BANK OF ENGLAND

# Speech

## From design to delivery: stability in the new retail payments infrastructure

Speech given by

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Good morning. I would like to thank the Westminster Business Forum for inviting me to speak at today's seminar on the future outlook for UK payments policy.

Two years ago I spoke at the Forum's seminar on the future of payments regulation. The theme of my speech that day was innovation and change, specifically how we could collectively manage change to maximise the positive impact that it can bring, both for the users of payment systems and the stability of the wider financial system. The timing of my remarks recognised that we were expecting to see an unprecedented scale of innovation and change in the payments landscape. And we have certainly seen significant initiatives launched over the last two years, driven from a variety of sources.

For example, the Payment Systems Regulator (PSR) is now firmly in place, nearly two years on from its operational launch, and in that time it has driven a series of changes focused on enhancing competition and innovation. It has established the Payments Strategy Forum (PSF) which has shown itself to be a positive force for bringing industry together behind a single retail payments strategy. And the Bank is making its own contribution through its review of the Real-Time Gross Settlement (RTGS) system that sits at the heart of the UK financial system; and also by continuing to evolve our supervisory expectations in relation to the operation of payment systems.

What I would like to do today is take stock in light of developments over the last two years, setting out the Bank's view on where we stand and some of the challenges ahead.

**Financial innovation**

To set the context for my remarks, I'd like to briefly touch on the Bank's approach to innovation and change. Our Governor, at a recent G20 conference, noted that technological innovation has long been twinned with finance.[1] This clearly applies to the infrastructure underpinning finance, where the foundations of ledger keeping have been built upon through a range of innovations in communication and information technology, leading to the structure of modern payments, clearing and settlement systems that we recognise today. And innovation in the infrastructure behind these systems will continue. It is the infrastructure underpinning retail payment systems, and the work of the Payments Strategy Forum specifically, that I will focus on today.

But before I get into that detail I do want to note that, through that G20 speech and in other contexts, the Bank has been very clear that it supports innovation both in terms of the opportunities for growth it can bring, but also the important financial stability benefits it can deliver. For example, in the payments sector, it has the potential to make settlement faster and increase settlement in central bank money thus yielding important benefits to financial stability. It can encourage new entrants, reducing market concentration. So inevitably we

[1] See the speech '*The Promise of FinTech – Something New Under the Sun?*' by the Governor of the Bank of England at the Deutsche Bundesbank G20 conference on '*Digitising finance, financial inclusion and financial literacy*', Wiesbaden (25 January 2017), available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech956.pdf

welcome the opportunity to attend events such as today, where we can reiterate our support for well-crafted change. But I will make no apologies for the stress that we put on the words 'well-crafted change'[2] and for the importance we attach to change taking place in a way that promotes financial stability and resilience.

**The work of the Payments Strategy Forum**

The successful implementation of the Payments Strategy Forum's plan for UK retail payments is something we are engaging closely with.[3] The PSF's strategy, announced in November last year, covers a number of areas.[4] Of particular interest to the Bank is the proposal for the consolidation of the UK retail interbank payment system operators: Bacs and Faster Payments, who we supervise as systemically important schemes, and the Cheque & Credit Clearing Company. Done well, this should reduce complexity, simplify access and enhance efficiency. We support the consolidation of these operators as a way of realising important financial stability benefits that should flow from the process. We expect the consolidated entity to be greater than the sum of its constituent parts and therefore even better placed to lead and tackle the challenges inherent in meeting the very high standards the Bank has of a systemic risk manager. We, and our colleagues at the PSR, are working closely with the industry-led delivery group tasked with developing the new consolidated entity to ensure that it is delivered effectively.

Another significant proposal in the PSF's strategy is a 'new payments architecture' or 'NPA'. The vision set out by the PSF is a payments infrastructure which delivers greater competition and innovation at lower costs, and which is agile and responsive to the needs of consumers, businesses and government. The consolidated payment system operator will be responsible for implementing this vision.

The NPA proposals are based around what is being termed the Simplified Payments Platform. Currently with the retail payment systems, such as Bacs and Faster Payments, separate payment mechanisms support different payment products. A business will likely use Bacs when it pays its staff their salaries on a regular, for example monthly, basis. A consumer will typically use Faster Payments when he or she makes an online payment directly from their bank account. With the Simplified Payments Platform concept, the PSF proposes a single retail payment mechanism, simply put the pushing of a payment message from A to B. The PSF calls this the "lowest common denominator in any payment".

Additionally, the person making such a payment would be able to select additional 'overlay services', most likely via Application Programming Interfaces (APIs), which determine features such as *when* the payment message is to be sent and *whether* any additional data is to be exchanged. In this way, the PSF vision is that

[2] The importance of well-crafted change was also emphasised by Andrew Hauser, Executive Director, Banking, Payments and Financial Resilience in his speech '*A payments strategy for the 21st century*' at the launch of the PSF's final strategy on 29 November 2016, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech948.pdf
[3] See, for example, the speech by Andrew Hauser cited at footnote 2.
[4] See the PSF's document '*A Payments Strategy for the 21st Century: Putting the needs of users first*' (November 2016), available at: http://consultation.paymentsforum.uk/final-strategy

retail payment products, including the ones we have today, can be developed as overlay services layered on top of the single retail payment mechanism.

The PSF has proposed two potential models for the Simplified Payments Platform. In a centralised model, the infrastructure and connectivity between payment service providers (PSPs) such as banks is provided by a single central infrastructure. In the decentralised model, connectivity is established between PSPs and allows for PSPs to procure their own infrastructure.

The PSF proposals are being developed into much more detail, however this summary suffices for the purposes of what I want to say next.[5]

You will no doubt have gathered where I am going. With a move to a new architecture for payments there comes potential risk which needs to be appropriately managed.

The Bank's approach to the supervision of financial market infrastructures (FMIs), including payment systems, is based on forward-looking judgements on whether an FMI's operations will pose unacceptable risks to financial stability.[6] Where we judge the risks are unacceptably high, we require the FMI to take action to reduce them. Inherent in this approach is the need for us to deal effectively with new or changing risks, evolving our supervision accordingly.

It's therefore important that we think about the potential risks, as well as the benefits, from the new payment architecture now so the appropriate controls and mitigations can be built into the NPA design process.

**The Bank's criteria for assessing change**

When I last spoke to this Forum I set out the criteria against which the Bank would assess change in the payments landscape.[7] These focus on settlement risk, standards of robustness and resilience, continuity of payments if a bank is in resolution, and our own supervision of payment systems. These criteria have given us an overarching framework for assessing change and have underpinned our analysis of industry developments since then.

Now that more detail is emerging in terms of what that change might look like with respect to payments infrastructure, it is an opportune moment for us to set out some key themes from a financial stability

[5] More information is available in the PSF's strategy document (see footnote 4) and more detailed design proposals will emerge from the NPA Design Hub established by the PSF.
[6] See '*The Bank of England's approach to the supervision of financial market infrastructures*' (April 2013), available at: http://www.bankofengland.co.uk/financialstability/Documents/fmi/fmisupervision.pdf
[7] See the speech '*The future of payments systems: stability through change*' by David Bailey at the Westminster Business Forum Keynote Seminar '*The future of payments regulation*' (25 February 2015), available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech799.pdf

perspective that we would expect to be taken into account as the NPA is developed. There are four key themes I would like to highlight:

**1. Settlement must be grounded in central bank money**

Many choices will need to be made as the Simplified Payments Platform is developed, for example whether to have a centralised or a decentralised structure. Whatever model is chosen, it is of crucial importance to the Bank that it is underpinned by, and promotes, settlement in central bank money which is the safest form of settlement asset; and that high value payments continue to settle in real time. To that end, and given the Bank is in the process of reviewing our RTGS system, which will continue to support the settlement of the highest value payments on a gross, real time basis, it is essential that we and industry remain closely engaged on this work.

We would also expect the consolidated payment system operator to ensure that settlement retains the existing level of legal certainty as provided for under the Settlement Finality Directive designations of the three payment systems. This legal certainty is important as it determines when a payment can be considered irrevocable.

**2. Concentrating retail payments through a single mechanism increases the importance of resilience**

At the heart of the Simplified Payments Platform is the principle that there is to be one retail payment mechanism. This implies less substitutability than today where, if one retail payment mechanism is unavailable, an alternative might be used. It therefore becomes more important that the payment mechanism is robust and resilient, and the Bank’s supervisory tolerance for infrastructure failures or participant incidents affecting the infrastructure or connections to it would be reduced.

As a result, the Bank will expect a clear demonstration of how the move from bespoke, but potentially substitutable, retail payment mechanisms to one multi-functional retail payment mechanism will deliver the high levels of robustness and resilience we expect.

**3. The payment system operator will remain accountable to us for managing risks across the system**

Managing the systemic risks posed by infrastructure services and third party overlay services will be a key responsibility for the new, consolidated payment system operator. In respect of infrastructure, this applies in a centralised model, where the operator is responsible for running infrastructure tenders and contracting with the infrastructure provider, but equally in a decentralised world where PSPs directly contract with their own infrastructure providers.

A potential benefit of bilateral procurement of infrastructure by individual PSPs is that it could offer increased competition amongst infrastructure providers. If that happens then competition must not drive down the standards of payment security, robustness or resilience. We will expect the operator to authorise or accredit infrastructure providers against robust standards and be able to ensure ongoing compliance with them, including through the use of appropriate sanctioning tools. We would also expect the operator to ensure the same high standards of any third party providers of overlay services connecting to the infrastructure.

**4. The Bank's supervision will continue to evolve**

It remains important for the Bank's supervisory regime to keep pace with the changes in industry structure and practice so that we can continue to deliver our mandate to maintain financial stability.

We will therefore keep our supervisory regime and its statutory underpinnings under review. Where necessary, and working with our colleagues in the PSR, the Financial Conduct Authority (FCA) and HM Treasury, we will make changes to our supervisory approach, to ensure that we have the appropriate suite of powers, over the right entities.

In line with this, I would also like to highlight a couple of notable changes to the scope of our regulatory regime.

In the coming months, HM Treasury will lay a statutory instrument which will extend our Banking Act 2009 powers to encompass designated infrastructure providers to recognised payment system operators. This legislative amendment will put our supervisory regime on the right footing to supervise infrastructure providers directly, where this is necessary and appropriate to promote financial stability, including in light of the infrastructure developments I have discussed today.

Looking further into the future, the Digital Economy Bill will, when it gains Royal Assent, give HM Treasury the ability to recognise payment systems whose membership is broader than banks. The Bank will, through its ongoing horizon-scanning, monitor wider payments landscape developments, including the potential for disintermediation of traditional interbank payment systems and the potential emergence of new payment systems which could in due course become systemically important and be recognised by HM Treasury.

We are also taking steps to make sure that our regulatory requirements and expectations are as clear as possible. In this vein, we have developed a Code of Practice and Supervisory Statement relating to governance in recognised payment system operators such as the operators of the Bacs and Faster Payments systems. We consulted on these documents at the end of last year.[8] We will publish the finalised Code and Supervisory Statement shortly, well before the new consolidated payment system operator comes

[8] See: http://www.bankofengland.co.uk/financialstability/Documents/fmi/governance_rps.pdf

into being, so that our requirements and expectations can be incorporated in the development of that new entity. The Code will set out our requirements in respect of an operator's governance arrangements, including that it must act as a systemic risk manager, and the Supervisory Statement will provide supporting guidance on how an operator is expected to comply with the Code. There will be a transitional period for compliance and the Code will come into force one year from its publication.

**Conclusion**

To conclude, I want to return to my opening remarks that well-crafted innovation, properly delivered, can yield significant benefits to service users and to financial stability. As such, we are engaging closely with the change and innovation proposed by the PSF. But we are also alert to the potential risks that this change presents.

To recap, we consider that, whatever form the payments infrastructure takes in the coming years: settlement must be grounded in central bank money; concentrating retail payments through a single mechanisms will increase our expectations of resilience; the Bank will continue to hold the payment system operator accountable for managing risks across the system; and the Bank's supervision of payment systems will continue to evolve. These four key themes that I have outlined today will inform our approach to the new payments architecture as it takes shape and we would expect them to be taken into account throughout that process. We look forward to working closely with industry and the PSF as the work develops.

Thank you for your time this morning and I am happy to take comments and questions from the floor.