a settlement member of BACS.
- D.26 The Working Group discussed ways of ensuring users' views were heard without those users having to become either owners of the scheme or settlement members. BPSL had briefed the Working Group on its own proposal of an 'affiliate scheme' (subsequently established). The BPSL Affiliate category provides its subscribers with scheme information and new opportunities to influence developments in a number of areas, including scheme rules, service levels and future service enhancements.

## **Advisory bodies in Canada and Australia**

- D.27 In considering the ways in which stakeholders' views could be fed to BPSL, and the mechanisms and processes required to make such communication effective, the Working Group investigated the fora and processes for such communication in Canada and Australia. The arrangements are summarised below.

## Canada – Stakeholder Advisory Council (SAC)

- D.28 In Canada, the purpose of the SAC is described on the CPA's website as being 'to provide counsel and advice to the CPA Board of Directors on payment, clearing and settlement matters, and other related issues. The SAC thus provides input on proposed initiatives, including by-laws, policy statements and rules impacting third parties. It also assists the CPA in identifying any issues of potential concern to payment system users and third-party service providers, and suggesting how they might be addressed'.<sup>32</sup>
- D.29 The SAC is made up of a minimum of 12 members representing payment system users, including at least two representatives of consumers, at least one representative of the retail sector, at least two representatives of government, and at least one representative of the treasury and cash management sector. A minimum of one member represents service providers to the payment system.
- D.30 The Chairman of the SAC has a seat on the CPA's Board. This is not a requirement, although most parties agreed that it had worked well.
- D.31 The SAC provides advice on the whole range of the CPA's activities (not just low-value, high volume payments like BACS). Members of the SAC sit on a number of committees and Working Groups run by the CPA, where they provide user or consumer input.

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<sup>32</sup> [www.cdnpay.ca/about/stakeholder\\_overview.asp](http://www.cdnpay.ca/about/stakeholder_overview.asp)

D.32 The Working Group sought a number of opinions on the SAC from various parties connected to the CPA. Feedback on the SAC was generally very positive. In fact, some Canadian banks felt that stakeholder representation in Canada did not go far enough. It was suggested that rather than have one SAC, there should be one each for specific issues, made up of stakeholders with specific interests in those issues. They would then form part of whatever Working Groups were set up by CPA in those areas. Some stakeholders also considered the SAC effective in addressing stakeholders' interests. Finally, respondents agreed that the SAC gave more credibility to the CPA.

### Australia – Advisory Councils

D.33 The Australians decided not to follow the Canadian example which has high level user involvement across all of the schemes overseen by the CPA. Instead APCA had looked for operational level involvement over three schemes: BECS (equivalent of BACS), debit and paper clearing. It did not seem that there was sufficient interest to establish advisory councils for cash or the high value system.

D.34 Advisory councils were made up of different categories of membership - users, suppliers etc - and APCA had tried to ensure the right balance by getting representation from these categories. Because of the rapidly changing market in debit cards, this is the council which attracted most enthusiasm and membership. BECS and paper are mature markets with fewer developments in them and so less enthusiasm and interest. The Councils for these have suggested real time clearing for BECS and something like Check 21 in the US, where to some extent images of cheques are exchanged in place of paper. However, there has been some frustration in the Councils as these suggestions have not been developed.

- D.35 As a result of these frustrations it had been suggested to the APCA Board that there was a need to reconsider the effectiveness of the advisory Councils. A professionally moderated workshop is planned which will look at whether the model should be altered and how the effectiveness of the Councils can be improved. This workshop may conclude that the current arrangements were in fact operating as best they can (albeit there are frustrations).
- D.36 There can be a problem with keeping up enthusiasm in the BECS advisory council. For example, a strategic workshop on BECS was held and it came up with 12 proposals (including direct entry credit into credit card accounts) but, the Working Group was told, APCA/BECS Board members chose not to take any of them forward.
- D.37 A BECS management committee standing member attends Advisory Council meetings and an Advisory Council member attends committee meetings. Minutes of the Council meetings can be considered by the committee and by Council members. An agenda item suggested by the Council must be considered at the next committee meeting and a member of the Council attends to talk to it. The Council has access to all committee papers and has the right to go directly to the Board.
- D.38 APCA has not invited consumer groups to be part of the Advisory Council but neither have the consumer groups shown much interest in joining. APCA is willing to engage with these groups but it can be difficult to get well-informed representation. The Australian Bankers Association has a consumers' consultative council where payment issues could be considered. There is also a banking ombudsman scheme.
- D.39 The APCA annual report gives details of the investigations of the Advisory Councils and how the proposals have been handled. There is no other forum for Advisory Council recommendations to be published.

## **Consultation**

- D.40 The Working Group considered ways to ensure that the different (and sometimes competing) interests of stakeholder groups could be given appropriate weighting for their needs.

D.41 In Canada, the CPA addresses the issue of differing interests by assigning a certain number of seats to different groups. For the United Kingdom to follow this approach, however, would mean limiting the number of interested parties that could become Affiliates. BPSL's proposal is to accept as many Affiliates as want to join. In addition, bodies that represent consumers and small businesses have finite resources and cannot attend a large number of meetings just in case a particular issue in which a particular organisation has an interest is raised.

### **Recommendations on governance and representation**

D.42 The Working Group endorses the introduction of the AIG, with clear procedures for ensuring a two-way flow of information between Affiliates and the BPSL Board. The Board may wish to use the Affiliates to sound out proposals, or to suggest new innovations or areas for consideration pro-actively.

D.43 The Working Group recommends that BPSL considers further some of the features of the stakeholder bodies mentioned above. In particular, the Working Group considers that the BPSL Board should make its meeting notes available to Affiliates (making items confidential where necessary), and should introduce a formal process so that Affiliates can see that recommendations have been formally and carefully considered by the Board.

D.44 BPSL will also wish to consider a number of other issues when introducing the Affiliate scheme – whether, for instance, Affiliates should be able to sit on working groups and committees, and whether they should be given the right to publish a report on the progress of BPSL.

D.45 There was little appetite in the Working Group for Affiliate representation on the Board and little demand from those users who attended the Heavy Users' forum. Representatives of potential Affiliates on the Working Group wanted to test the Affiliate proposition first to see whether it met their needs. The Working Group felt that the affiliate proposal was a good place to start. If it proved to be an effective forum,

there would be little need for further access to the Board. If that proved not to be the case, the Affiliates would report to the Task Force and request that further action be taken.

- D.46 A consultation process for other users who do not sit on the Affiliate scheme will be introduced. When substantial changes to the BACS proposition are being considered, interested parties must be given a reasonable length of time to consider and respond to them.
- D.47 BPSL's objectives will be broadened to cover innovation and responding to user and market needs in an efficient and cost effective manner. These objectives will be published, and the performance of BPSL in achieving these will be available for all stakeholders to scrutinise.

## **Access**

- D.48 Cruickshank was concerned that access to payment systems was limited to large financial organisations, and that other bodies could get access to schemes only through one of those bodies. Cruickshank believed that this put non-members at a commercial disadvantage as they had to rely on a competitor for access, had to pay for the service, and received poorer information about the scheme.
- D.49 Cruickshank also said that there were legitimate reasons for regulating access to high value payment systems such as CHAPS, because of the high credit and liquidity risks that could result from the large daily values that flow through them. However, Cruickshank did not believe this was the case for low value systems such as BACS. The report therefore considered that access restrictions to BACS were too high, and that allowing direct access for highly solvent large corporates should be considered.

D.50 The Working Group therefore considered the costs and demand for greater access to the BACS scheme by corporates and other bodies. Two specific proposals were examined:

- access to settlement membership for non-financial institutions, and
- access to settlement membership for government departments.

Additionally, other rules and requirements were examined to see if they prevented entry to the scheme.

### **Access to settlement membership for non-financial institutions**

D.51 Each payment system requires a mechanism for settlement (that is, the transfer of money between its members in settlement of the payments made on their customers' behalf). In the case of BPSL, settlement is carried out by debiting and crediting the members' accounts held at the Bank of England. Under the current membership criteria, all members must settle directly with the Bank of England, and all current members are thus referred to as 'settlement members'. Alternatively, an agency relationship with a settlement member can be established to use another party to settle on a user's behalf.

D.52 BPSL restricts settlement membership to credit institutions subject to prudential capital and liquidity regulation, thereby limiting the risk that the multilateral settlement could fail to complete due to a settlement member's failure to meet its settlement obligations in a timely manner. This is a prudent step in order to avoid the disruption to the wider economy and public that a failure to settle, and consequent interruption to BACS processing, could cause.

D.53 There are clearly advantages and disadvantages to allowing settlement membership by non-financial institutions. The Working Group considered a new form of 'clearing' membership which would allow access to the BACS scheme, but with fewer risks to the system.

- D.54 BPSL suggested introducing the clearing membership category because it believed that, for prudent risk management reasons, only credit institutions should be full settlement members (except perhaps for government departments – see below). This is because only credit institutions have the necessary level of liquidity required for the safe functioning of a payment system. BPSL has to ensure that the overall financial position of each of its settlement members is sufficiently robust to be able to operate within the settlement system, and that the liquidity position of each settlement member is sufficiently strong to enable it to settle amounts due at the end of each settlement period. Therefore, a mechanism for assessing liquidity is required.
- D.55 By limiting settlement membership to credit institutions, BPSL is able to take advantage of the monitoring of liquidity levels of credit institutions carried out by the FSA and equivalent requirements of the regulators of credit institutions in other EU member states.
- D.56 The potential benefits of clearing membership include access to the wholesale tariff, access to the Board, and better provision of information. It may also lead to greater competition, if non-financial institutions are able to offer services through their membership of BACS. There would, though, be potential costs to clearing membership. A clearing member would still have to settle through a settlement member. It would also have to put procedures in place to deal with the underwriting of the direct debit guarantee through a settlement member.
- D.57 Clearing membership was introduced as a concept at the heavy users' forum. Users interested in the concept were then asked to attend a follow up meeting with BPSL. Although the forum was well attended, there was little interest among attendees in becoming clearing members. The Working Group therefore considers that clearing membership should remain as an option, but be considered further by the AIG only if there is firm interest shown in the future.

## **Settlement membership by government departments**

- D.58 At the same forum, BPSL introduced the concept of government departments becoming settlement members of BACS. Although not credit institutions, some government departments could present a profile similar to that of a settlement member, as far as credit risk, operational risk and reputational risk is concerned. In place of the requirement to be a credit institution there would be a requirement that the government department enjoyed a credit standing identical to HM Treasury and the Bank of England.
- D.59 There would be costs and benefits to a government department becoming a settlement member. The government department would need to provide the appropriate level of resources to meet any obligations. Potential benefits would include access to the wholesale tariff, access to the Board, and better provision of information.
- D.60 As with the clearing membership option outlined above, however, there was little interest shown by government departments in joining BACS as settlement members. The Working Group similarly considers that this, too, should remain as an option, but be considered further by the AIG only if there is firm interest shown in the future.

## **E LIST OF BODIES CONSULTED**

Australian Payments Clearing Association

Bank of Canada

Canadian Payments Association

Euroclear

Mr Ron Matthews, Imperial Oil Limited and Independent Director, Canadian Payments Association (CPA). Ron Matthews is also Chair of the CPA Stakeholder Advisory Council (SAC)

ING Bank of Canada

LINK Interchange Network Ltd

Reserve Bank of Australia

Retail Council of Canada

Royal Bank of Canada

Mr Pen Kent CBE, Chairman, UK Euroclear Market Advisory Committee

TRM Corporation, an independent deployer of automatic teller machines

### **Organisations represented at the heavy users seminar at the OFT**

AXA

Bottomline Technologies

British Gas Services

BT

CASS Business School

Department of Work and Pensions

Direct Line

Dixons

EDF Energy

H M Office of the Paymaster General

Legal and General

Local Government Association

Next

Royal Mail

Sainsbury's

Shell

SKY

Standard Life

UKPIA

Yorkshire Building Society

## F GLOSSARY

The following glossary of terms is not intended to provide precise legal definitions but to assist in reading the report:

|                         |   |
|-------------------------|---|
| Agency bank             | A non-settlement financial institution that makes an arrangement with a settlement member of a payment system, allowing the agency bank to obtain clearance of items on behalf of itself and its customers.   |
| AIG                     | Affiliates Interest Group. A forum created for registered BPSL Affiliates to facilitate the discussion and exchange of information relevant to BPSL and its payment schemes.  |
| APCA                    | Australian Payments Clearing Association<br><a href="http://www.apca.com.au">www.apca.com.au</a>  |
| BACS                    | Bankers' Automated Clearing Services. An automated clearing house (ACH), the system used for bulk clearing of electronic payments between bank accounts in the United Kingdom. It handles all direct debits and direct credits, as well as interbank standing orders and remote banking payments. BACS Ltd was the clearing company for BACS prior to being split into BPSL for the payment scheme and Voca Ltd for payment infrastructure. |
| BACSTEL and BACSTEL- IP | The upgraded BACSTEL service, which was the telecommunications channel which enabled users to submit BACS payment files directly to Voca. BACSTEL has been phased out in favour of BACSTEL-IP, which features Internet Protocol and Public Key Infrastructure security.   |
| BECS                    | Bulk Electronic Clearing System. Bulk Electronic Clearing System (BECS) for recurring electronic debit  |

|                     |  |
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|                     | and credit payment instructions in Australia.  |
| BPSL                | BACS Payment Schemes Limited. A membership based industry body whose role is to own, develop, enhance and preserve the integrity of automated payment and payment-related services. It is the scheme company for the BACS payment system. BPSL sets the business rules that govern the operation of the direct debit and direct credit payment schemes. It also manages and has responsibility for the operation of these schemes. |
| C&CCC               | Cheque and Credit Clearing Company   |
| CHAPS               | Clearing House Automated Payments System. The United Kingdom's real time gross settlement system. Sterling and euro payments processed through the CHAPS systems are individually and continuously settled during the day in real time.  |
| Clearing Membership | A potential new class of membership of BPSL. Clearing members would have many of the rights and obligations of settlement members of BPSL. However, Clearing members would have to secure services from a settlement member to provide settlement at the Bank of England and to sponsor the clearing member's direct debit guarantee.  |
| CPA                 | Canadian Payments Association. Responsible for establishing and operating systems for the clearing and settlement of payments in Canada. See <a href="http://www.cdnpay.ca">www.cdnpay.ca</a>  |
| Direct debit        | A direct debit enables a beneficiary (i.e. a direct debit originator) to request payment from the payer's bank account by automated means. The payer gives prior authority for his/her account to be debited by completing a Direct Debit Instruction (DDI). The   |

|                           |  |
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|                           | 'direct debit guarantee' provides comprehensive consumer safeguards.   |
| EBPP                      | Electronic Bill Presentation and Payment. A service that enables consumers and/or businesses to view and pay their bills online, at the web site of the biller or via their Internet banking service, for example.             |
| EFTPOS system             | Electronic Funds Transfer at Point of Sale. EFTPOS in Australia provides customers with a payment mechanism for the supply of goods and services at the point of sale.   |
| EPC                       | European Payments Council. The decision-making and coordination body of the European banking industry in relation to payments.   |
| Euroclear                 | A provider of settlement services in equities and fixed income securities  |
| Internet banking payments | Direct credit payments initiated by the payer through the use of internet banking.   |
| LINK                      | LINK Interchange Network Ltd is the transaction management company whose primary focus of attention is switching and settling shared transactions for LINK, the UK's ATM network.  |
| MAC                       | Market Advisory Committee. Euroclear has set up MACs made up of users in each of the markets in which it operates. The MACs are seen as a primary source of feedback and interaction between Euroclear and the user community. |
| NewBACS                   | The BACS technological renewal programme.  |
| OFT                       | Office of Fair Trading   |

|                            |   |
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| Payment system             | An arrangement which allows the users of that system to transfer money. It facilitates funds transfer between the members of the system and consists of the network which links them, the switches for routing payment messages and the rules and procedures for the use of this infrastructure.  |
| Payment Systems Task Force | The OFT announced the creation of the Task Force in March 2004. This followed an announcement by the Chancellor of the Exchequer that the OFT would play an enhanced role in payment systems for a period of four years. The Task Force aims 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 which derive from, or are associated with, features of payments systems are also considered. |
| SAC                        | Stakeholder Advisory Council. In Canada the SAC is made up of representatives of stakeholders in the Canadian payments system. The SAC has a mandate to provide counsel and advice to the CPA's Board of Directors on payment system issues.  |
| SEPA                       | Single Euro Payment Area. The European Commission and European Central Bank have announced an intention to create a single payment area within the EU.  |
| Settlement member          | A member of an operational clearing scheme which settles (makes or receives payment) for the value of its clearings over its account at the Bank of England. In some payment systems, a direct or settlement member may sponsor other financial institutions such as agency banks and fulfil settlement obligations on  |

|                            |   |
|----------------------------|---|
|                            | their behalf.   |
| SME                        | Small or Medium sized Enterprise  |
| Standing order             | 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.   |
| Systemic risk              | The danger that problems in a single financial institution might spread and, in extreme situations, could disrupt the normal functioning of the entire financial system.  |
| Telephone banking payments | Direct credit payments initiated by the payer through the use of telephone banking.   |
| Voca                       | Voca Limited (known as BACS Limited prior to 12 October 2004). A company which provides processing and related services in the United Kingdom for direct debit, direct credit and standing order transactions, originated either by Settlement Members of BPSL or by others sponsored by them to use the service. |