PAYMENT SYSTEMS REGULATOR CONSULTATION PAPER – A NEW REGULATORY FRAMEWORK FOR PAYMENT SYSTEMS IN THE UK: BANK OF ENGLAND RESPONSE

1 Introduction

1.1 The Bank of England (the Bank) welcomes the Payment Systems Regulator's (PSR) consultation paper *A new regulatory framework for payment systems in the UK* (PSR CP14/1). In light of the importance of the design and smooth operation of payment systems to financial stability and the effective implementation of monetary policy - and the multiple roles that the Bank undertakes with regard to payment systems[1] – the purpose of this paper is to set out the Bank's position on the issues identified in the consultation paper. This builds on the Bank's response to the PSR's Call for Inputs that was published in 2014.[2]

1.2 When designing its policy proposals, the PSR is required under its legislative mandate to have regard to the importance of payment systems in relation to the Bank's role as monetary authority and to the importance of maintaining UK financial stability.[3] This will clearly necessitate close cooperation between the Bank and PSR, and the Bank has welcomed the opportunity to engage closely with the PSR in the build-up to the publication of its first consultation paper. The importance of ongoing cooperation between all the relevant Authorities will increase further as the PSR takes on its powers on 1 April 2015 and, to underpin this relationship, the Authorities will enter into a statutory Memorandum of Understanding by this date setting out how the Authorities intend to coordinate the exercise of their relevant functions.[4]

1.3 The optimal market structure of the UK payment systems is a subject of active and lively scrutiny and debate. From a financial stability perspective, UK payment systems have historically demonstrated a high degree of stability and reliability and the Bank considers that financial stability is not, at this point, a primary driver for major changes to the industry (see Box 1). Nevertheless, as set out in the Bank's response to the PSR's Call for Inputs, the Bank recognises that the PSR needs to consider structural change in order to determine the best way to advance its objectives to promote competition, innovation and the broader interests of service users. While change could present opportunities to further enhance financial stability, and the Bank's response to the PSR's Call for Inputs highlighted areas where opportunities may arise, it could also present risk. Section two of this paper therefore sets out four key criteria against which, in the Bank's view, potential changes can be assessed from a financial stability perspective. The Bank recognises that some proposed changes could involve trade-offs between these criteria and the Bank stands ready to support the PSR and other stakeholders in assessing proposals against these criteria.

---

[1] The Bank's relevant functions with regard to payment systems include being the supervisor of systemically important inter-bank payment systems, provider of settlement services and operator of real-time gross settlement infrastructure, resolution authority, participant in some payment systems and supervisor of banks and building societies (the latter is exercised through the Prudential Regulation Authority)

[2] See http://www.fca.org.uk/your-fca/psr/non-confidential-responses-to-the-March-2015-PSR-call-for-inputs

[3] This is required by the Financial Services (Banking Reform) Act 2013

[4] The relevant Authorities identified in legislation are the Bank, Financial Conduct Authority, Prudential Regulation Authority and PSR

Box 1: Performance of the current industry structure

UK payment systems have historically exhibited a good degree of stability and reliability as demonstrated, for example, by the stable operation of UK payment systems throughout the financial crisis and in data on the systems' operational availability (table 1).

The Bank has a statutory responsibility to supervise payment systems that are recognised by HM Treasury as systemically important to the UK financial system. The Bank performs this role with a view to protecting and enhancing UK financial stability and will continue to supervise the UK's recognised payment system operators to achieve this objective.

Table 1: Operational availability for supervised payment systems (provisional data)

Operational Availability			
System	**2012**	**2013**	**2014**
Bacs	100%	99.8%	99.99%
CHAPS	100%	100%	99.65%
FPS	100%	100%	100%

1.4 The Bank recognises there is also ongoing debate about the types of institution that can become members of payment systems. Some of this debate revolves around whether it is necessary for members of payment systems to have a settlement account at the Bank. Section three therefore outlines the Bank's position on whether payment system members require settlement accounts.

Box 2: The Bank's role as RTGS provider

The Bank's role as settlement agent – providing the ultimate, risk-free means of discharging payment obligations between parties in 'central bank money' – emerged in the mid-19th century with the provision of settlement accounts for the banking sector. Since 1996, these accounts have been held within the Bank's Real Time Gross Settlement (RTGS) system, which provides for real-time posting with finality and irrevocability of debit and credit entries to participants' accounts.

Using RTGS, the Bank currently acts as settlement agent for the Bacs, CHAPS, Cheque and Credit Clearing, FPS, LINK and Visa Europe payment systems.

The Bank's role as provider of interbank settlement services across its balance sheet gives rise to a broader interest in the structure of UK payment systems given the use of the RTGS infrastructure.

1.5 The Bank stands ready to work closely with the PSR as it reviews responses to its consultation paper and determines next steps. The Bank's more detailed views on appropriate approaches to implementing some of the initiatives contained in the consultation paper are summarised in section four.

2 The Bank's criteria for assessing structural change

2.1 The UK payments industry is undergoing a period of significant change. The formation of the PSR as an independent economic regulator has changed the regulatory framework in the UK and a number of other developments are currently ongoing which could lead to significant changes to UK payment systems. The PSR is seeking to foster industry-wide collaboration to support effective strategy setting through creating the Payments Strategy Forum and the Bank looks forward to participating actively in that forum.

2.2 More generally, the Bank intends to participate actively in the debate on the future of the UK payment systems landscape to ensure that its objectives, especially with respect to financial stability, are given due consideration. To this end, set out below are four criteria against which, in the Bank's view, potential changes can be assessed from a financial stability perspective. These criteria offer guidance to help interested parties identify opportunities to advance financial stability as part of their analysis. The extent to which specific change proposals risk, or offer opportunities to enhance, financial stability will of course depend on their detailed design and implementation. To that end, the Bank stands ready to work with the PSR, industry and other stakeholders from an early stage to help assess whether any proposed changes would help improve financial stability, have minimal impact or create risk the Bank may find unacceptable.

Criterion one: changes should not lead to an unacceptable increase in settlement risk

2.3 Settlement risk in payment systems is the risk that settlement will not take place as intended. This generally refers to the credit and liquidity risk faced by a payment system and/or its participants. Participants may face this risk with respect to the other participants in the system or with respect to the system's settlement agent. Determining how settlement risks are addressed will be key to assessing the merits of any reforms to the payments landscape; such reforms must not unacceptably increase settlement risk.

2.4 To mitigate the risk that the settlement agent defaults, the Bank requires that systemically important payment systems settle in central bank money – that is, using liabilities of the central bank to settle payment system obligations. The advantage of settlement in central bank money is that the risk of failure of the settlement agent (the central bank) is greatly reduced. This is because central banks have the lowest credit risk and are the source of liquidity with regard to their currency of issue. Reducing this risk enhances financial stability as payment system participants can have a greater degree of certainty that their payments will settle. However, this does not mean that the Bank requires all *participants* in systemically important payment systems to settle in central bank money; more details on this aspect can be found in section three below.

2.5 Settlement risk between payment system participants comprises the risk that a counterparty will not meet an obligation for full value, either when due (liquidity risk) or at any time thereafter (credit risk). The basis on which a payment system conducts settlement will have implications for the extent to which its participants face these risks. Payment systems can settle using one of two settlement methods: real time gross settlement or deferred net settlement (DNS). From a financial stability standpoint, the Bank prefers real time gross settlement for high-value payment systems because obligations are settled in such a way that removes interbank settlement risk. In DNS systems, participants may face settlement risks vis-à-vis each other given the financial exposures inherent in this settlement method. The Bank has recently worked with Bacs and FPS to design new default arrangements that will eliminate settlement risk in these systems (see Box 3).

Box 3: Prefunding in Bacs and FPS

The operators of Bacs and FPS have developed new default arrangements which will see members prefund their outward payments in full, with cash held at the Bank of England. These arrangements, known as 'prefunding', will eliminate settlement risk for the members of both systems when implemented in 2015.

In these systems, members' credit and liquidity exposures are limited by capping the net debit position that each member can accumulate over a given settlement cycle. Under the new prefunding arrangements, members will lodge cash at the Bank of England to ensure that each member is able to settle their obligations at all times.

2.6 Credit, liquidity and operational risk may also exist between indirect participants and their sponsor banks. The risk arising from this 'tiered participation' is known as tiering risk, and is discussed further in section three and Box 4.

Box 4: Tiering risk

Tiered participation in payment systems, whereby direct participants provide services that allow other institutions to access the system indirectly, can create risks to the financial system. These risks arise through three main channels, namely credit risk, liquidity risk and operational risk.

The Bank expects supervised payment systems to identify, monitor and manage any material risks arising from tiered participation.[5] Indirect participants responsible for a significant proportion of a system's transactions, or indirect participants whose volumes and values are large relative to the capacity of their sponsor bank, should be identified in order to manager tiering risk.

As part of its broader work to reduce systemic risk in the UK, the Bank has worked with the payments industry to identify indirect participants in CHAPS that are systemically important to the system. Direct participation in CHAPS has increased as a result of this initiative, as noted in the Bank's 2014 FMI Supervision Annual Report.[6]

Criterion two: changes should maintain or enhance the robustness and resilience of UK payment systems

2.7 Given their importance to the broader financial system, the Bank expects payment systems to display adequate levels of robustness and resilience. Any changes in the payments landscape must allow payment systems to continue to meet high standards of robustness and resilience to operational risks. Systems should ensure that measures are in place to minimise the likelihood of operational disruption, whilst establishing robust contingency arrangements so as to minimise service disruption in the event that such an incident occurs. Measures to address operational risk may cover technical reliability, back-up facilities and contingency plans, security measures and internal controls. In recent years, the Bank has put particular emphasis on the importance of addressing cyber risk. This will continue to be an important subset of operational risk for payment systems going forwards.

[5] As required by Principle 19 of the CPMI-IOSCO Principles for Financial Market Infrastructures (http://www.bis.org/cpmi/publ/d101a.pdf)
[6] http://www.bankofengland.co.uk/publications/Documents/fmi/fmiap1403.pdf

2.8 One option to reduce the financial stability impact of a disruption to a key payment system would be to improve the ability to redirect payments going through any one system to an alternative payment system. While there are a number of different payment systems in the UK, the current limited substitutability between them means that these potential resilience benefits of acting as a contingency for another system are not being realised. One barrier to substitutability is the current absence of standardised messaging formats among the payment systems. To the extent that wider structural change in payment systems may present an opportunity to improve substitutability, there is the potential for UK financial stability to be enhanced.

Box 5: Benefits of simplification

It could be argued that UK payment systems are unnecessarily complex, both in terms of their infrastructure and more broadly. All payments can be characterised across two dimensions: whether they are push (initiated by the payer) or pull (initiated by the payee); and whether they settle on a real-time or deferred net basis.

A more streamlined payment system structure could feasibly accommodate the UK's range of retail payment services, and moving towards such a structure may help address this complexity. Additional benefits may include a reduction in the overall cost of resilience, as having fewer systems would mean lower aggregate costs for back up and contingency planning. There may also be resolution benefits from reducing the number of systems affected by a member in difficulty, and liquidity benefits as participants could centrally pool liquid assets needed for settlement.

In the Bank's view, there may be merit in exploring whether substantial simplification could bring about long-term resilience benefits as well as improvements to efficiency, competition and innovation.

Criterion three: UK payment systems should facilitate the continuity of payment services in resolution

2.9 The Bank is the UK's resolution authority for banks and building societies, central counterparties and certain investment firms. If a firm within the scope of the Bank's resolution regime should fail, the Bank aims to ensure that the adverse effects of that failure are minimised. This requires that "critical economic functions" are continued, including payments activity where interruption to these operations would have adverse systemic impact. It is important for any changes in the payments landscape to take this into account.

2.10 It is therefore essential that banks and building societies' arrangements for accessing payment systems remain intact in resolution. This applies both to banks that directly participate in a payment system and those that participate in them indirectly through an arrangement with a direct participant. The Bank is working closely with UK payment system operators and members to identify any practical issues that banks' interaction with payment systems could raise when seeking to resolve a member bank. As part of this work, the Bank will require the schemes to make any necessary changes to their membership agreements, rules, procedures and system functionality to remove any barriers identified. This is a necessary ingredient for the broader work on resolution planning underway with individual banks. For those that access payment systems indirectly through other banks, it is important that clear contractual provisions specify how this access will be maintained in times of stress.

2.11 The Bank is also undertaking work with the payment systems themselves to ensure that continuity of critical payment services can be maintained even in the event of a financial failure of the payment system operator.

Criterion four: the Bank's ability to effectively supervise systemically important payment systems must be maintained

2.12 Payment systems are a vital part of the economic and financial infrastructure. When designed and managed effectively, they are a key contributor of financial stability. However, if they are poorly designed or managed, they can present serious risk to financial stability both through their impacts on the banks that use them and by being a channel for the transmission of disturbances from one part of the financial system to another. This systemic risk makes the supervision of payment systems an integral part of the Bank's responsibility to protect and enhance UK financial stability.

2.13 It is important that payment systems are designed and operated in a way that manages risks to the financial system to an acceptable level. The Bank's supervision[7] seeks to ensure that payment system operators take into account the potential impact of their systems on financial stability. In the context of structural change, it will be important for any changes to facilitate the effective regulation of systemically important payment systems from a financial stability perspective.

2.14 The Committee on Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions' (IOSCO) *Principles for Financial Market Infrastructures* (PFMIs) provide an internationally-agreed foundation to the Bank's supervisory regime for payment systems and other Financial Market Infrastructures (FMIs). The PFMIs are a set of standards that seek to enhance the safety and efficiency of payment systems and other FMIs. The Principles provide guidance for addressing the risks faced by FMIs, setting out minimum requirements where appropriate to encourage the mitigation of specific risks. Following their publication in 2012, the Bank adopted the PFMIs as the basis for its supervision of payment systems in line with international best practice. To the extent that it may impact their operation and design, it will be important for any structural change not to limit the ability of systemically important payment systems to continue to have regard to the PFMIs.

Box 6: The separation of scheme company and infrastructure provider

The current organisation of Bacs and FPS involves scheme companies (Bacs Payment Schemes Ltd and Faster Payments Scheme Ltd) that set rules and requirements but outsource their infrastructure to third parties. This degree of separation does not exist in many of the other financial market infrastructures supervised by the Bank, such as the securities settlement system CREST, the foreign exchange settlement system CLS, and UK central counterparties. It is also unusual internationally. This model was introduced in 2003 when Bacs was split into two separate organisations in order to increase innovation and competition in the provision of infrastructure. It is not clear that this separation has achieved its intended outcomes.

As noted in the Bank's response to the PSR's Call for Inputs, this separation has had some drawbacks from a financial stability perspective. In particular, it has made it difficult for scheme companies to effectively challenge and monitor their commercial infrastructure provider, given the need to hold significant technical expertise. Moreover, separation can serve as an obstacle to information flows.

[7] See http://www.bankofengland.co.uk/publications/Documents/news/2012/nr161.pdf

3 Access to payment systems

3.1 The Bank's longstanding position remains that systemically important payment systems should conduct final settlement in central bank money. Consequently, the Bank is the settlement agent for the major sterling payment systems, and provides accounts to their members if they meet its eligibility criteria. However, as part of its supervisory framework, the Bank does not require all members of a payment system to settle their own obligations directly using their own settlement account at the Bank. Instead, the Bank is content for members that generate low-value interbank settlement obligations to conduct settlement through banks that do have a settlement account at the Bank. For some Payment Service Providers, settling through a direct participant bank may be more suitable than settling directly in a payment system. There are already examples of participants having direct access to a payment system but settling their interbank obligations via another participant's settlement account.

3.2 In its role as supervisor of systemically important payment systems, the Bank considers the extent of any risks arising from tiered participation and seeks to ensure that these are properly managed (see criterion one in section two). If a participant which accesses settlement indirectly accounts for a proportion of a system's transactions that is large enough to create financial stability risks, the Bank may ask that participant to settle directly. Similarly, if a participant accessing settlement indirectly has volumes/values of payments that are large relative to the size of their sponsor bank, the Bank may ask for a change in this arrangement.

3.3 The range of institutions which are eligible to apply for settlement accounts is defined to include banks, building societies, broker-dealers, CCPs and other systemically important financial market infrastructures. This is set out in the Bank's Settlement Account Policy which was last updated in November 2014 (to expand the perimeter to include broker-dealers and CCPs).[8]

3.4 The Bank notes the views stated in the PSR's paper *'Access to payment systems'* that direct access for non-bank payment service providers (PSPs), such as e-money issuers and payment institutions, would support increased competition in payment services.

3.5 The Bank wishes to work closely with the PSR on changes to improve direct and indirect access to payment systems. It supports the PSR's proposals for payment systems to introduce an 'access rule' to clarify the requirements for direct access, and asking payment systems to consider whether a settlement account at the Bank is a necessary requirement. It also supports the PSR's proposed actions to address participants' concerns on indirect access, for example by launching a market review in 2015. Outcomes from these actions will be an important input into the Bank's review of its policy for access to settlement accounts.

[8] http://www.bankofengland.co.uk/markets/Documents/paymentsystems/boesettlementaccounts.pdf

Box 7: The Bank's settlement account policy

The Bank uses its balance sheet as part of its mission to maintain monetary and financial stability. For example, it provides facilities via its Sterling Monetary Framework to implement the MPC's decisions or provide liquidity insurance; provides accounts for eligible direct participants of payment systems for which it acts as settlement agent, including the provision of intraday liquidity; conducts the issuance of banknotes; and provides Emergency Liquidity Assistance.

In granting financial institutions access to its balance sheet, the Bank considers the policy drivers for monetary and financial stability, and seeks to maintain consistent access criteria across its balance sheet. The range of institutions which are eligible to apply for settlement accounts is selected carefully by the Bank, given the need for appropriate checks to protect the Bank from risk.

The Bank periodically reviews its policy as to which types of institution should be eligible to hold a settlement account.

4 Detailed Bank views on implementation of the PSR's proposed initiatives

4.1 The Bank welcomes the close cooperation already in place with the PSR and the ongoing commitment to work together to ensure that the Authorities' respective objectives can be achieved. To facilitate the detailed development and implementation of the PSR's proposals, the Bank is providing the detailed comments attached at Annex A.

Annex A: Detailed Bank views on implementation of PSR's proposed policy initiatives

Topic	PSR proposals	Bank view
1) Industry strategy	(a) We will take control of the strategy development and setting process to enable the UK to have world class payment systems – we will set up a new Payments Strategy Forum (PSF) with broad representation of industry and service-users	(a) The Bank welcomes the PSR taking forward the role of leading the strategic development process for payment systems. The Bank wants to ensure that strategic change takes into account, and gives appropriate weight to, the financial stability implications and operational challenges of change. To this end, **the Bank is publishing four criteria against which any proposals for change should be assessed to determine their financial stability impact. The Bank stands ready to work with the PSR, industry and other stakeholders to undertake these financial stability assessments.** **The Bank looks forward to playing an active role in the Payments Strategy Forum.**
	(b) We will launch a market review into the ownership and competitiveness of infrastructure provision commencing by April 2015	(b) The market review into infrastructure provision could potentially have a material impact on future developments in payment systems. In particular, this is likely to be the route that considers key issues such as the ownership and structure of payment systems. This work is therefore likely to have clear financial stability implications. Given the above, **the Bank expects to work closely with the PSR throughout the market review into the ownership and competitiveness of infrastructure provision**, including through undertaking some joint work on topics of mutual interest. The Bank is also offering its expertise to assist and inform the ongoing review.
2) Ownership, governance and control of payment systems	(a) We will open up governance and control of payment systems by involving additional players in more transparent decision making: • all Operators will be required to ensure service-users are appropriately represented in decision-making • conflicts of interest will need to be	(a) **The Bank supports the proposed governance requirement that is consistent with PFMI 2, which requires an FMI to have clear and transparent governance arrangements**. Nevertheless the Bank, as payment systems supervisor, will need to ensure that opening up governance and decision-making in payments systems to a broader range of stakeholders does not lead to less importance being attached to financial stability issues. **The Bank supports the PSR's recommendation for payment system operators to publish their Board minutes and votes, but recognises the risk that publication has**

	addressed so that individuals are not simultaneously a director of an Interbank Operator and of a Central Infrastructure Provider to the same payment system • all Operators will be required to publish board minutes and votes	**the potential to inhibit full and open discussion and challenge at Boards. The Bank expects to work closely with the PSR to ensure that this requirement is implemented in a manner that mitigates this risk.**
	(b) Operators will be required to report to us on compliance with our service-user direction annually	(b) **The Bank is working closely with the PSR to coordinate regulatory reporting to both regulators** where schemes are asked to report similar information to both the Bank and PSR.
3) Direct access to payment systems	(a) Operators (of Bacs, C&CC, CHAPS and FPS) must have objective, risk-based, and publicly disclosed Access Requirements, which permit fair and open access. LINK, MasterCard and Visa, which are already subject to an access rule under Article 28 of the European Payment Services Directive, must publicly disclose their Access Requirements	(a) **The Bank supports the proposed requirement that is consistent with PFMI 18 which requires an FMI to have objective, risk-based and publicly disclosed criteria for participation, which permit fair and open access.** The Bank expects to work closely with the PSR when assessing schemes' compliance with this principle to ensure that an appropriate balance is struck between the need for the schemes to protect themselves from risks that could impact financial stability, such as operational risks, and the need to permit wider access.
	(b) All Operators must report to us on compliance with the relevant access rule applicable to them annually.	(b) **The Bank is working closely with the PSR to coordinate regulatory reporting to both regulators** where schemes are asked to report similar information to both the Bank and PSR.
4) Indirect access to interbank systems	(a) Sponsor Banks must publish information on the sponsor services they offer (including access criteria and processes)	(a) No comments.
	(b) Industry will develop a PSR-approved Code of Conduct	(b) **The Bank will review the Code of Conduct and work with the PSR to ensure it strikes an appropriate balance between promoting access and financial stability**

		considerations on topics such as continuity of access to payment services in resolution.
	(c) We will launch a market review into Indirect Access, commencing by April 2015	(c) The market review into indirect access could potentially have a material impact on future developments in payment systems. This work therefore may have financial stability implications. **The Bank expects to work closely with the PSR throughout the market review into indirect access**, including through undertaking joint work on topics of mutual interest. The Bank is also offering its expertise to assist and inform the review, for example to assess any potential financial stability risks from increased indirect access or new technological solutions.
5) Interchange fees	(a) We will engage with relevant authorities on the proposed EU Interchange Regulation. If implementation is delayed we will consider taking action in the UK	(a) No comments.
6) Regulatory tools	(a) We will introduce Principles on our expectations of industry behaviour. Industry will work with us on a 'no surprises' basis, discussing significant developments with us in advance and on an ongoing basis.	(a) The Bank will consider how the PSR's principles fit with its own work as supervisor of payments systems, particularly if the PSR considers additional principles on areas like management and control of schemes.
	(b) We will issue Powers and Processes Guidance setting out our enforcement and complaints procedures, Guidance on our statutory Objectives, Penalties Guidance and our Administrative Priority Framework	(b) **The Bank will work closely with the PSR in considering the impacts of exercising both authorities' regulatory tools on their respective objectives generally and payments systems and regulated firms more specifically.** As the Bank is not to be regarded as a participant in any payment system, **the Bank is excluded from the PSR's remit** and is therefore, for example, exempt from PSR penalties levied against payment systems of which the Bank is a member.