#FinTechAccess

PAYMENT INFRASTRUCTURE: A CALL FOR FAIR AND EQUAL ACCESS FOR FINTECH

Rich Wagner, CEO and founder Advanced Payment Solutions (APS) and Chairman of the Emerging Payments Association (EPA)

ADVANCED PAYMENT SOLUTIONS

In collaboration with

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Introduction and message from Rich Wagner, CEO and founder APS and Chairman of the Emerging Payments Association (EPA)

With the UK's history of sophisticated financial services, it is unsurprising that the nation is now leading the charge with FinTech innovation. Investments in the sector have grown at 74% a year in the UK and Ireland since 2008, compared with 27% globally and 13% in Silicon Valley. The payments space in particular has been shaken by new entrants, with an average of £20 billion in annual revenue now generated across payments software, data and analytics platforms. The UK government is keen to maintain this momentum, and has announced a number of schemes to ensure the UK remains at the forefront of global innovation in the financial services sector – from appointing industry veteran Eileen Burbidge as the UK's FinTech envoy, to announcing a regulatory sandbox for financial services innovators.

Yet, while appearances may suggest that the industry and regulatory landscape is opening the doors to disruption, there is still a key barrier to innovation in the payments sector. Access to payment systems operators, such as BACS, Faster Payments and CHAPS is reserved only for banks. This means that the myriad of alternative payment service providers (PSPs) and e-money issuers (EMIs) are forced to run on the rails of traditional banks, despite being heavily regulated by the FCA themselves. In a world where thousands of payments are processed through non-traditional providers every day, this system no longer makes sense.

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I have been in the payments industry for over 30 years and have always fought to level the playing field between banks and alternative financial services providers. It has been my belief that if you push hard enough, make your voice heard and believe strongly enough in the value of your own service, the traditional infrastructures will sit up and listen. At a time when only traditional banks could partner with the major card associations in 2007, APS became the first non-bank issuer to gain MasterCard membership. Similarly, while it may have taken seven years of persistence, last year we became the first ever non-bank to link up with the Post Office – enabling us to provide real-time face-to-face banking services via its network of 11,000 branches.

However, I have realised that this ‘access challenge’ is beyond the reach of my voice alone. It is not just a case of rallying services such as Faster Payments, but engaging in conversation with the Payment Systems Regulator (PSR), core technology providers such as VocaLink and ultimately the Bank of England (BoE). This is not a job for one man alone. For that reason, I have been an active member of the Emerging Payments Association (EPA) for the past two years in order to harness the support and backing of payments business founders and industry experts who share my view and want to drive forward fair and equal access to payments infrastructure for alternative payments providers. Now, as the Chairman of the EPA, I aim to harness the voices of over 75 members, who see that innovation in payments requires collaboration.

As part of this mission, I have devised the following report, with insights from the EPA’s members, which outlines our consolidated views on how to build a payments system that works for the banks – without excluding the increasingly influential alternative payment providers.

NB. Direct Access as we are defining in this white paper (and specifically in the UK) refers to gaining direct membership to infrastructures such as BACS and Faster Payments and most importantly, direct settlement accounts with the BoE.

Why do non-banks want direct access to payment infrastructure?

There are four key restrictions associated with the current model that act as barriers to alternative payments providers.

1. Legacy Problems:

When banks developed their core operating systems over two decades ago in a pre-Internet era, they were not anticipating the technological revolution that would develop in the years that followed. Fast growth for banks in the 80s and 90s saw many making quick fixes to keep up, rather than overhauling the whole system. What's left is a convoluted mess of system upgrades on top of antiquated architecture, which struggles to keep pace with today's digital financial demands.

As a result, those that now control this payment ecosystem – the high street clearing banks – don't have the robust operating technology to maintain and develop the core payment infrastructure they built, which now controls services such as BACS and Faster Payments. Over the past few years we have witnessed a number of IT outages and errors in processing payments at major high street banks. One incident last year resulted in a high street bank having to disclose 600,000 missing payments in the Faster Payments system.

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Forced to run on the rails of the banks, alternative providers suffer the consequences when traditional banks' systems fail. Given the opportunity to access infrastructure such as Faster Payments directly, alternative payment providers could rely on their own, flexible modern IT architectures to manage the payment flow.

2. Hindering Innovation:

Alternative providers currently offer streamlined solutions through their innovative front-end technology. But all the while these alternative providers are chained to the back-end system of the banks, they cannot truly adapt their core technology and evolve at the speed that they, and their customers, desire.

3. Lack of Control:

Having suffered a slew of regulatory fines for lax anti-money laundering controls, high street clearing banks took extreme measures to better manage and govern compliance risks These controls can include a restriction on the size, number and type (e.g. international) of payments that can be offered to end customers, whether these payments are executed by the bank itself, or on behalf of clients using the bank's services. In addition, many banks chose to rule out the provision of financial services to entire industries, rather than taking a prudent (yet admittedly laborious) risk-based approach, as advised by the regulators.

Money Service Businesses (MSBs) – non-bank institutions that transmit or convert money – suffered in particular with this approach. In some instances, MSBs who had worked with banks for decades received letters to notify them of the closure of their banking facilities. This denied them access not only to credit, but to basic services such as bank accounts. This blanket decision to eliminate certain industry sectors from participation has also resulted in clearing banks preventing their own partners from servicing those same industries, even if the partner is regulated in its own right.

With widespread business operations and therefore compliance considerations, it is understandable that high street banks want to avoid additional regulatory hurdles. This is why smaller, more tailored providers, who have the flexibility and means to dedicate time to analysing specific industry risks, require the control to be able to make these risk-based decisions for themselves.

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4. The Cost Issue:

As the number of clearing banks offering access to payments services is limited, alternative payments providers are forced to pay a mark-up price to operate through a high street bank – which is in many cases up to 600%. Direct access would not necessarily solve this issue, as many FinTech players do not have the scale to support the fixed cost that technology platforms require. But with a greater number of credible banks and hopefully some larger electronic money issuers (EMIs) accessing the scheme, a more competitive market would drive down existing pricing, enabling those procuring these services to pass savings onto customers and continue their mission of creating a fairer financial landscape.

Why are non-banks denied access?

There are four key restrictions associated with the current model that act as barriers to alternative payments providers.

1. Hesitance from traditional banks

Let's be fair to banks, when the system was created in the 1960s there were no FinTech players. Likewise, there were no thoughts that anyone besides banks would ever need access to payment systems.

Banks built the system (the 'rails') that we all 'ride on' today. Billions have been spent over the past 50 years to create a fantastic payments environment whereby today's payments can be sent and received in seconds – this entire capability was initially funded by the banks.

It is therefore understandable that banks are putting up resistance when it comes to opening up the payments rails to alternative players. There is a fear and frustration amongst banks, that they would be expected to open up their systems for free, to competitors who have not contributed to the development of the infrastructure.

Banks hold a sacred responsibility to look after the system. With that in mind, they are right to fear that 'FinTech cowboys' could disrupt the whole system. Any move to open up the infrastructure must address this, whilst still updating the status quo to ensure that new, regulated FinTech firms can be granted entry.

Proposed solution: Banks need to understand that FinTech players are not out to gain a free ride on the infrastructure that they spent billions of pounds developing – FinTechs simply want a fair system that doesn't block them out entirely, purely because they arrived later to the market.

It is fair and reasonable for the founding fathers of the core payments infrastructure to expect some sort of ongoing compensation. So let's give it to them. FinTech companies, certainly in the short term, do not have the economies of scale that banks have. During this time it is right that smaller players should pay a higher unit cost than those that process – in some cases – tens of millions more transactions. FinTech providers that desire direct access to the traditional payments infrastructure need to be realistic about what it is they are demanding and be open to paying for this service. As the overall cost would still be less than the banks currently charge for accessing the system indirectly, this approach would likely be attractive to many FinTech providers.

If new entrants were allowed access, these incremental revenues would reduce the running costs of the schemes, and therefore the overall costs for the small number of big banks who currently split the cost between themselves to support these payment schemes. Regulators, banks and FinTech providers need to recognise that by expanding access to a wider group of PSP providers, all participants benefit, including the founding members who set-up the original infrastructure.

2. Cost of granting direct access

In the past, setting up access to infrastructure such as Faster Payments, cost millions of pounds. The reason the cost was so high? Every time a new bank sought to join Faster Payments, a bespoke integration project was required, including a robust testing and certification process to sync the bank up to the network. As these integrations were set up to process what could be billions in transaction value, no one would dispute the effort and cost to ensure these were done at the highest quality level possible. However, repeating this work each time was costly and inefficient.

Proposed solution: Standardising the set up process, and allowing a more uniform technology gateway whereby a technology provider who sits between the scheme and the member is certified, would allow new entrants to access the system at a lower cost. It would also allow them to put the tools in place to link up to the system, without requiring an integration from scratch each time.

Faster Payments is leading the way to certify technology partners in line with this approach. Although this will lower the price, the implementation cost of circa £500,000 will likely only be viable for the larger, more financially capable PSPs. The move is undoubtedly a step in the right direction, though more still needs to done to standardise this process in order to further reduce cost and give more FinTech businesses the opportunity to drive and control their own technology.

Implementation cost of circa

£500,000

When APS joined MasterCard, it was a costly exercise (but well worth it). It then opened the doors for other PSPs to do the same and at a lower cost.

Likewise, all it takes is one PSP to successfully gain direct access to the Faster Payments system and it will be possible to define the standard for all others that follow. A number of larger players, including APS, would be willing to act as the 'test bed' for the future of the payments industry.

3. Access to Bank of England (BoE) settlement accounts

Aside from the fears of traditional banks, the main hurdle to gaining direct access for alternative players is that access to Faster Payments requires a settlement account through the BoE – a service which is denied to non-banks. With responsibility for the nation's economic health in its hands, it is understandable that the BoE exercises caution when granting access to settlement accounts. As such, any solution needs to mitigate the risk from non-banks, without simply ruling them out altogether. Regulators (primarily the PRA and the FCA) have created significant capital requirements on banks in order to operate as a bank. The BoE leverages this strong governance as the main criteria for granting a settlement account. This level of risk mitigation is a justified requirement. In the event of a 'run on the banks', the BoE needs to ensure that these institutions have the capital liquidity to pay out, in order to maintain the financial stability of the nation.

Proposed solution: With such responsibility, it is therefore crucial that the BoE takes an equally rigorous approach to non-banks. However, as smaller payments players do not have the capital of the larger players, a different approach to protect 'the system' is required to avoid ruling them out altogether.

Rather than demanding "banking" status or even a large amount of collateral/capital at all times, the BoE could impose a condition, whereby non-banks are required to pre-fund their settlement account to an amount that supports a member's outward payments. In fact, Faster Payments already supports this type of model and it would greatly benefit the ecosystem if there was an opportunity to leverage this similar process within the BoE. Ironically, the 100% collateral EMIs are already required to hold on all customer funds, along with this potential prefund model for settlement accounts at the BoE, would result in PSPs having less systemic risk (at least financial risk) than the current model that banks create for the BoE to oversee.

What has been achieved so far?

Introduction of the Payment Systems Regulator

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The Payment Systems Regulator (PSR), launched in April 2015, is the biggest groundswell of thinking, momentum, regulation and political pressure to have been generated within the payments space for generations. A core objective of the PSR is to work towards establishing access to traditional infrastructure such as (but not limited to) BACS and Faster Payments for non-banks. While this is still a work in progress, the mere existence of the body has created positive movement among the payment schemes and technology providers that the PSR now regulates, to not just review, but to act on initiatives that will drive viable updates to the access model.

One concern is that, in its bid to drive much-needed change, the PSR's objective may in fact be too ambitious in its timeline. The PSR is demanding access to Faster Payments for non-banks but without detailing how banks would be compensated. As explained earlier, if we are to reach a point where PSPs and other non-bank payment institutions have direct access to these systems, we will need to negotiate a solution and a pricing model that recognises the work of the founding fathers of the infrastructure – the banks. Such a solution will take time to implement. We need the backing of the PSR to continue pushing for the long-term aim of gaining direct access, but a short term compromise is required in the meantime, to support FinTech players immediately.

No one has taken on the PSR mandate better than the Faster Payments service itself. This is thanks to the fact that the service is relatively new. Operating for just eight years, compared to BACS, which is the grandfather of the payments industry, Faster Payments is open to non-banks gaining better access to these schemes.

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What has Faster Payments achieved?

Faster Payments has created three main models for access, summarised below:

Indirect Agency:

This is today how most non-banks and current FinTechs like APS access Faster Payments. This option enables a PSP (the Indirect Agency) to generate a Faster Payment request via its Direct Member Agency Sponsor (typically a high street bank). The Direct Member then applies the funds, subject to its own rules for compliance. In this instance the Indirect Agency is reliant on the Direct Member for both access to the technology platform and access to the BoE settlement platform.

Drawbacks: It is the lack of control offered to Indirect Agencies, the poor number of banks offering this service and subsequent inefficiencies – as outlined in detail earlier in the paper – that has created the need for the PSR and its mission

It may be a number of years before any sort of action is implemented

to improve access for all payment providers. This would be a viable model in an open marketplace with no monopoly, though this is not currently the case with limited competition.

Direct Member:

This enables members to connect directly into the Faster Payments Central Infrastructure to send and receive Faster Payments. Directly connected members also perform their own settlement with the BoE. This is the 'Holy Grail of Access' for many non-banks, as it provides the greatest freedom for innovation and control of a member's own destiny. Faster Payments membership was modified in the run up to the establishment of the PSR to allow membership to non-banks for the first time. However, Direct Membership is subject to having a settlement account with the BoE and currently non-banks are denied this.

Drawbacks: The BoE has recognised that a review into its own access model is required. However, as the BoE is only in the early stages of a review process for opening up access to settlement accounts to non-banks, it may be a number of years again before any sort of action is implemented.

Moreover, while large established PSPs, including APS, have the transaction volume to justify the cost of this model, the UK's smallest and emerging

PSPs require the option of a mid-way solution that works for them also. The technology gateways that connect a Direct Member to schemes such as Faster Payments today costs £500,000 to build and approximately £250,000 a year to support. Analysis completed by Faster Payments estimates that a PSP or any member of Faster Payments would need to process over 1.2 million transitions a year to make this model commercially viable.

APS will continue to lobby for direct access, but if we want to collectively drive payment innovation sooner, for PSPs of all sizes, there needs to be a sense of realism and a commitment to a phased approach, so short term advancements towards wider access can be made.

Direct Agency:

This model, as the name implies, is a hybrid of the two models above, therefore potentially providing a feasible short-term solution and a more cost-effective model for the smallest PSPs. Unlike the Indirect Agency model, this option provides a PSP (in this case, the Direct Agency) with Direct Access to the Faster Payments Central Infrastructure technology, but like the Indirect Agency Model, BoE settlement is handled on the PSP's behalf.

This solution offers PSPs much needed control over how payments are initiated via the scheme – allowing innovation to flourish especially around device solutions (e.g. mobile) and the drive for improved customer experience. As the PSP is not reliant on the technology of the bank, it also removes the risks associated with relying on legacy infrastructure.

> There needs to be a sense of realism and a commitment to a phased approach

However, with the Direct Member managing the BoE settlement, ultimately the PSP is still dictated by the compliance restrictions of a Direct Member. The decision over who to service (such as MSBs), and what type of payments can be made would still lie in the hands of the Direct Member.

Nonetheless, as this model can be implemented in the short-term, without the need for immediate action from the BoE, it is important that we concentrate on driving this forward where possible.

Making the Direct Agency model work for the short term – a question of liability

The simplest way to move forward with this model, without falling foul of Direct Members' restrictive compliance procedures, is to work with a non-high street bank settlement partner. Unlike high street banks, who reluctantly offer this service (the regulatory risk and fines can in no way be compensated by the commercial models that are currently in place), emerging challenger banks and smaller private banks would benefit from the new business and opportunities of this model. Their risk-based approach to AML and compliance procedures would also provide PSPs with greater flexibility over who they serve.

Independent UK bank Raphaels has recently confirmed its intention to become a Direct Member of Faster Payments and initiate this hybrid model, with a number of new financial services providers expected to follow suit this year.

With this model consequently looking set to become increasingly popular this year, regulators (FCA and PRA) should look to address compliance responsibility within this model. As PSPs are regulated entities themselves, with their own requirements for AML and compliance, the liability for the payment should reside with the PSP executing the payment, not the bank settling the transaction. This change to current regulation would go a long way to give FinTech players what they really want – control – in a timeframe that would not be protracted by any review by the BoE.

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Closing comments:

Don’t let perfection be the enemy of progress

Rich Wagner, CEO and Founder, APS and Chairman, Emerging Payments Association (EPA)

I wholeheartedly support the BoE’s decision to review the current model, which denies non-banks from accessing settlement accounts, and thus infrastructure such as Faster Payments. We have been fighting for such a move for a long-time and the fact that the BoE is at last considering this issue, is a step in the right direction. Such a measure would not be possible without the support and rallying of the Payment Systems Regulator (PSR), which has created a real force for change over the past year. We hope to build a long-term solution that provides fair and equal access to non-banks, while paying due credit to banks, who were the founding fathers of these systems. However, we urge both regulators and infrastructures – in particular Faster Payments – not to be stalled by the plans of the BoE. Actual change from the BoE will take significantly longer to implement. In the meantime, key non-bank payment providers will lose out on valuable business and growth opportunities, all the while being chained to high street banks. A short-term hybrid solution would deliver the perfect test-bed for the BoE – providing proof that alternative payment providers can be trusted with access to these systems, while the BoE works on its long-term plan to grant truly direct access to non-banks.

Tony Craddock Director General, Emerging Payments Association (EPA)

I have been championing change in the UK payments system for over a decade. The changes I have helped to enforce have opened up opportunities to a number of companies, resulting in not only more innovation, but also greater competition. The Emerging Payments Association represents more than 75 companies from across the payments ecosystem, and together we aim to advance innovation while driving the UK forward as the global innovation hub for payments. The EPA accepts that change in payment systems does not happen overnight, and nor should it. But the EPA fully supports making changes to access to the payments system soon. Not only will the EPA’s members and their customers benefit, this will also allow the UK to continue to demonstrate its global leadership as the most progressive and innovative country in the world for payment systems.

About the Author:
Rich Wagner, CEO and Founder, APS

Rich has over 30 years' experience in both the payments industry, having held leading roles across both Visa and Barclaycard, before forming his own FinTech payments enterprise APS in 2004. Today APS is one of the largest non-bank e-money issuers in the UK – providing digital current account and payment solutions to consumers, SMEs and the Public Sector.

Rich has a long history of battling traditional barriers in the financial services space to make room for alternative players. Rich fought for APS to become the first non-bank issuer to gain MasterCard membership in 2007 and last year became the first non-bank to sync up with the Post Office to offer banking services.

An advisory board member of the Emerging Payments Association since 2014, Rich now serves as the organisation's chairman – active January 2016. As part of this role, Rich is passionate about fighting for non-banks to gain access to traditional payment infrastructure.

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About the Emerging Payments Association (EPA)

The EPA is a trade body for the emerging payments industry built by experienced payment practitioners and a community for the UK's most progressive payments companies, supported by our benefactor Visa Collab. The EPA helps its members to have influence over the payments landscape and get access to the people operating in it, whether they are buyers, sellers or partners. Based in the heart of London, the EPA houses the Catalyst – the world's only incubator dedicated to early stage PayTech companies, sponsored by MasterCard and The Bancorp.

The EPA works with its members – from global giants to niche start-ups – to shape the future of the payments industry landscape by raising the profile of the industry, helping members grow their business and addressing the barriers that stifle innovation.

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