



FINANCIAL CONDUCT AUTHORITY  
**PAYMENT SYSTEMS  
REGULATOR**

Market review into the ownership  
and competitiveness of  
infrastructure provision

**MR15/2.2**

# **Interim report**

February 2016

In this interim report we set out our initial view on the ownership and competitiveness of infrastructure provision.

We are asking for comments on our interim report by 21 April 2016. You can send your comments and responses by email to [infrastructurereview@psr.org.uk](mailto:infrastructurereview@psr.org.uk).

You can also respond in writing to the address below (although we ask all respondents to also provide electronic Word and PDF versions of their response).

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- publication in appropriate cases
- exercising our functions as transparently as possible

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You can download this interim report from our website [www.psr.org.uk](http://www.psr.org.uk).

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<sup>1</sup> The Gateways are set out in the Financial Services (Banking Reform) Act 2013 (Disclosure of Confidential Information) Regulations 2014, S.I. 2014/882

# Contents

1 .....	3
<b>Executive Summary .....</b>	<b>3</b>
The importance of the UK payments sector.....	3
Our market review .....	3
Our initial key findings .....	4
Interim proposals on remedies .....	5
What do you need to do next? .....	6
2 .....	7
<b>Our Approach .....</b>	<b>7</b>
Why we are conducting this review.....	7
Scope of the review .....	8
Why we are publishing an interim report .....	9
The evidence gathered to support our analysis.....	9
3 .....	11
<b>Market background .....</b>	<b>11</b>
Introduction .....	11
Why payment systems are important .....	12
Main UK payment systems .....	12
Recent trends for Bacs, LINK and FPS .....	13
Main participants in a payment system.....	15
Payment service providers .....	16
Payment system operator .....	17
Central infrastructure provider .....	19
VocaLink’s business model .....	20
The origin and evolution of Bacs, LINK and FPS .....	23
4 .....	31
<b>Competition for the provision of central infrastructure services .....</b>	<b>31</b>
Introduction .....	31
Current state of competition and outcomes .....	36

Barriers to switching infrastructure provider .....	52
Barriers to entry .....	56
Conclusion .....	60
<b>5.....</b>	<b>62</b>
<b>Competition in the provision of other infrastructure services.....</b>	<b>62</b>
Introduction .....	62
Current state of competition in gateway solutions .....	63
Barriers to switching .....	66
Barriers to entry .....	67
Conclusion .....	69
<b>6.....</b>	<b>70</b>
<b>Ownership and control of payment systems.....</b>	<b>70</b>
Introduction .....	70
Ownership of VocaLink and operators.....	71
Corporate governance and decision-making processes at VocaLink and at the operator level.....	72
Stakeholder views on VocaLink's ownership.....	78
Conclusions .....	83
<b>7.....</b>	<b>85</b>
<b>Interim conclusions.....</b>	<b>85</b>
Introduction .....	85
Initial findings .....	86
<b>8.....</b>	<b>90</b>
<b>Potential remedies .....</b>	<b>90</b>
Key principles for considering remedies.....	90
Our initial thinking on potential remedies .....	91
The future of the payment systems market .....	94
Other alternatives.....	95
<b>9.....</b>	<b>96</b>
<b>Next steps.....</b>	<b>96</b>
Stakeholder feedback .....	96
Further work planned .....	96
Final report .....	96

# 1

## Executive Summary

This document sets out for consultation our initial view on the ownership and competitiveness of infrastructure provision.

We have found that there is no effective competition for the provision of UK payments infrastructure for the three main interbank payment systems (FPS, Bacs and LINK). There is a lack of incentives for operators to look for alternative infrastructure providers that could better meet the needs of their service-users. We consider that this is partly due to the fact that the operators and the infrastructure provider are both owned and controlled by the payment service providers (PSPs) who use them. We have also found that there are barriers to entry that prevent or deter potential central infrastructure providers from competing to provide these services.

### The importance of the UK payments sector

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- 1.1 Payment systems form a vital part of the UK's financial system – they underpin the services that enable funds to be transferred between people and institutions. In 2014, these payment systems processed more than 21 billion transactions worth around £75 trillion.
- 1.2 Well-functioning payment systems contribute to the country's economic productivity by reducing the costs of transactions, improving financial markets' liquidity and enhancing the financial sector's stability. There have been many studies over the last 15 years by government and regulatory bodies that have examined UK payment systems. The Cruickshank Report in 2000 noted that the ownership and governance of the UK payment systems was restricting innovation, and advocated a separation of infrastructure providers and operators. The Office of Fair Trading (OFT) later noted that the proposed separation seemed unlikely to have the desired effect, because the ownership profile of operator and infrastructure provider would remain the same. Further studies sought to address these issues, but were not effective. The government made it clear that the current system was not adequately meeting objectives to promote and develop new and existing payment systems, and to facilitate competition.<sup>2</sup> This led to the creation of the PSR.

### Our market review

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- 1.3 In June 2015, we published our Terms of Reference<sup>3</sup> outlining our decision to proceed with a market review of the supply of infrastructure services. As explained in our Terms of Reference, we have statutory objectives to promote effective competition and innovation in the market for payment systems and for the services the systems provide – including services between operators, PSPs and infrastructure providers.
- 1.4 The payment systems infrastructure is the hardware, software, secure telecommunications networks and operating environments that support the clearing and settlement of payments. It is important that infrastructure services are reliable and efficient, and deliver the best outcomes for

<sup>2</sup> *Setting the strategy for UK payments*, HM Treasury, (July 2012).

<sup>3</sup> PSR, PSR MR15/2.1, *Final terms of reference: market review into the ownership and competitiveness of infrastructure provision*, (2015): <https://www.psr.org.uk/psr-publications/market-reviews/mr1521-final-terms-reference-infrastructure>

service-users. Three interbank payment systems – Faster Payments Service (FPS), Bacs and LINK – all share the same infrastructure provider, VocaLink.

- 1.5 Competition for infrastructure services has the potential to improve efficiency, and can lead to lower prices and higher quality to the benefit of PSPs and their customers. It may also encourage infrastructure providers to innovate, so they can attract and retain operators or PSPs as customers. When VocaLink was subject to some competitive pressure through the LINK Request for Information process, it proposed to improve its service quality and dropped the price it offered by approximately [3<]%.<sup>4</sup>
- 1.6 Innovation in infrastructure could have many benefits for PSPs and, ultimately, their customers. Examples include additional functionality (such as better liquidity management tools), faster and more flexible service, and other services which in turn could spur more competition and innovation downstream.

## Our initial key findings

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### Competition in the provision of central infrastructure services

- 1.7 Our provisional finding is that competition in the provision of central infrastructure services is not effective.
- 1.8 Ownership and control of payment systems, at both operator and infrastructure provider level, have an impact on the effectiveness of competition and the extent of innovation in the provision of infrastructure services.
- 1.9 An estimated 2,500 PSPs are authorised to offer payment services in the UK. Currently, a relatively small number of these PSPs own and control Bacs, FPS, LINK and VocaLink. These PSPs are also these systems' main users.
- 1.10 We find that the operators, as the current procurers of infrastructure services on behalf of the PSPs, don't look for alternative providers. They have not held periodic competitive procurement exercises<sup>4</sup> that would allow them to directly compare the potential offerings of alternative providers. And the direct PSPs – as the main users of the payment systems – do not encourage the operators to seek alternatives. Operators and direct PSPs lack the incentive to seek alternative offerings because:
  - i. Operators are not-for-profit and simply pass on costs to PSPs. Therefore they do not have the incentive to drive cost savings through competition for central infrastructure services, and may also place a disproportionate weight on avoiding risk.
  - ii. Direct PSPs do not derive any competitive advantage over other PSPs from competition for central infrastructure provision, and perceive that it could be costly and risky to make changes to their internal systems to connect to a new provider.
- 1.11 We find that PSPs' common ownership and control of both the operators and the infrastructure provider, reinforces this inertia in seeking alternative providers because:
  - i. Shareholder PSPs see the ownership and control of the infrastructure services provider as a way of ensuring security and resilience, and introducing competition for infrastructure services as introducing a degree of risk.

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<sup>4</sup> In this report, we refer to a competitive procurement exercise as one that incorporates both a market testing and a competitive procurement process.

- ii. Shareholder PSPs have an interest in protecting their investment in VocaLink. The same PSPs are responsible for deciding whether to change infrastructure, and have a disincentive to expose VocaLink to competition that may put their investment at risk.
- 1.12 We are concerned that operators have not compared VocaLink's offerings with those of other providers. Most operators and direct PSPs are satisfied with the value for money and quality of service they receive. However, given the lack of incentives to explore alternative service providers, the operators and direct PSPs are not regularly informed about or exposed to alternative propositions that could facilitate innovation in a fast-changing industry like payments. Competition and innovation can provide real benefits to service-users, not only in the provision of services provided by payment systems, but also in wider retail banking services.
- 1.13 The lack of competitive procurement exercises is a barrier to entry that prevents other potential providers from competing, despite several being interested in offering central infrastructure services.
- 1.14 We also find there are other barriers that deter some potential providers from entering:
- i. Some providers are deterred from competing because they perceive that VocaLink will have a competitive advantage in procurement exercises, as VocaLink's shareholders control the operators which will award the contract.
  - ii. Some providers have told us they would not be willing to enter because Bacs, FPS and LINK's messaging standards are different to those used internationally.
- 1.15 We also consider that the current governance and contractual arrangements for the LINK core services contract are a barrier to switching. LINK and VocaLink are currently not legally separate entities and the contract for core services is between VocaLink and all 38 PSPs in LINK, which makes it difficult to change provider. The issue is compounded by a lack of allocated intellectual property rights and provisions for termination, exit and liability in the current contract.

### Competition in the provision of other infrastructure services

- 1.16 Our provisional finding is that competition in the provision of gateway services and solutions (which enable connection to the payment system and central infrastructure) is effective.
- 1.17 It appears that PSPs have sufficient choice of providers for the gateway solutions they require, and they do not all use the same provider. There do not appear to be any barriers to switching – PSPs have switched gateway providers in the past where there has been a good business case.
- 1.18 VocaLink does not appear to foreclose the market for gateway solutions to other providers. However, it is unclear whether VocaLink's accreditation process for Bacs is a barrier to entry for potential providers. It appears some providers would value greater transparency on the tests undertaken by VocaLink to grant accreditation.

### Interim proposals on remedies

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- 1.19 As a result of our interim findings, we are considering the following potential remedies to address the problems in the provision of infrastructure services for FPS, Bacs and LINK. We propose:
- a. **Competitive procurement exercises are undertaken before current contracts for central infrastructure services come up for renewal, or at the next break clause in a contract:** We consider that this will increase competition in the provision of central infrastructure services, which is likely to benefit service-users by introducing the potential for cheaper, more efficient and innovative service offerings than are available under the current arrangements. To ensure an open, transparent procurement process, and to maximise the

potential numbers of interested parties taking part, we would require the development of a strategy for procuring infrastructure; a market-testing exercise to establish availability of service provision options; a competitive exercise that is open, fair and based on best practice; monitoring by an independent person; and agreements with the current provider that enable transition to a new provider.

- b. **Enhanced interoperability, including a common international message standard, for FPS, Bacs and LINK:** This is to address the barrier to entry due to the lack of common international message standards in the UK, and to facilitate a wider choice of provider. It could also enhance interoperability between systems as well as enable UK payment systems to evolve. The Payments Strategy Forum will examine the type of message standard to be adopted and the simplification of rules.
- c. **Divestment by shareholder PSPs of their interest in VocaLink:** This is to address potential bidders' perceptions about the likelihood of winning a competitive procurement exercise, as well as the operators' lack of incentive to consider alternative infrastructure providers arising from common ownership and control of operators and the infrastructure provider.
- d. **Measures that separate common ownership of the functions of LINK from VocaLink and implement industry-led governance changes:** We acknowledge that these actions are planned, but it is important that this separation is completed for the same reasons as the divestment remedy proposed. This is to ensure that the body responsible for setting the rules for the payment system and awarding the contract is functionally and legally separate from the infrastructure provider that delivers these services. The proposed changes by industry to Link Scheme's governance and operational structure to make it legally independent of VocaLink should help to address this issue. We acknowledge that this is planned, but not yet fully implemented. We consider it important that it is also completed.

1.20 We consider that these potential remedies working together have the potential to promote our statutory objectives, and in particular to increase competition for the provision of infrastructure services. This can help promote more innovation in payment systems, and therefore promote the interests of service-users.

1.21 We recognise that if we decide after this consultation to implement some or all of the potential remedies, further work would be required to determine how they would be best implemented. We are seeking feedback from stakeholders on how effective and proportionate the potential remedies are, and the potential costs and benefits. A full list of consultation questions can be found in Annex 8. In proposing remedies focused on the issues identified in this market review, we are also mindful that alternative structures are, and may further develop in the future which differ from the current predominant three-party structure of PSP, operator and infrastructure provider. Our potential remedies are intended not to preclude such developments. Further consideration will be given by the PSR to the appropriate mechanism to examine potential alternative models, such as competition in the market.

## What do you need to do next?

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1.22 We welcome your feedback on our initial findings and potential remedies. If you would like to provide comments, please email these to us by 5pm 21 April 2016 at [infrastructurereview@psr.org.uk](mailto:infrastructurereview@psr.org.uk), or write to the address on page 2.

1.23 We will consider your comments to this interim report when preparing our final report, which will be published later this year. This will set out our final findings and conclusions.



## 2 Our Approach

2.1 In this chapter, we set out:

- why we are conducting this review
- the scope of the review
- why we are publishing this interim report
- the evidence we gathered to support our analysis

### Why we are conducting this review

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2.2 In November 2014, we published our consultation paper on a new regulatory framework for payment systems in the UK.<sup>5</sup> During this consultation, some stakeholders raised concerns relating to the overlapping vertical relationships and common ownership of the operators and the infrastructure provider of payment systems and its effects on incentives to compete.

2.3 As explained in our June 2015 terms of reference<sup>6</sup>, we have a statutory objective to promote effective competition in the markets for payment systems and for the services provided by those systems, including between operators, PSPs and infrastructure providers. We also have statutory objectives to ensure that payment systems are operated and developed in a way that considers and promotes the interests of service-users and to promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems.

2.4 Currently, a small number of payment service providers (PSPs) own and/or govern<sup>7</sup> the Bacs, FPS and LINK payment systems and the central infrastructure for these systems. These PSPs are mainly banks and building societies which are also the main users of these payment systems. These arrangements are perceived to have resulted in the development of relatively robust and resilient payment systems. Such arrangements may provide incentives to keep infrastructure services costs down. However, concerns have been raised that they may also enable some PSPs to exert greater influence over infrastructure development and operation in a way that is in their own interests rather than in the interests of other service-users. There is more detail on the structure and evolution of UK payments systems in Chapter 3.

2.5 We have sought to address some of the concerns that relate to the functions of operators already through our general directions to operators of the interbank payment systems. These include:

- a. General Direction 4 requiring interbank operators (except Northern Ireland Cheque Clearing (NICC)) to ensure appropriate representation of service-users' interests in the decision-making processes of their governing bodies.

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<sup>5</sup> PSR, PSR CP14/1, *A new regulatory framework for payment systems in the UK*, (November 2014): <https://www.psr.org.uk/psr-publications/consultations/consultation-paper-141>

<sup>6</sup> PSR, PSR MR15/2.1, *Final terms of reference: market review into the ownership and competitiveness of infrastructure provision*, (June 2015): <https://www.psr.org.uk/psr-publications/market-reviews/mr1521-final-terms-reference-infrastructure>

<sup>7</sup> BPSL, FPSL and LINK are membership organisations and do not issue shares.

- b. General Direction 5 requiring interbank operators (except NICC) to ensure any individual acting as Director of an operator must not simultaneously act as a Director of a central infrastructure provider to the payment system. This is to address any potential conflict of interest which could stand in the way of new competing and innovative infrastructure providers having a fair opportunity to bid and win contracts and to not distort the competitive tendering process.
- c. General Direction 6 requiring interbank operators (except NICC) to publish minutes of their governing body, including votes. We expect this increased transparency about decision-making will enable service-users to assess whether interbank operators are appropriately considering their interests when taking decisions.

2.6 As explained in our Terms of Reference, we are carrying out this study to understand whether the current provision of infrastructure services in the UK interbank payment systems delivers a good outcome for service-users. This review explores how the ownership arrangements and vertical relationships of interbank payment systems and infrastructure providers affect decision making, innovation and the competition dynamics within the market.

## Scope of the review

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2.7 This review considers the supply of infrastructure services related to interbank payment systems, focusing on Bacs, FPS and LINK's clearing of payments. Clearing is the process that transmits, validates, routes, reconciles and in some cases confirms a payment instruction or transfer order (i.e. a promise to pay someone).

2.8 We also look at other infrastructure services that are provided at the boundary between PSPs and clearing functions, namely:

- provision of database services – such as the Bank Reference Data, Customer Reference Data and Extended Industry Sort Code Database which include data needed to validate and route payments in the correct way
- communication channels services – ranging from standard telecommunication lines to more complex channels such as the Enhanced Transmission Service and SWIFTNet Transmission Service (ETS and STS)
- gateway services – gateways are typically the entry point to the communication channel between the PSP (or any third-party service provider such as a bureau) and the central clearing infrastructure
- accreditation services – where individual providers are approved to deliver particular functions within the payment systems
- other services between central clearing functions and direct PSPs

2.9 The review also covers other aspects of infrastructure services in interbank payment systems. These include services provided by providers of central clearing services on behalf of PSPs, such as ATM (Automated Teller Machine) managed services and other similar services.

2.10 The emphasis of our review is on those services related to Bacs, FPS and LINK for the reasons set out in our Terms of Reference<sup>8</sup>.

2.11 The key questions that we explore during the review are:

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<sup>8</sup> PSR MR15/2.1, paragraphs 1.16 to 1.17, p. 7.

- Is competition effective in the provision of infrastructure services in interbank payment systems, and if not, what are the reasons for this?
- What is the likelihood of entry or expansion in respect of the provision of infrastructure services?
- How do demands from interbank payment system operators as customers of infrastructure services providers; demand from PSPs as customers of interbank payment system operators; and demand from ultimate end-users of interbank payment systems, affect competition and innovation in the provision of infrastructure services related to interbank payment systems?
- What could be the benefits of greater levels of competition and innovation in the provision of infrastructure services in interbank payment systems?
- How do the current ownership arrangements of infrastructure providers affect competition and innovation in the provision of infrastructure services related to interbank payment systems?

### **Why we are publishing an interim report**

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- 2.12 We are publishing this interim report to present what stakeholders have told us so far and our provisional assessment. We also want to give all interested parties an opportunity to comment on our findings, analysis and potential remedies.
- 2.13 In this report, we set out our initial observations on:
- a. the role of operators and PSPs in driving effective competition and innovation
  - b. competition in the provision of central infrastructure services
  - c. competition in the provision of other infrastructure services
  - d. how the current ownership arrangements affect competition and innovation
  - e. potential remedies that could improve competition and innovation in the interests of service-users

### **The evidence gathered to support our analysis**

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- 2.14 To gain a better understanding of the market in the UK, we analysed a wide range of data and information. We also met with operators, infrastructure providers, PSPs, independent ATM deployers (IADs), fintechs and received input from interested parties in responses to our Terms of Reference. We would like to thank all participants for their time and for their constructive engagement to date. A full list of those who contributed to the review can be found in the stakeholder list in Annex 9.

### **Requests for Information**

- 2.15 To understand both the demand side and supply side of the market, we requested quantitative and qualitative data from PSPs, operators and VocaLink. Through requests for information we gathered information and views on:
- a. the pros and cons of the current ownership arrangement of VocaLink

- b. the price and quality of infrastructure services VocaLink provides (both core services and non-core services)
- c. the current drivers of innovation within central infrastructure
- d. the current level of competition and tendering processes
- e. the potential costs and benefits of alternative infrastructure models/provision
- f. contract negotiations between operators and VocaLink
- g. VocaLink's strategy, governance structure and cost of business

The detailed questionnaire can be found in Annex 6.

### **Meetings with PSPs, infrastructure providers and fintechs**

- 2.16 Over the course of the market review we have had more than 50 meetings with PSPs, operators, IADs, associations and infrastructure providers. We also organised a round-table to gather views from the fintech community.

### **Desk-based research**

- 2.17 Desk-based research has provided us with the information on the development of payment systems, regulatory changes and issues previously identified. We have also done some research on other payment systems to shed light on the form and possibility of alternative industry structures. A summary of these can be found in Annex 5.

### **International Comparison**

- 2.18 We also commissioned a study to understand the central infrastructure services providers market for 13 countries and one region.<sup>9</sup> This informed our thinking by helping us to understand the market structure, regulation, governance and ownerships, as well as innovation development internationally. The results of this work are published separately alongside this report and can be found on our website.

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<sup>9</sup> The countries included in this study are Australia, Brazil, Canada, Denmark, Japan, New Zealand, Belgium, Germany, Italy, Singapore, Sweden, United Kingdom, and United States of America. The Single Euro Payments Area (SEPA) was also included in the research.

# 3

## Market background

Payment systems form a vital part of the UK's financial system as they can contribute to the country's financial stability and economic growth. In the UK there are a number of payment systems. These involve participants such as end users, payment service providers, payment system operators, central infrastructure providers and gateway services and solutions providers. The payment system operators and the central infrastructure provider have a key role in ensuring good outcomes for users. We explain the role of each of these participants and how the systems have evolved over time.

UK payment systems can be divided into interbank payment systems and card payment systems. This market review concentrates on three interbank payment systems – Bacs, FPS and LINK – and their central infrastructure provider VocaLink. In 2014 these payment systems were responsible for nearly ten billion transactions involving the movement of nearly £5.5 trillion.

The current make-up of these three payment systems is the result of a series of changes over time. Many of these changes have been driven by regulatory intervention, while others happened naturally within the industry. Regulatory intervention has looked at addressing concerns around how the lack of competition and innovation has affected these systems and focused on governance.

### Introduction

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- 3.1 In this chapter we give an overview of the payment systems in the UK, focusing on Bacs, FPS and LINK. We also look at competition issues in the market for infrastructure services for these systems – including some regulatory interventions that have already been introduced by other authorities.
- 3.2 In this chapter we set out:
- why payment systems are important
  - the main UK payment systems
  - recent trends for Bacs, FPS and LINK
  - the main participants in a payment system
  - who PSPs are
  - the role of operators and their procurement function
  - the role of the central infrastructure provider and the services it offers
  - VocaLink's business model

- the origin and evolution of Bacs, FPS and LINK

## Why payment systems are important

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- 3.3 Payment systems form a vital part of the UK's financial system and are critical to the economy. In 2014 UK payment systems dealt with more than 21 billion transactions worth around £75 trillion.<sup>10</sup>
- 3.4 Well-functioning payment systems reduce the cost of transactions, improve the liquidity of financial markets and enhance the stability of the financial sector. In contrast, ineffective and inefficient payment systems can severely undermine the stability and developmental capacity of a country and its economy. These could result in inefficient use of financial resources, inequitable risk-sharing among market participants, losses for participants and a loss of confidence in the financial sector.
- 3.5 Well-functioning payment systems also contribute to a country's financial stability and economic growth. Failures or disruptions of a payment system could destabilise financial markets and cause widespread economic disruption.

## Main UK payment systems

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- 3.6 Payment systems support the services that enable money to be transferred between people, businesses, and institutions. There are a number of payment systems in the UK.
- 3.7 Currently, each UK payment system supports a different kind of payment service. Broadly, they can be divided into interbank payment systems and card payment systems.

## Interbank payment systems

- **Bacs** provides two main payment instruments:
  - Direct Debit (a 'pull' payment used, for example, to pay bills)
  - Bacs Direct Credit (a 'push' payment used, for example, to pay employee salaries and benefits)

Its operator is Bacs Payment Schemes Ltd (BPSL) and its central infrastructure services provider is VocaLink.<sup>11</sup>

- **Cheque and Credit (C&C)** processes cheques and other paper instruments in England, Scotland and Wales.

Its operator is the Cheque and Credit Clearing Company Ltd (C&CCCL). The members of C&C have outsourced many of the processes associated with the clearing of these instruments to two commercial providers, iPSL and Hewlett Packard Enterprise Services (HPES).

The industry is in the process of implementing a new image-based clearing system for cheques, which will use a new single central infrastructure supplied by a third-party provider, CGI.<sup>12</sup>

- **CHAPS** is the UK's high-value sterling interbank payment system, where payments are settled over the Bank of England's Real-Time Gross Settlement (RTGS) system. It processes domestic

<sup>10</sup> PSR PS15/1, Policy Statement, Foreword, *A new regulatory framework for payment systems in the UK*, (March 2015): [psr.org.uk/psr-publications/policy-statements/policy-statement-151](http://psr.org.uk/psr-publications/policy-statements/policy-statement-151)

<sup>11</sup> For roles of the central infrastructure provider, see paragraphs 3.29 - 3.33.

<sup>12</sup> C&CCC, *Cheque imaging* available at: [www.chequeandcredit.co.uk/cheque\\_and\\_credit\\_clearing/cheque\\_imaging/](http://www.chequeandcredit.co.uk/cheque_and_credit_clearing/cheque_imaging/)

and international wholesale payments (money market transactions and the sterling leg of foreign exchange transactions) and certain retail payments, such as house purchases.

Its operator is CHAPS Clearing Company Ltd (CHAPS Co) and the central infrastructure services provider is the Bank of England.

- **Faster Payments Service (FPS)** provides near real-time payments, one-off forward-dated payments and standing orders. Virtually all internet and telephone banking payments in the UK are now processed through FPS.

Its operator is Faster Payments Scheme Ltd (FPSL) and the central infrastructure services provider is VocaLink.

- **LINK** enables payment account holders to take cash out (among other activities) using the LINK network of ATMs.

The operator is Link Scheme<sup>13</sup> and the central infrastructure services provider is VocaLink.

- **Northern Ireland Cheque Clearing (NICC)** processes cheques and other paper instruments in Northern Ireland.

The operator is Belfast Bankers' Clearing Company Ltd (BBCCL). NICC has no central infrastructure provider since its members exchange payments bilaterally.

## Card payment systems

- 3.8 Card payment systems enable individuals and organisations to make card and card-based payments – for example, debit, pre-paid and credit cards.
- 3.9 The main card payment systems in the UK are MasterCard and Visa. They both operate their respective payment system and underlying infrastructure themselves.

## Recent trends for Bacs, LINK and FPS

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- 3.10 This review is focused on the supply of infrastructure services related to interbank payment systems. In particular we are focusing on Bacs, FPS and LINK.
- 3.11 In 2014 Bacs, FPS and LINK were responsible for nearly 10 billion transactions involving the movement of nearly £5.5 trillion.<sup>14</sup>
- 3.12 To understand how Bacs, FPS and LINK are relevant to UK consumers, it is useful to examine trends over the last ten years. These are summarised in Figure 1.

## Bacs

- 3.13 Between 2005 and 2009, the average annual volume growth for Bacs transactions was 4.2%, but it was 0.7% between 2010 and 2014. However, in 2014 transactions grew by 2.6%, to 5.84 billion – the fastest rate since 2007, when transactions increased by 3.4%.<sup>15</sup>

<sup>13</sup> While the executive report to a corporate board at BPSL and FPSL, in the case of Link Scheme the operator reports to the Network Member Council (NMC). The NMC is composed of all PSPs that participate in the payment system.

<sup>14</sup> Payments UK data, *Historical monthly statistics*, available at: [paymentsuk.org.uk/industry-information/free-industry-statistics](http://paymentsuk.org.uk/industry-information/free-industry-statistics) and data from LINK, *Statistics*, available at: [www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx](http://www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx)

<sup>15</sup> Payments UK data, *Historical monthly statistics*.

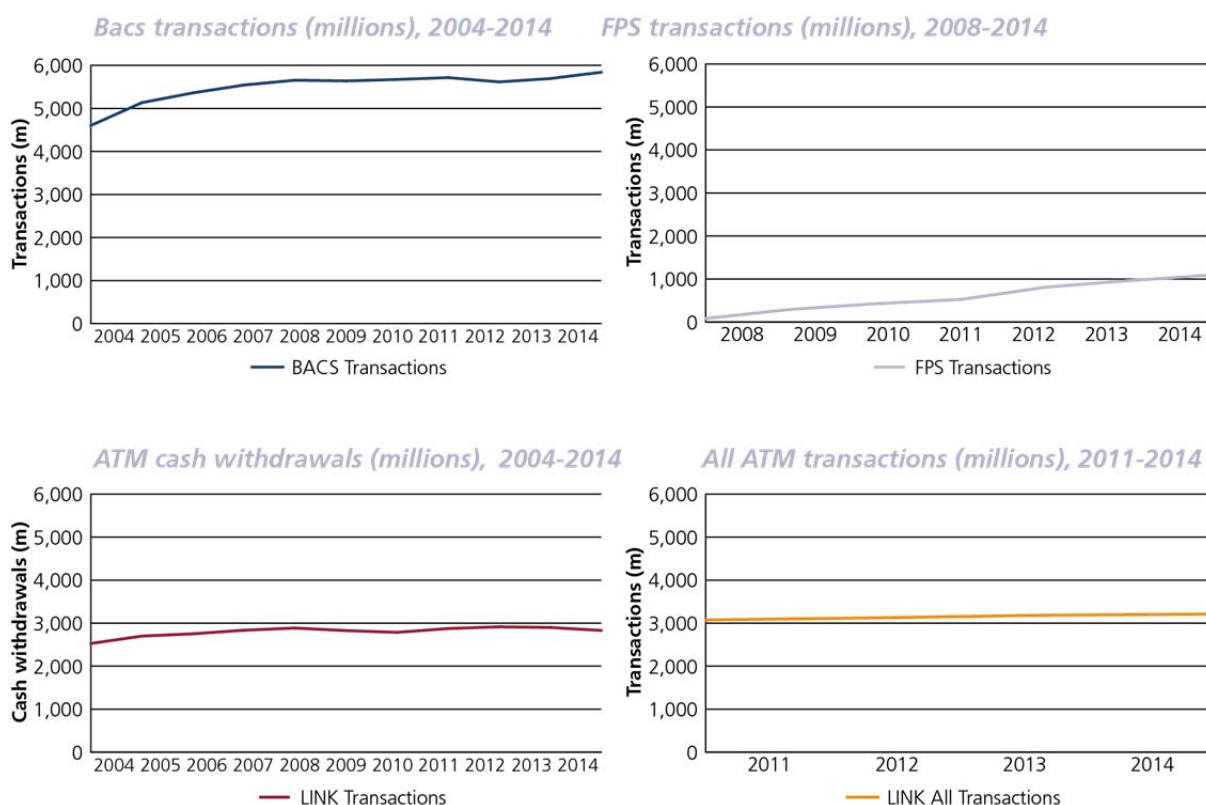
## LINK

3.14 Between 2005 and 2009, withdrawals from cash machines grew on average by 2.3% per annum. Between 2010 and 2014 growth was stagnant overall: the trend increased between 2010 and 2012 and then dipped from 2012.<sup>16</sup> LINK cash withdrawals decreased by 0.5% in 2013 and by 2.3% in 2014, to £2.83 billion – the fastest rate of reduction since 2001.<sup>17</sup> The number of all ATM transactions – including LINK cash withdrawals, balance enquiries and PIN changes – has increased slowly but steadily in recent years, going from 3.07 billion in 2011 to 3.21 billion in 2014.

## FPS

3.15 FPS processed over 1.1 billion payments in 2014, a growth of 13.5% compared to 2013. More consumers are using FPS each year, which might be expected considering that FPS was launched only in 2008.<sup>18</sup>

**Figure 1: Number of transactions for Bacs, FPS and LINK**



Source: PSR analysis of Payments UK data and data from LINK

3.16 To summarise, the use of electronic payments is increasing. In particular, consumers increasingly use real-time or same-day payment services and so FPS transactions are growing. ATM and Bacs transactions are also increasing, even though they are already well established.

<sup>16</sup> LINK, *Statistics*, available at: [www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx](http://www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx)

<sup>17</sup> LINK, *Statistics*, available at: [www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx](http://www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx)

<sup>18</sup> Payments UK data, *Historical monthly statistics*.

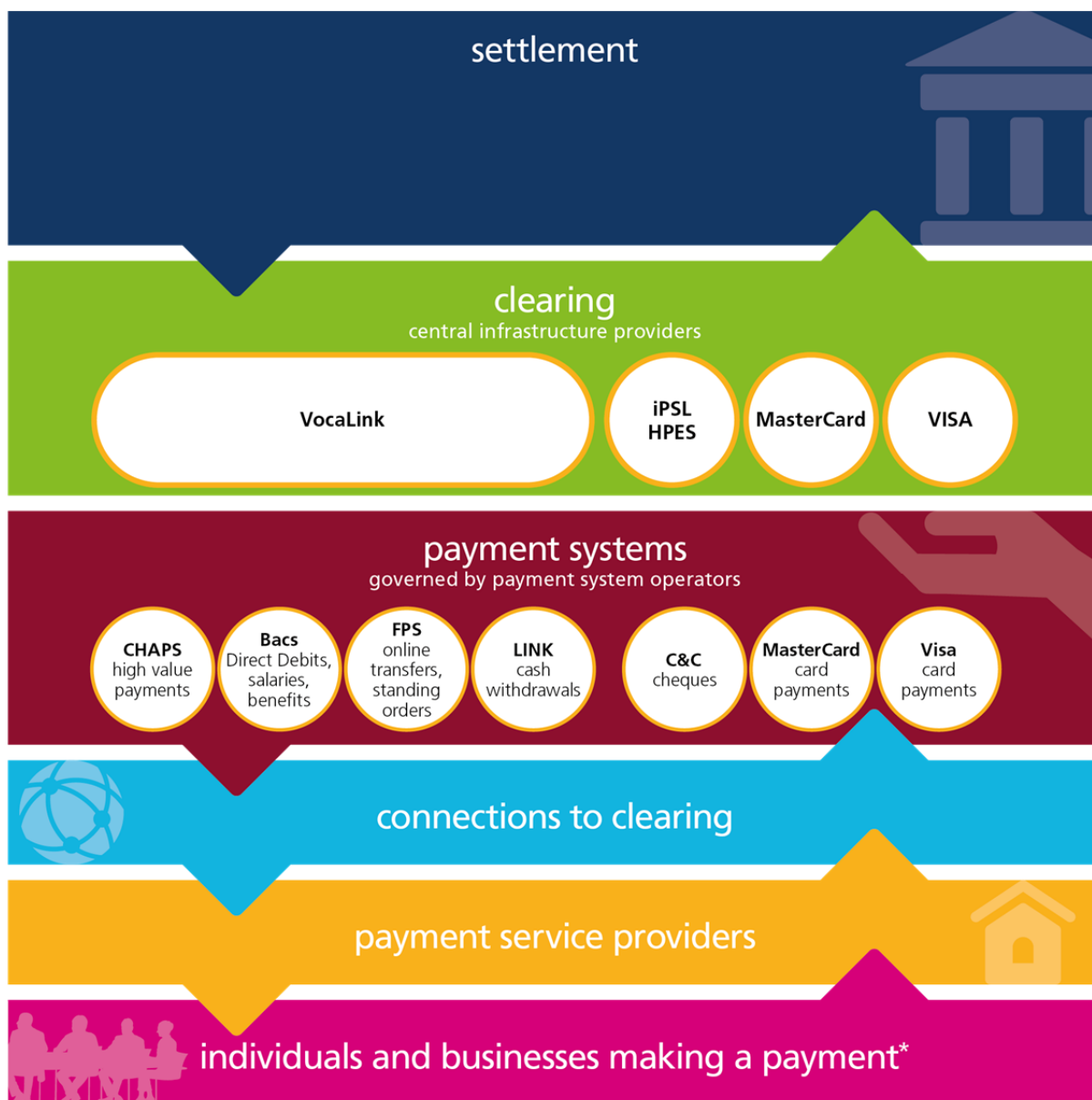


## **Main participants in a payment system**

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- 3.17 A payment system involves several participants. The party making the payment is the payer and the party who receives the payment is the payee. The payer and the payee are both end users of the payment system and include individuals, such as consumers, and organisations including businesses, corporations and the government.
- 3.18 Figure 2 provides an overview of the value chain of the main UK payment systems.
- 3.19 This review focuses on the middle section of this value chain:
- PSPs
  - operators
  - the central infrastructure provider
- 3.20 The following sections describe the roles they play.

**Figure 2: Value chain of the main UK payment systems**



\* Many businesses connect directly into the clearing functions for Bacs and FPS, but this is not represented on this simplistic diagram.

### Payment service providers

3.21 Financial services firms that provide payment services, known as payment service providers (PSPs), are often credit institutions such as banks and building societies. These are authorised to hold deposit accounts and so have customers who need to make payments into and out of their accounts on a regular basis. In most cases, end users have a contractual relationship with the PSP executing payment transactions on their behalf. The PSP will initiate the payment instruction and execute the payment on behalf of its customer. Credit unions, authorised payment institutions (APIs), small payment institutions (SPIs) and electronic money institutions are also PSPs.

## Payment system operator

- 3.22 How a payment system works is based on a set of rules governing, for example, the payment processing cycle and the responsibilities of the parties in the process. The rules also cover technical standards, such as the format for exchanging electronic messages for processing payments. In the UK, operators are currently responsible for setting these rules. They also determine the functional and operational requirements that the infrastructure provider must meet. The role played by operators in other countries sometimes differs from that in the UK model.
- 3.23 At the moment, for Bacs, FPS and LINK, the operator<sup>19</sup>
- is the custodian of the payment system's rules and technical standards
  - manages and operates the payment system
  - must comply with regulatory aspects governing the payment system
  - determines access criteria and the application process for joining the payment system
  - procures the central infrastructure for the payment system
- 3.24 We give more details around the UK operators' current functions in Box A. The function of the current operators that is most relevant to this market review is the one concerning the procurement of central infrastructure services (see paragraphs 3.25 to 3.28).

## Box A: Functions of operators

### Rules and standards

System rules and procedures form the 'instruction manual' that dictates how money is moved from PSP A to PSP B within the particular payment system and payment infrastructure. Adherence to these rules is mandatory for all participants.

Examples of these rules and technical standards include:

- the deadlines that PSPs must meet when processing a transaction
- the standard data formats used to exchange payment instructions and related messages in the payment systems
- the information that must or may be provided within payment instructions
- the basis for settlement of payment values

### Regulatory aspects governing operators and payment systems

In the UK, operators determine the functional and operational requirements that infrastructure services providers must meet and ensure that international standards for systematically important payment systems are met – for example, CPMI-IOSCO.<sup>20</sup>

The Bank of England is the financial stability supervisor of recognised payment systems in the

<sup>19</sup> Access to payment systems, available at: <http://www.accesstopaymentssystems.co.uk/introduction-payment-systems/what-payment-scheme>

<sup>20</sup> CPMI-IOSCO Principles must be adopted by systemically important payment systems. In the UK, only Bacs and FPS have been recognised by the Treasury as systems subject to the Bank of England's oversight under the Banking Act 2009.

UK including Bacs and FPS (but not LINK) for which Vocalink is the infrastructure provider.

Section 188 of the Banking Act 2009 provides that the Bank may publish Principles, to which operators of recognised payment systems must have regard. Operators will be expected to take appropriate action in respect of matters described in the Principles in a way that is appropriate to their system's particular characteristics and the risks they pose to the UK financial system or to business and other interests. The Principles for Financial Market Infrastructures (PFMIs) were adopted by the Committee on Payments and Market Infrastructures (CPMI) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) (CPMI-IOSCO) in April 2012 following consultation and were published by the Bank as its Section 188 Principles in December 2012.<sup>21</sup>

### Access criteria and requirements

Under the current setting, operators have established a range of access criteria that PSPs must meet to be eligible for becoming a member of their respective payment system. Operators have also determined the processes that PSPs must follow to become members.

### Price

Currently, the operational cost of each operator is covered by its members' fees. Calculation of the relevant fees for each member varies and depends on a number of factors, such as volume and profile of transactions. BPSL, FPSL and the Link Scheme operate on a not-for-profit basis. The operator of LINK sets the ATM Interchange fee under a formula approved by the Office of Fair Trading (OFT) in 2001.<sup>22</sup>

### Change requests

Currently, operators in the UK are also responsible for identifying, developing and submitting change requests to the central infrastructure services provider. These are generally enhancements to existing services, but can also relate to new services or products. Change requests can be initiated by the PSPs and submitted via the operator or by the operator on a stand-alone basis. Change requests relative to services that are centrally procured and initiated by the PSPs are first evaluated by the operator.

## Procurement of central infrastructure services

- 3.25 Under current contractual arrangements, procurement can be done periodically, either through a competitive procurement exercise (see Box D) – where potential providers are benchmarked – or through a negotiated process between the operator and the incumbent central infrastructure services provider.
- 3.26 As the procurement body, each operator in the UK determines the services and products to be procured. Infrastructure services that are not centrally procured by operators, such as gateway solutions and services, are procured by the PSPs individually.
- 3.27 In procuring central infrastructure services, the operator agrees with the central infrastructure services provider on key elements such as:
- length of the contract
  - service level agreements (SLAs), relative financial penalties and incentives

<sup>21</sup> The CPMI was previously known as Committee on Payment and Settlement System (CPSS). In September 2013, in the light of the Committee's standard-setting activities and the associated greater public scrutiny, the CPSS reviewed its mandate. The new mandate was approved by the Global Economy Meeting, which has also endorsed the renaming of the CPSS as CPMI, Committee on Payments and Market Infrastructures. Both changes became effective as of 1 September 2014.

<sup>22</sup> LINK, *Introduction to the Link Scheme*, (February 2015): [http://www.link.co.uk/SiteCollectionDocuments/Introduction\\_to\\_the\\_LINK\\_Scheme\\_Feb\\_2015.pdf](http://www.link.co.uk/SiteCollectionDocuments/Introduction_to_the_LINK_Scheme_Feb_2015.pdf)

- price for the provision of services
  - a rate card to be used when the supplier carries out ad hoc work, such as change requests, and associated procedures
  - contract termination provisions, including day-to-day management and exit management during transition phase
  - the level of resources or investment committed to procured services and the underlying infrastructure
- 3.28 When procuring services on behalf of their members, the operators may manage certain key risks – for example, the risk of poor performance by the provider, unforeseen fees or charges, property damage or data loss.

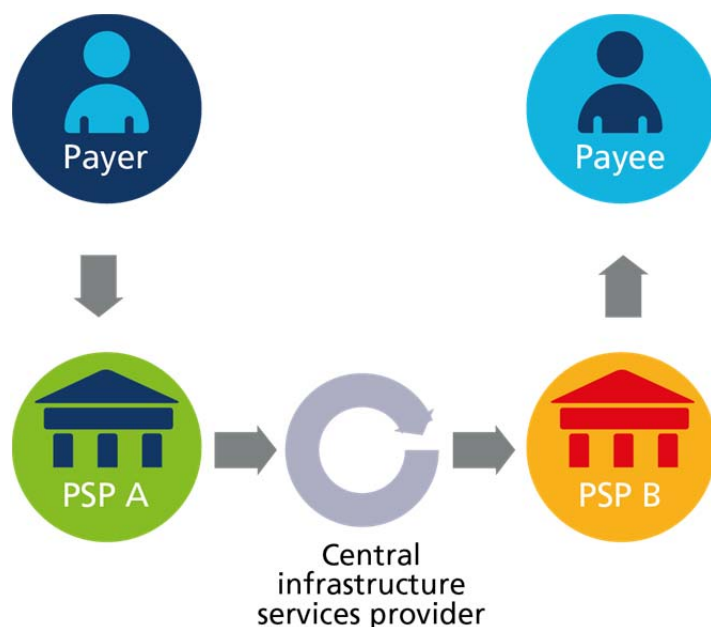
### **Central infrastructure provider**

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- 3.29 The central infrastructure for payment systems consists of the hardware, software, secure telecommunications network and operating environments that support the clearing and settlement of payment transactions. In the UK central infrastructure services providers usually provide and run the facilities used to process payments. Electronic interbank payment systems like Bacs, FPS and LINK are based on centralised structural models with a single provider: they each have a single provider of central infrastructure services. As mentioned in paragraphs 3.25 to 3.26, these services are centrally procured by the operators on behalf of the member PSP.
- 3.30 VocaLink is the central infrastructure services provider for Bacs, FPS and LINK .
- 3.31 Centralised procurement of central infrastructure services from a single provider by an operator is not the only possible structural model. Annex 5 discusses alternative payment system models that are used in other countries.

### **The role of the central infrastructure services provider within a payment system**

- 3.32 Figure 3 shows where the central infrastructure sits in a push payment (a transaction initiated by the payer). When a payer initiates a payment, their PSP (PSP A) sends a message with payment instructions to the receiving PSP (PSP B) through the central infrastructure. The central infrastructure routes the payment instruction to PSP B based on the content of the message. Depending on the system, PSP B may then confirm it has received the message. PSP B subsequently processes the transaction and provides value to its own service-user – the payee.

**Figure 3: The main participants in a payment system**

- 3.33 Members and users of payment systems that settle in central bank money benefit from the mitigation of two risks: credit risk on the settlement agent and disruption risk – for example, the risk of widespread disrupted access for the users of payment services arising from the failure of the settlement agent. The Bank of England also acts as the settlement agent for most of the major UK payment systems including Bacs, FPS and LINK.

### Providers of gateway solutions and services

- 3.34 Gateway solutions and services are the infrastructure services that PSPs (or other authorised organisations) may use as their entry point to the secure communication channel for a central clearing infrastructure. They enable PSPs or other authorised parties to have technical connectivity to the payment system. Gateway solutions and services will be chosen depending on a PSP's specific requirements, which include:
- developing its entire gateway solutions in-house
  - acquiring gateway solutions from a third-party infrastructure provider and then customising them in-house
  - fully outsourcing its gateway solutions to a third-party service provider.

### VocaLink's business model

- 3.35 VocaLink provides payment processing infrastructure services both in the UK and abroad. Its UK provision can be distinguished between core services and non-core services.

#### Core services

- 3.36 Core services are the processing, clearing and back-office services – such as transmission, validation, routing, reconciliation and exception handling – VocaLink provides to PSPs using the Bacs, FPS and LINK systems. These are all governed by contractual agreements between VocaLink and the operators of those systems (in the case of Bacs and FPS, and between VocaLink and the members in the case of

LINK). VocaLink is the sole provider of these services for Bacs, FPS and LINK and runs, maintains and services:

- the central infrastructure that processes Bacs payments, under contract with BPSL
- the FPS real-time payments platform, under contract with FPSL
- the central switch operation, which is the central infrastructure used for processing and routing payments, under contract with LINK's members

3.37 From 2010 to 2014, VocaLink's annual revenues from the provision of core services to Bacs, FPS and LINK ranged from about [redacted] to about [redacted] of overall revenues. At the request of its shareholders VocaLink does not distribute its profits through dividends. [redacted].

### Non-core services

3.38 Non-core services are other services that VocaLink provides to Bacs, FPS or LINK, and other UK domestic banking needs. These include 'elective' services that VocaLink provides to PSPs or other system users on a bilateral basis, and also services to operators under different contracts to the core services. Examples of non-core services include:

- ancillary services to operators and PSPs that involve Bacs, FPS and LINK, such as change requests which are outside the scope of the service contract
- services to BPSL under a marketing agreement
- Bank Reference Data: a database and related reports on banks and bank offices that participate in the UK interbank payment systems
- Cash ISA transfer service: provision of the technical infrastructure for the service that makes it easier for the holder of a Cash ISA account to switch to a new Cash ISA provider
- the Current Account Switch Service (CASS): provision of the technical infrastructure for the CASS service that makes it easier for a current account holder to switch to another bank or building society
- gateway services
- government services, including bespoke UK services such as the HMRC Real Time Information (RTI) initiative that allows HMRC to reconcile Bacs payroll payments with data sent to it by employers
- contingency services: payment processing services offered to a small number of government, bank and corporate customers
- Paym: provision of the platform that supports the Paym person-to-person mobile payments service, which is an overlay service that leverages the FPS system
- Payments Data Insight: data analytics services based on the use of payments data
- LINK ancillary services: a range of ATM-related solutions and managed services provided directly to PSPs, including a mobile phone top-up service and ATM estate management services
- Zapp: a proprietary service that will leverage the FPS system to allow individuals to send payments to retailers via their own bank's mobile banking app

3.39 Much of the non-core services work is closely connected to VocaLink's provision of the core services.

### Other services

3.40 VocaLink is currently looking to diversify its service provision to reduce its financial dependency on the core services and associated non-core revenues.

3.41 VocaLink also provides other payment-related services, including payment systems that operate in other countries.

3.42 In 2008, VocaLink signed a deal to provide processing infrastructure services for the Swedish Bankgirot payment system.

3.43 In 2014 VocaLink, in partnership with BCS Information Systems Pte Ltd (BCSIS), launched FAST, an immediate payments service in Singapore. This enables 14 Singaporean banks and their end users to transfer funds between bank accounts in near real time.

3.44 Towards the end of 2015, VocaLink signed a contract with The Clearing House (TCH) to develop a national real-time payment service in the United States. This will enable US consumers and businesses to send and receive real-time payments, and also provide a platform to launch innovative services including new message capabilities for financial services that go beyond basic payments.<sup>23</sup>

### Potential competitors

3.45 So far, VocaLink (or its predecessor companies) has been the only provider of central infrastructure services for Bacs, FPS and LINK. In paragraph 4.20 and Box E, we provide a more detailed explanation of how operators have procured central infrastructure services. Other providers could represent alternatives to VocaLink for the future provision of central infrastructure services. In Box B, we provide a list of potential alternative providers, which is not intended to be definitive or exhaustive. It is likely that these could all provide similar services or components of services to those that VocaLink offers. In most cases, they already provide central infrastructure services in the UK, Europe or elsewhere.

## Box B: Other potential infrastructure services providers

### CGI

CGI is a global information technology and consulting firm based in Canada. It has been involved in the design, implementation and operation of national payment systems for more than 40 years, and currently operates payments infrastructures in Canada for payment systems similar to Bacs, CHAPS and LINK. It has also recently been awarded the contract to build and run the central infrastructure for the UK's planned new cheque imaging service.

[><]

### Equens

Equens is a European payments processor. Its main areas of business are central infrastructure services, back-office services and card services. Equens holds processing sites in the Netherlands, Germany and Italy and currently provides payments infrastructure services in the Netherlands, Italy and Hungary.

[><]

<sup>23</sup> Businesswire.com, *VocaLink and The Clearing House sign a ground-breaking deal to deliver national real-time payment services in the U.S.*, (10 Dec 2015): [www.businesswire.com/news/home/20151209006285/en/VocaLink-Clearing-House-sign-groundbreaking-deal-deliver](http://www.businesswire.com/news/home/20151209006285/en/VocaLink-Clearing-House-sign-groundbreaking-deal-deliver)



[X]

**MasterCard**

MasterCard is a worldwide payment organisation. Its business activities include the switching operations for multiple banks and schemes.

[X]

[X]

**NETS**

The Northern European Transaction Services (NETS) provides payment services that are organised along seven business lines, including clearing services.

Its clients are banks and other PSPs, governments, public authorities, SMEs and corporates from Denmark, Norway, Sweden, Finland and Estonia.

[X]

**STET**

STET offers clearing services for a broad range of payment instruments, such as SEPA Credit Transfers (SCTs) and SEPA Direct Debits (SDDs) as well as other payment instruments such as card payments, ATM transactions and cheques in France and Belgium. Its clients are primarily banks.

[X]

**Visa Europe**

Visa Europe is a payments technology business and consists of both a scheme and a processing entity, which operate independently in terms of accounting, organisation and decision-making processes.

While Visa Europe's scheme entity is responsible for rules and regulations relating to the Visa brand, Visa Europe Processing provides central infrastructure services.

[X]

[X]

**Other providers**

Other providers that could be competitors of VocaLink to provide central infrastructure services include ACI, FIS, EBA Clearing and SIA.

- 3.46 As we explain in paragraphs 5.50 to 5.52, there is a well-established market for the provision of some non-core services, such as gateway services. However, VocaLink is the sole provider for other non-core services – for example, the Current Account Switch Service and cash ISA transfers.

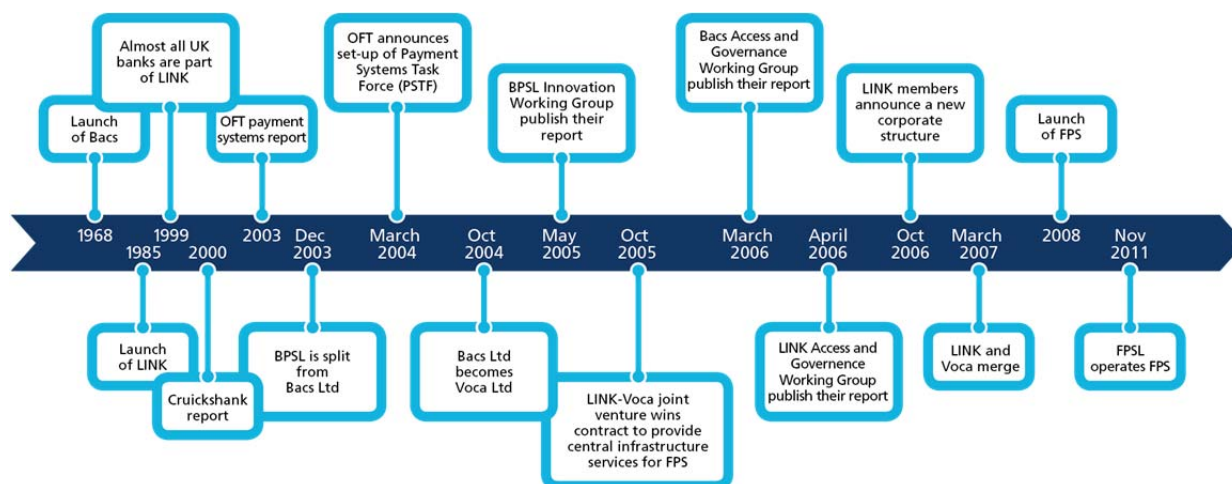
## The origin and evolution of Bacs, LINK and FPS

- 3.47 The Bacs, LINK and FPS payment systems have evolved over time, fulfilling different needs for consumers as new methods of payments have developed. Banks and building societies developed these incrementally and often collaboratively. This is because payment systems are networks requiring the participation of enough PSPs to reach a critical mass of users. Developing payment systems requires the coordination and collaboration of different PSPs to agree on common rules and standards, and to build and run the underlying infrastructure. Over time, these functions have been delegated to operators and central infrastructure services providers.
- 3.48 Understanding how Bacs, LINK and FPS began and evolved helps explain the need to review the ownership and competitiveness of infrastructure provision.

## The evolution of Bacs, LINK and FPS

- 3.49 The current make-up of these three payment systems is the result of a series of changes over time. Many of these have been driven by regulatory intervention, while others happened naturally within the industry. Figure 4 shows the main events that have shaped the payment systems, and the ownership and governance arrangements for their operators and VocaLink.

**Figure 4: Timeline of main events influencing Bacs, LINK and FPS**



## Bacs

- 3.50 Consumers use the Bacs Direct Debit payment method for recurring payments such as household bills, subscriptions and memberships. Organisations use Bacs Direct Credit to make regular payments such as salaries, benefits, pensions and tax credits.
- 3.51 Businesses value the use of Bacs Direct Debits to collect payments from their customers as they offer a timely, efficient and effective way of collecting payments. Large billers often offer incentives to their customers to pay by Direct Debit. Currently, eight in ten current account holders use Bacs Direct Debits to make regular payments.<sup>24</sup>
- 3.52 Businesses and organisations find Bacs Direct Credits a cost-effective way to transfer money to individuals and other organisations, especially for bulk payments where the value and the time of the transactions are known in advance.<sup>25</sup>

### The origin and evolution of Bacs

- 3.53 The Inter-Bank Computer Bureau was set up in 1968. Taking advantage of IT developments, it transferred funds electronically between business, banks and corporations. It operated both the system rules and the underlying infrastructure and adopted the name Bankers' Automated Clearing Services Limited (BACS Limited) in 1971.
- 3.54 Over the years, more banks and building societies joined the Bacs system. In the early 1980s the service was also made available via telephone (BACSTEL). In 2003, Bacs moved from the telephone-based version to the internet-based version (BACSTEL-IP), offering faster and more secure services.

<sup>24</sup> Payments Council, *UK automated payments 2014*, (November 2014), p. 8

<sup>25</sup> Payments Council, *UK automated payments 2014*, (November 2014), p. 8

- 3.55 In December 2003, BACS Payment Schemes Limited (BPSL) was split from BACS Limited. BPSL would act as the operator of the system, while BACS Limited would own and run the infrastructure used by the system. BACS Limited changed its name to Voca Limited (Voca) in October 2004.

## **LINK**

- 3.56 The primary purpose of the LINK network is to support access to cash within the UK. The network enables customers to withdraw cash from any ATM that is connected to the network, not just the ATMs of the bank or building society they hold an account with.
- 3.57 Around 70,000 cash machines or ATMs are connected to the LINK network, which accounts for almost every ATM in the UK, both free-to-use and pay-to-use.<sup>26</sup>
- 3.58 Alongside ATM cash withdrawals, the payment system also provides other services such as balance enquiries and PIN (personal identification number) changes.

### ***The origin and evolution of LINK***

- 3.59 In the 1970s and early 1980s more and more customers joined the banking system as the payment of wages directly into current accounts became more common. Cash machines were being introduced to allow bank customers to withdraw cash more conveniently, especially outside normal banking hours.
- 3.60 Cash machines were originally perceived by banks as an important way to attract more customers and gain a competitive advantage over other banks. In the 1970s, banks and building societies launched cash machines that could be used only by their own customers.
- 3.61 In the 1980s building societies and banks started to agree that a shared network of ATMs was the way to offer this increasingly popular technology to the UK population and ease congestion at retail bank branches. The LINK system was set up at the end of 1985 to enable small banks and building societies – 33 members overall – to share ATMs. These members formed a company called LINK Interchange Network Ltd (LINK) to operate the system and its underlying infrastructure.<sup>27</sup> The network of ATMs grew in size over time as other ATM networks, building societies and banks joined, including Halifax in 1989, RBS and NatWest in 1997 and Barclays in 1998.<sup>28</sup>
- 3.62 In October 2006 LINK owners and members announced a new corporate structure. This would functionally separate the central infrastructure services provider called LINK Interchange Network Ltd (LINK) from the operator of the payment system called the Link Scheme.
- 3.63 In May 2007 LINK and Voca merged into a new entity called Vocalink Limited, integrating the companies that supplied the central infrastructure services to both Bacs and LINK. Vocalink continued to be vertically integrated and the Link Scheme was an operating division of Vocalink.<sup>29</sup>
- 3.64 Currently, the Link Scheme and Vocalink are in the process of becoming legally separated entities.<sup>30</sup>

## **FPS**

- 3.65 FPS is an automated clearing and settlement system that processes individual push payments from personal customers, corporate customers and financial institutions. It operates 24 hours a day, seven days per week.

<sup>26</sup> LINK, *Statistics*, available at: [www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx](http://www.link.co.uk/AboutLINK/Statistics/Pages/Statistics.aspx)

<sup>27</sup> Cruickshank Report, *Competition in UK banking: A report to the Chancellor of the Exchequer* (March 2000), paragraph 3.4, p. 53.

<sup>28</sup> Batiz-Laso, B, *Emergence and evolution of ATM networks in the UK, 1967–2000* (2009).

<sup>29</sup> See PSR CP14/1.3, *Ownership, governance and control of payment systems* (13 November 2014) p. 9, available at: [www.psr.org.uk/sites/default/files/media/PDF/psr-cp14-1-3-sp3-ownership-governance--control-of-payment-systems.pdf](http://www.psr.org.uk/sites/default/files/media/PDF/psr-cp14-1-3-sp3-ownership-governance--control-of-payment-systems.pdf)

<sup>30</sup> The Link Scheme Limited has been set up as a separate company, but at the moment governance and operations still remain within the old structure.

- 3.66 FPS is mainly used for three types of transactions: one-off single immediate payments (SIPs), one-off forward-dated payments (FDPs) and standing order payments (SOPs). It also supports direct corporate access (DCA) payments.

**SIPs** are near-real time and are typically initiated by consumers using their bank's internet, mobile or telephone banking services.

**FDPs** are one-off payments sent and received on a pre-arranged date, set up by the customer in advance, typically to pay bills, such as rent.

**SOPs** are regular payments that pay a fixed amount to the same recipient on regular dates.

**DCA** is a payment initiation service for business customers, enabling bulk files of payment messages to be sent directly to FPS.

### ***The origin and evolution of FPS***

- 3.67 When launched in 2008, FPS was the first major new payments service to be introduced in the UK in over 20 years. The development of the Faster Payments Service was driven in 2005 by pressure from the OFT and HM Treasury through the Payments Systems Task Force. The contract to build and maintain the infrastructure was awarded by the Association for Payment Clearing Services (APACS) – the organisation that procured the central infrastructure services for the new FPS system at the time – to Immediate Payments Limited, which was a joint venture between Voca and LINK.<sup>31,32</sup> As mentioned in paragraph 3.92, in 2007 Voca and LINK merged and became VocaLink – provider of central infrastructure services for Bacs, LINK and FPS.
- 3.68 Since its launch in May 2008, the service has processed over five billion payments.<sup>33</sup>
- 3.69 Ten banks and building societies are direct participants in this payment system and hundreds of other financial institutions are able to offer the service to their customers through indirect access arrangements with a sponsor bank. These institutions are also able to join the service as a direct member should they wish and if they meet the FPS eligibility requirements for admission.
- 3.70 Since its launch, a number of different organisations have operated the FPS payment system. The last handover was in November 2011, when Faster Payments Scheme Limited (FPSL) was established to operate FPS.

### **Regulatory interventions**

- 3.71 As banks and building societies developed payment systems, they set both the rules governing the payment systems and the requirements for the supporting infrastructure. For each payment system, the same payment scheme company managed the rules and also built and operated the supporting infrastructure. For example, until 2003 BACS Limited was acting as both operator and central infrastructure provider for Bacs.
- 3.72 Over the past 15 or so years, payment systems have been the subject of various reviews and there have been various regulatory interventions relating to Bacs, LINK and FPS. In what follows we provide an overview of these interventions to illustrate how these have contributed to the current make-up of these three payment systems.

<sup>31</sup> The Association of Payment Clearing Services was the industry organisation responsible for interbank payments within the UK at the time

<sup>32</sup> Faster Payments, *CPSS-IOSCO Self-assessment public disclosure for Faster Payments Scheme Limited 2014*, (16 July 2014), pp. 3–4.

<sup>33</sup> PSR analysis of Payments UK data, *Historical monthly statistics*: [www.paymentsuk.org.uk/industry-information/free-industry-statistics](http://www.paymentsuk.org.uk/industry-information/free-industry-statistics)

### ***The Cruickshank Report (2000)***

- 3.73 At the end of the last century the Chancellor of the Exchequer commissioned a report on competition in UK banking services – the Cruickshank Report. Its goal was to examine the levels of innovation, competition and efficiency in the main UK banking markets, including the money transmission market (UK payment systems).
- 3.74 The Cruickshank Report found that the money transmission market had profound competition problems and inefficiencies, plus a lack of innovation.<sup>34</sup> The report noted how some of these problems could be traced back to the governance structure of the UK payment systems.<sup>35</sup> Payment systems like Bacs and LINK were mutually owned and effectively were controlled by the larger high street banks.
- 3.75 Cruickshank concluded that this structure enabled the banks that controlled the payment systems to create barriers to entry for competitors by restricting access to these systems. In all payment systems, full access to the system was granted only to full members. Non-members could access the system only through obtaining sponsorship from a full member. This was putting non-members at a commercial disadvantage, as they depended on a competitor for access.<sup>36</sup>
- 3.76 The Cruickshank Report also noted that the mutual ownership and governance of the UK payment systems was restricting innovation. Existing member banks had little incentive to innovate, especially if this required a costly change in the existing infrastructure and was purely to benefit customers or new entrants.<sup>37</sup>
- 3.77 The report also stated that, with mutual ownership and governance, innovation typically moved at the pace of the slowest members. Decisions within payment systems required consensus. Members were then able to deliberately slow progress and delay innovation if interests were not aligned.<sup>38</sup>
- 3.78 The report mentioned that an effective first step in the reform of Bacs and LINK would be to transfer the central infrastructure to independent for-profit companies.<sup>39</sup> These companies would operate and develop the infrastructure for the payment systems, independent of the operators. The operators would continue to be responsible for setting the rules of the payment systems. The report claimed that these changes would promote more flexible and innovative use of the infrastructure.<sup>40</sup>

### ***The OFT Payment Systems Report (2003)***

- 3.79 In 2003 the OFT reviewed developments in the payment systems industry since the Cruickshank Report. The review noted that Bacs had initiated governance reforms and innovative developments.<sup>41,42</sup> These included, as suggested in the Cruickshank Report, a proposal to separate the operator (Bacs Payment Schemes Limited (BPSL)) and the central infrastructure provider (first called BACS Ltd, then Voca). Separation took place in December 2003.<sup>43</sup> But the review also noted the proposed separation would result in a similar ownership arrangement for the central infrastructure services provider and the operator, as the same banks were involved in both.
- 3.80 In its 2003 market study of UK payment systems, the OFT stated:

‘The proposed separation of scheme [operator] and infrastructure with BACS might facilitate inter-system competition, and in particular, plastic card networks might be able to use their infrastructure to

<sup>34</sup> Cruickshank Report, executive summary.

<sup>35</sup> Cruickshank Report, executive summary.

<sup>36</sup> Cruickshank Report, paragraph 3.67, p. 70.

<sup>37</sup> Cruickshank Report, paragraph 3.124, p. 83.

<sup>38</sup> Cruickshank Report, paragraphs 3.125 to 3.127, p. 83.

<sup>39</sup> Cruickshank Report, paragraphs 3.210 and 3.214, pp. 99–100.

<sup>40</sup> Cruickshank Report, paragraphs 3.210 and 3.215, p. 99 and p. 100.

<sup>41</sup> OFT658, *UK payment systems: An OFT market study of clearing systems and review of plastic card networks*, (May 2003) – paragraph 2.5, p. 15, available at: [webarchive.nationalarchives.gov.uk/20140402142426/http://oft.gov.uk/shared\\_oft/reports/financial\\_products/oft658.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://oft.gov.uk/shared_oft/reports/financial_products/oft658.pdf)

<sup>42</sup> Some of the self-regulated changes related to the governance of the payment system operators. See OFT658, paragraphs 1.17 to 1.20.

<sup>43</sup> OFT658, paragraph 8.17, p. 46.

offer competing clearing systems. However, such separation seems unlikely to have much impact on inter-system competition in the short term when the ownership profile of scheme and infrastructure will remain similar.<sup>44</sup>

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

- 3.81 In December 2003 the government gave the OFT a remit to address the issues in payment systems over the following four years.
- 3.82 In March 2004 the OFT created the Payment Systems Task Force (PSTF). Its task was to identify, consider and try to resolve competition, efficiency and incentive issues relating to payment systems, especially those identified by the Cruickshank Report.<sup>45</sup> The PSTF established working groups – chaired by the OFT and including PSPs, consumer associations and other industry organisations – to focus on specific issues. Some of these included: the BPSL Innovation Working Group, the Bacs Access and Governance Working Group, and the LINK Access and Governance Working Group.<sup>46</sup>
- 3.83 The BPSL Innovation Working Group considered the potential for innovation in the services BPSL offered, and in particular the introduction of faster payment services (specifically, a same or next-day service). This working group identified the market appetite for these services in their report, published in May 2005.<sup>47</sup> Following this, the OFT and the Treasury pressured the industry to implement a new system offering the services that would become the FPS system.<sup>48</sup> This was introduced in May 2008, enabling PSPs to offer near real-time retail payments.
- 3.84 The Bacs Access and Governance Working Group’s role was to examine the negative impact on competition and innovation caused by:
- the mutual governance model of the Bacs operator
  - the restrictions on access to the Bacs payment system<sup>49</sup>
- 3.85 These were issues raised in the Cruickshank Report and the 2003 OFT Report.
- 3.86 The working group published its report in March 2006 and recommended:
- the Bacs operator should broaden its objectives – the Directors appointed to the board should be required to promote the interests of the operator, not the member banks that appointed them<sup>50</sup>
  - the operator’s objectives should include the promotion of efficiency and innovation in payments, and responding to user and market needs<sup>51</sup>
- 3.87 The LINK Access and Governance Working Group focused on the governance of LINK Interchange Network Limited – the company providing central infrastructure services – and the Link Scheme that operated the system. The working group published its report in April 2006.

<sup>44</sup> OFT658, paragraph 1.44, p. 9.

<sup>45</sup> OFT901, *Final report of the Payment Systems Task Force* (February 2007) paragraphs 2.7–2.8, p. 5, available at:

[webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared\\_of/reports/financial\\_products/of901.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared_of/reports/financial_products/of901.pdf)

<sup>46</sup> OFT789a, *First annual progress report of the Payment Systems Task Force*, (May 2005), paragraph 1.9, p. 3 and Annex E, available at:

[webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared\\_of/reports/financial\\_products/of789a.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared_of/reports/financial_products/of789a.pdf)

<sup>47</sup> OFT789a, *First annual progress report of the Payment Systems Task Force*, (May 2005), Annex C, available at:

[webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared\\_of/reports/financial\\_products/of789a.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared_of/reports/financial_products/of789a.pdf)

<sup>48</sup> HM Treasury, *Setting the strategy for UK payments*, (July 2012)), paragraph 4.9, p. 16, available at:

[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/81567/setting\\_strategy\\_uk\\_payments190712.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81567/setting_strategy_uk_payments190712.pdf)

<sup>49</sup> OFT836, *Bacs Access and Governance Working Group report*, (March 2006) paragraph 1.3, p. 1, available at:

[webarchive.nationalarchives.gov.uk/20140402142426/http://of.gov.uk/shared\\_of/reports/financial\\_products/of836.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://of.gov.uk/shared_of/reports/financial_products/of836.pdf)

<sup>50</sup> OFT836, paragraph 4.7, p. 23.

<sup>51</sup> OFT836, executive summary.

- 3.88 While the LINK Access and Governance Working Group recommended increasing the degree of separation between LINK's two constituent parts, it did not recommend full separation.<sup>52</sup> This was because LINK had been an innovative payment system, and the working group felt greater competition for its infrastructure services provision would not have made it significantly more innovative. In fact, they were concerned that a split between the two companies would actually serve to reduce innovation, because the Link scheme executive provided expertise to the infrastructure company and assisted with innovations to the LINK system.<sup>53</sup>
- 3.89 The working group highlighted competition and innovation issues related to the governance of the company providing central infrastructure. They found that ownership and control of this company had been restricted, constraining new opportunities and innovation.<sup>54</sup> The company was owned by 22 banks, and shares were restricted to those owners – therefore non-owners could not buy shares in the LINK company. This implied that the company's non-executive Directors all came from financial institutions. Considering that LINK is a technology company, the working group concluded that Directors from other backgrounds would enrich the existing expertise of the Directors.
- 3.90 The working group recommended that:
- the ownership of the company should be opened up to other market participants
  - the size of the board should be reduced to make it more effective
  - a number of independent Directors should be introduced on the board (as well as the existing independent chair)<sup>55</sup>
  - the degree of separation should be increased, though falling short of a full legal split
- 3.91 As mentioned in paragraph 3.62, LINK's owners and members announced their new corporate structure in October 2006. LINK would provide the central infrastructure services, while the Link Scheme and its governing body (the NMC) would operate the system.<sup>56</sup>

### ***The merger between Voca and LINK***

- 3.92 In March 2007 Voca and LINK notified the OFT of a proposed merger of the two companies. As mentioned in paragraph 3.67, the two companies had already set up a joint venture company in 2005 to bid together to provide central infrastructure services for FPS. The OFT approved the merger in May 2007.<sup>57</sup> The merged entity, VocaLink, operated central infrastructure services to three payment systems, Bacs, LINK and FPS.
- 3.93 Following the merger, some of the LINK Access and Governance Working Group's recommendations on governance were implemented. Independent non-executives joined the new VocaLink.<sup>58</sup> The recommendation to open up shareholding to other relevant market participants was not implemented.

### ***Current situation***

- 3.94 Currently, VocaLink provides central infrastructure services to three UK payment systems, Bacs, LINK and FPS.

<sup>52</sup> OFT840, *LINK Access and Governance Working Group report*, (April 2006) paragraph 5.5, p. 33: [webarchive.nationalarchives.gov.uk/20140402142426/http://oft.gov.uk/shared\\_oft/reports/financial\\_products/oft840.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://oft.gov.uk/shared_oft/reports/financial_products/oft840.pdf)

<sup>53</sup> OFT840, paragraph 5.5, p. 33.

<sup>54</sup> OFT840, paragraph 4.14, p. 28 and paragraph 6.24, p. 42.

<sup>55</sup> OFT840, paragraph 6.32, p. 45.

<sup>56</sup> OFT901, paragraph 1.10, p. 3.

<sup>57</sup> OFT, *Anticipated merger between LINK Interchange Network Limited and Voca Limited* (May 2007): [www.gov.uk/cma-cases/link-interchange-network-ltd-voca-ltd](http://www.gov.uk/cma-cases/link-interchange-network-ltd-voca-ltd)

<sup>58</sup> LINK press release, *Voca and LINK get green light from OFT to merge* (3 May 2007): [www.link.co.uk/Media/NewsReleases/Pages/VocaandLINKgetgreenlightfromOFTtoemerge.aspx](http://www.link.co.uk/Media/NewsReleases/Pages/VocaandLINKgetgreenlightfromOFTtoemerge.aspx)

- 3.95 Bacs now has a separate operator (BPSL) and central infrastructure services provider (Vocalink), FPS is characterised by similar arrangements and LINK has some degree of separation. But in all cases, there is still a significant overlap in the governance of the operator and the central infrastructure services provider. This is due to a significant overlap in banks controlling the operators and the central infrastructure services provider. These banks are also the main direct participants of the related payment systems.
- 3.96 In 2012–13, the Treasury proposed the creation of a new and independent regulator of payment systems<sup>59,60</sup> and the OFT welcomed this proposal.<sup>61</sup> The new regulator would ensure that the governance and operation of the payment systems is not a barrier to competition in the provision of payment services, and in the wider UK financial services market.<sup>62</sup> The regulator would also have powers to address ownership structures, if appropriate.<sup>63</sup>
- 3.97 In November 2014 we announced this market review, focusing on the provision of central infrastructure services to Bacs, LINK and FPS payment systems.<sup>64</sup> In 2015, we decided to proceed with the review.<sup>65</sup>
- 3.98 The key question of our current market review is whether competition is effective in the provision of infrastructure services related to interbank systems and, if not, what the reasons for this are. This includes investigating whether the current ownership arrangements of infrastructure providers affect competition in the provision of these services.
- 3.99 To summarise, banks and building societies have developed the three payment systems in a collaborative manner. This has led to secure and resilient payment systems – but there have been concerns about innovation and competition, which have been attributed to the ownership and governance arrangements of these systems. Some changes have been made in recent years to address these concerns. In the course of this review, we have examined how far these changes have delivered their anticipated benefits.

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<sup>59</sup> HMT, *Setting the strategy for UK payments* (July 2012) paragraphs 5.43– to 5.44 and 5.48 pp. 28–29.

<sup>60</sup> HMT, *Opening up UK payments*, (March 2013) paragraphs 3.20 and 4.7 pp. 10 and 16:

[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221903/consult\\_opening\\_up\\_uk\\_payments.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221903/consult_opening_up_uk_payments.pdf)

<sup>61</sup> OFT, UK payment systems (July 2013), paragraph 1.3, executive summary:

[webarchive.nationalarchives.gov.uk/20140402142426/http://oft.gov.uk/shared\\_oft/reports/financial\\_products/oft658.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://oft.gov.uk/shared_oft/reports/financial_products/oft658.pdf)

<sup>62</sup> HMT, *Setting the strategy for UK payments*, (July 2012) paragraphs 3.20 and 4.7, pp. 10 and 16.

<sup>63</sup> HMT, *Opening up UK payments*, (March 2013) paragraph 3.21, p. 10.

<sup>64</sup> PSR CP14/1, *A new regulatory framework for payment systems in the UK* (November 2014), paragraphs 61 to 63, p. 24: [www.psr.org.uk/psr-publications/consultations/consultation-paper-141](http://www.psr.org.uk/psr-publications/consultations/consultation-paper-141)

<sup>65</sup> PSR MR15/2.1, *Market review into the ownership and competitiveness of infrastructure provision, Terms of reference*, (June 2015), paragraphs 1.2 to 1.3, p. 4: [www.psr.org.uk/sites/default/files/media/PDF/Infrastructure%20final%20terms%20of%20reference.pdf](http://www.psr.org.uk/sites/default/files/media/PDF/Infrastructure%20final%20terms%20of%20reference.pdf)



## 4

# Competition for the provision of central infrastructure services

This chapter explores whether there is effective competition for the provision of central infrastructure services. We have considered:

- the current state of competition and outcomes
- barriers to switching
- barriers to entry

We find that operators – as the current procurers of core services on behalf of direct payment service providers (PSPs) – do not shop around and both operators and direct PSPs lack the incentive to do so. Most operators and direct PSPs are satisfied with the value for money, quality of service and innovation they receive from VocaLink, but they are not fully informed about alternative infrastructure services. These alternatives could potentially be more efficient and innovative. Furthermore, VocaLink is not subject to direct competition.

We identify the lack of competitive procurement exercises as a barrier to entry that prevents potential providers from competing, despite there being a number of providers that are interested. In addition, VocaLink's ownership arrangements and the lack of common international messaging standards deter some potential providers from entering the market.

We also find that the current LINK contractual arrangements and provisions are a barrier to switching, but Link Scheme's plans to change its governance and operational structure to become independent of VocaLink should help to address this.

### Introduction

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- 4.1 We consider that competition for infrastructure services can provide a number of benefits. It can lead to lower prices, higher quality of service and promotes efficiency and innovation. If competition in the market is working effectively, we would expect to see a range of infrastructure providers competing for contracts with operators and/or direct PSPs. Operators and/or direct PSPs would assess the service proposals and pricing of these infrastructure providers to choose one or more providers that best suit their needs. In such a market, infrastructure providers would need to continue to offer a competitive service, price and innovation to attract and retain operators and/or direct PSPs.
- 4.2 Innovation at the infrastructure level could deliver many benefits to PSPs. Examples include additional functionality (such as better liquidity management tools), faster and more flexible service, and additional overlay services which could spur more competition and innovation downstream. The procurement could be done unilaterally or collectively, depending on the firm's cost benefit analysis and the firms' and the industry's preference towards collaboration. As Figure 5 shows, when both the customer side (operators and PSPs) and firm side (infrastructure providers) of the market are functioning well, this can lead to a 'virtuous circle' of competition and to better outcomes for service-users.

**Figure 5: Virtuous circle of competition**

## Natural monopoly and competition

- 4.3 Before we evaluate the state of competition, it is important to note that we do not see the provision of central infrastructure services in Bacs, FPS and LINK as a natural monopoly. This is key as it influences the scope and form of competition and how we evaluate the state of competition in UK payment systems. A natural monopoly occurs where it is most efficient for production to be permanently concentrated in a single firm rather than contested competitively. It is typically characterised by high barriers to entry – for example, due to extremely high fixed costs and significant economies of scale. A natural monopoly can be contested in terms of competition for the market.
- 4.4 The provision of central infrastructure services by VocaLink has some features similar to a natural monopoly. For example, it requires high upfront investment that needs to be recovered over a few years. [3<]. There are also efficiency gains due to economies of scope across different systems – [3<]. Our analysis of past volume and cost data for the period 2010 to 2014 also found some economies of scale within FPS.
- 4.5 However, the provision of central infrastructure services has other distinct features that lead us to conclude that it is not a natural monopoly:
- Alternative infrastructure providers already exist (at least in part) elsewhere in Europe (see Box B). Therefore, although the central infrastructure requires high fixed upfront investment, this cost would not act as a barrier to potential new entrants because European providers of similar services in other markets already have the infrastructure in place, which can be used to provide services in the UK. Hence, unlike traditional utilities like water and energy – where there are no existing competing infrastructures and it is expensive to build new networks to enter the market – entrants to this market do not need to incur such significant upfront costs.
  - The efficiency gain that VocaLink receives from economies of scope would not act as a barrier to entry. We note that there are potential entrants to the UK market that are currently providing infrastructure services elsewhere, that could leverage on the economies of scale or scope from that provision. Alternatively, services could be provided by a consortium of parties.
  - The asset life (depreciation period) used by traditional utilities is around 20 to 45 years.<sup>66</sup> A long asset life means that investment costs are recovered over a long period and it is efficient to have one permanent provider to recoup costs and encourage investment. However, VocaLink’s assets have a much shorter life – [3<]. Any new entrant should therefore be able

<sup>66</sup> Sinclair Knight Merz and GL Noble Denton, *The economic lives of energy network assets: A report for Ofgem* (2010), Cambridge Economic Policy Associates Ltd, Table 1.1.

to recoup its investment in a relatively shorter period and it is not necessary to grant permanent or very long-term contract rights to a provider. This means it is not necessary to have one permanent provider of central infrastructure services.

- 4.6 Furthermore, there are other structural models of central infrastructure provision, such as the Single Euro Payments Area (SEPA), where there are multiple central infrastructure providers (see Annex 5: Alternative payment system models). This suggests that the most efficient structure may not be for one firm to permanently operate the central infrastructure. We therefore conclude that the provision of central infrastructure services for Bacs, FPS and LINK is not a natural monopoly and that competition is possible.

### Competition ‘for the market’ and competition ‘in the market’

- 4.7 There are two possible types of competition in a market – competition **in** the market and competition **for** the market.
- 4.8 Competition **in** the market occurs when there are multiple providers in a market that simultaneously compete for customers’ business, with the customer choosing the product or service they prefer. This means that providers have an incentive to become more efficient and innovative, and to respond to customers’ needs. If they don’t, they risk losing customers. This type of competition is found in most markets.
- 4.9 Competition **for** the market occurs when there is only one provider to the market at a given time. This is usually because providing the product or service involves high fixed costs, investments or set-up costs. For these costs to be recovered, it typically requires sufficiently large customer demand over a certain period. In this situation, the duplication of these costs when there is more than one provider leads to higher prices for the customers. Therefore, having a single provider is more efficient.
- 4.10 Rail services are an example of competition **for** the market. These services are provided under regional franchises for a specified period. The government awards the franchises to the train companies through a competitive procurement process. In most cases, the franchisee is the only provider of train services in the local area or for a defined set of routes.<sup>67</sup>

### Competition for the provision of central infrastructure services

- 4.11 In the current industry structure for Bacs, FPS and LINK, there is theoretically competition **for** the market for the provision of central infrastructure services (see paragraphs 3.25 to 3.28). The operators of Bacs, FPS and LINK each procure core services from only one provider at a time and for a certain period (core services are defined in paragraphs 3.36 to 3.37). This is done through a contract for core services (see Box C). Under the current structure, operators procure these services collectively on behalf of the direct PSPs.

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<sup>67</sup> Competition and Markets Authority, *Competition in passenger rail services in Great Britain* (July 2015), paragraph 1.10, p6: [https://assets.digital.cabinet-office.gov.uk/media/55a8d1d6e5274a6fea000011/Passenger\\_rail\\_services\\_in\\_Great\\_Britain.pdf](https://assets.digital.cabinet-office.gov.uk/media/55a8d1d6e5274a6fea000011/Passenger_rail_services_in_Great_Britain.pdf)

## Box C: Recent awarding of contracts for the provision of core services

### Bacs

Bacs Payment Schemes Limited (BPSL) currently procures core services from VocaLink. The current contract started in 2014. It can be terminated on or after 1 December 2020, with 24 months' prior notice (i.e. notice can be given from 1 December 2018).

### FPS

Faster Payments Scheme Limited (FPSL) currently procures core services from VocaLink. The current contract was signed in 2014. It expires on 30 June 2020 and can be terminated on 30 June 2018 or 30 June 2019, with 24 months' prior notice.

### LINK

Currently, VocaLink provides core services for LINK under an evergreen contract – known as the Network Members Agreement (NMA) – between VocaLink and the PSPs of LINK. The NMA has been in place since the functional separation of the operator and infrastructure provider within LINK in 2006. Unlike BPSL and FPSL, the operator, Link Scheme, does not hold a contract with VocaLink on behalf of the PSPs as it is not a legally separate entity (see paragraph 3.61).

LINK Scheme, is currently reprocurring core services as part of changes to the governance and operational structure of LINK to become legally independent from VocaLink. Link Scheme has reselected VocaLink as its preferred provider, in order to enter into further negotiation. We have been told by VocaLink that it has been engaged with all parties in order to put in place this new arrangement. This could be implemented by a members' vote which is currently scheduled for 25 February 2016. The new contract for the provision of core services is expected to be a five-year contract starting in the first half of 2016.

- 4.12 In this situation, providers are not subject to competitive pressure from competition **in** the market. However, the incumbent and other potential providers can face competitive pressure when there is competition **for** the market. If the incumbent thinks that the procurer might change provider at the end of the contract, it has the incentive to innovate and deliver quality services, and compete to retain the contract. Similarly, other potential providers have the incentive to invest in innovation to put forward more competitive proposals in the next procurement round.
- 4.13 This competitive pressure can be achieved by the procurer periodically testing the market (market testing) to see what providers and services are available, and inviting potential providers to submit proposals for the work (competitive procurement) (see Box D). The procurer would then compare the proposals and select its preferred provider as a result of this benchmarking exercise. The winning provider would be allowed to offer services to the entire market for the defined contract period. Throughout this report, we refer to a competitive procurement exercise as an exercise that incorporates market testing and a competitive procurement process.

## Box D: Market testing and competitive procurement

### Market testing

In this context, general market testing is when a prospective buyer seeks to gauge the level of interest of potential providers and assess the capacity of the market to deliver certain products or services. Market testing is not a formal procurement process and is not governed by specific rules, but it does imply that the desired provision of products or services is discussed with potential providers. These discussions might also relate to:

- which additional products or services are available
- anticipated future changes as a result of legislation, user demands and/or best practice
- possible innovations relative to the products or services that potential suppliers could introduce
- terms of the contract, payment mechanisms and tentative price offerings
- performance indicators

Providers engaged in the market-testing phase will normally submit bids if a competitive procurement process follows.

### Competitive procurement

Competitive procurement is the process of buying goods or services through a controlled process in which potential providers are invited to express their interest and willingness to supply the relevant goods or services. A competitive process typically involves steps such as: request for proposals, evaluation, selection and contract issuance. There are different forms of competitive procurement – open tenders, two-stage tenders, restricted tenders and competitive dialogue procedures. The most suitable form of competitive procurement depends on specific circumstances – for example, the number of potential competitors, value of the contract to be awarded and existence of a technical specification detailing the characteristics of the provision. A competitive procurement implies that different providers are benchmarked on the basis of their proposals. The winning proposal is the one believed to best meet the buyer’s decision-making criteria (for example, offering the best value for money or with most innovative aspects).

- 4.14 We focus our assessment of competition in the context of the current UK arrangements with a collective purchasing model and competition for the market. However, we recognise that there are alternative ways to structure payment systems and the provision of central infrastructure services (see Annex 5: Alternative payment system models). For example, in the SEPA euro clearing system, there is competition **in** the market for central infrastructure services. In SEPA, many PSPs directly choose from multiple central infrastructure providers. However, we note that collective procurement does occur in SEPA at the national level in some areas.

### Our assessment of effective competition

- 4.15 In the remainder of this chapter, we assess whether there is effective competition for the provision of central infrastructure services for Bacs, FPS and LINK, and if there are any barriers to effective competition.
- 4.16 To determine this, we look at:

- the current state of competition and outcomes
- barriers to switching
- barriers to entry

4.17 We then give our overall conclusion on competition for the provision of central infrastructure services.

### **Current state of competition and outcomes**

4.18 To assess whether there is effective competition for the provision of central infrastructure services, we look at:

- the extent of shopping around when procuring core services
- the value for money that operators and direct PSPs get from VocaLink
- the quality of services provided by VocaLink
- incentives to innovate
- potential competitors

### **Shopping around**

4.19 Customers can drive effective competition in a market if they are both engaged and active. They can do this by monitoring the competitiveness of the products they already hold and shopping around and comparing the products offered by other firms. We consider the extent to which the operators have compared different offerings of core services.

4.20 We asked operators if they had attempted to run a competitive procurement exercise to compare VocaLink's offerings for the core services for Bacs, FPS and LINK with other potential providers' proposals. They did not mention any previous competitive procurement exercises for core services – except for the initial build-and-run tender for FPS in 2005 (see Box E). Link Scheme told us they ran a closed request for information (RFI) process in early 2015, but we do not consider this a full competitive procurement exercise (see paragraphs 4.26 to 4.29). BPSL said it is planning to run a benchmarking survey. [§<].

## **Box E: How core services have been procured to date**

We outline the previous procurement events in Bacs, FPS and LINK over the past 12 years since the separation of governance and infrastructure provision within these payment systems.

### **Bacs**

Since the separation of operator and infrastructure provider in 2003, BPSL has renegotiated its contract with VocaLink on two occasions – in 2008 and 2014. In 2008, BPSL decided to extend the contract with VocaLink and renegotiated some of the terms. In 2014, when the contract came up for renewal, BPSL renegotiated with VocaLink using a single-supplier Request for Approach (this was not a competitive procurement). BPSL and VocaLink signed a new contract in November 2014 – which is the current contract for core services. BPSL has never run a competitive procurement exercise for these services.

### **FPS**

When FPS was created, a competitive tender was held in 2005 to select the central infrastructure provider that would build and run the FPS infrastructure. VocaLink was awarded the build-and-run contract and the FPS payment system was launched in early 2008. When the contract came

up for renewal, FPSL renegotiated terms with VocaLink and signed the new contract in 2014. FPSL did not run any competitive procurement exercise during this process.

### LINK

Currently, VocaLink provides core services for LINK under an evergreen contract – known as the Network Members Agreement (NMA) – between VocaLink and the PSPs of LINK, which has been in place since the functional separation of operator and infrastructure provider in 2006 (see Box C). The NMA was renegotiated once, in 2007, following the merger of Voca and LINK Interchange Network Ltd. Link Scheme is currently reprocurring its core services and ran a closed RFI process in early 2015. This RFI process had some characteristics of market testing, but in our view was not a full competitive procurement exercise (see paragraphs 4.26 to 4.29). Link Scheme has reselected VocaLink as its preferred provider, in order to enter into further negotiation. We have been told by VocaLink that it has been engaged with all parties in order to put in place this new arrangement. This could be implemented by a members' vote which is currently scheduled for 25 February 2016. The new contract for the provision of core services is expected to be a five-year contract starting in the first half of 2016.

- 4.21 We asked the operators why they had not periodically run competitive procurement exercises to reprocur core services.
- 4.22 BPSL told us that the existing contract's termination and exit provisions and allocation of intellectual property rights (IPR) made it difficult to switch provider. BPSL added that it faced resource constraints as renegotiation was around the time that the Current Account Switch Service (CASS) was being implemented. It also said that VocaLink was the only suitable provider as it thought there were no other adequate or interested providers at the time.
- 4.23 FPSL told us that it renegotiated its contract with VocaLink in 2013/14 due to several factors. It said it faced resource constraints due to the implementation of CASS, and was a relatively new organisation at the time with limited staff and little time to organise a competitive procurement exercise.<sup>68</sup> FPSL told us it was subject to external requirements from the Payments Council (now Payments UK). At the time, the Payments Council had power of approval over certain reserved matters for FPS (and Bacs and CHAPS), and wanted the operators to align the termination dates of their infrastructure contracts to a window from mid-2018 to mid-2020 to allow for the possibility of a coordinated move to a new payment systems architecture under its proposed Road Map Strategy in this time frame. This limited the period that FPSL could contract core services to three years. FPSL told us that other providers would not have likely been interested in a short contract period.
- 4.24 Link Scheme told us that it did not attempt to run a competitive procurement exercise before 2015 because the existing contractual arrangements for the provision of core services made it difficult to switch to another provider. Link Scheme said that to do this it would have to get all the PSPs in LINK (38 PSPs) to agree to switch to the new provider, which would be difficult to achieve and to coordinate (see paragraph 4.139). Link Scheme said it ran the RFI based on the expectation that proposed changes to LINK's governance and operational structure to become legally independent from VocaLink would help to address this barrier to switching (see Box E).

### Our assessment

- 4.25 As outlined in Box E, none of the operators have held a competitive procurement exercise for reprocurring their core services contract in the past 12 years. This is despite the contracts for core services provision in each payment system coming up for renewal at least once during this time.

<sup>68</sup> FPSL was established in 2011 to take over as the operator of FPS. For more details, see paragraphs 3.65 to 3.70.

- 4.26 We do not consider the LINK RFI to be a fully competitive procurement exercise (which some stakeholders told us they believed it was). However, the process had some characteristics of market testing.
- 4.27 At the start of the process, Link Scheme used an external consultancy firm [X] to shortlist potential infrastructure providers. The consultancy firm identified over [X] organisations that could potentially provide suitable services, then shortlisted [X] providers that best met the defined criteria (one of which was VocaLink, the incumbent). It gave the shortlisted firms an RFI with seven criteria that their submissions would be evaluated against. The providers were free to decide the content they would present for each of these criteria. The RFI did not provide any additional indications about the content of the presentations. Three providers responded to the RFI – VocaLink, [X] and [X]. Link Scheme offered briefings to all firms from the CEO and Independent Chairman on requirements. This meeting was taken up by the providers that responded. At the end of the process, the selection panel named VocaLink as the preferred provider, in order to enter into further negotiation. Another provider, [X], was identified as the reserve provider.
- 4.28 [X].
- 4.29 In our view, the LINK RFI process cannot be considered a fully competitive procurement exercise for the following reasons:
- The process was open to only a small number of potential providers. While many of the organisations identified by the consultancy firm did not meet all the defined criteria, the process did not allow for the possibility of a joint venture and consortium of bidders. This could have increased the pool of bidders able to meet the selection criteria.
  - The process was short. Potential providers had only two weeks to prepare their submission after they received the formal letter inviting them to participate.
  - The RFI included poor information. It invited the potential providers to carry out a presentation against seven generic criteria, and did not include any technical specification for the services to be provided or service level agreements (SLAs). The RFI also lacked information that could have helped the providers to make detailed proposals.
  - The panel only considered the costs and benefits of switching to an alternative provider at a high level.
- 4.30 The LINK RFI process gave the Link Scheme and the PSPs the opportunity to compare the prices of VocaLink (the incumbent provider) to other potential offerings. As a result of the process, Link Scheme was offered a [X]% discount on the current contract price by VocaLink. One other bidder submitted a price (which was lower than VocaLink's). Link Scheme was also offered an increase in SLAs to [X]% (from [X]%). VocaLink said it also offered an improvement in other commercial terms including termination and exit conditions. One provider [X] submitted a bid with a higher SLA for service availability (of [X]%) than the current contract with VocaLink. VocaLink's initial bid did not, but in further negotiations, it offered a higher SLA of [X]%.
- 4.31 Outside of the LINK RFI, there have been no other instances of operators directly comparing VocaLink's offerings to alternative proposals. As the operators do not proactively seek direct comparisons or engage with alternative providers, they are not fully informed about alternative – and potentially more efficient and innovative – infrastructure services. The incumbent provider is also not subject to competitive pressure. As a consequence, the incumbent may have reduced incentives to suggest ways of being more efficient and innovative.



- 4.32 We note that it is not common in other countries to hold competitive reprourement exercises. In an international comparison of 12 countries, one held competitive procurement exercises to reprocore the central infrastructure services.<sup>69</sup>
- 4.33 There have been more examples of competitive procurement exercises for new systems – for example, the tender for FPS, Australia’s and Singapore’s faster payment systems, and more recently, the Future Clearing Model (FCM) for cheque imaging. These examples show that it is possible to run a competitive procurement exercise for core services (see Box F) and the LINK RFI process shows that it is possible to run a market-testing exercise.

## Box F: Role of competitive procurements in promoting competition for the market

In 2015, competitive tendering was used to procure the core infrastructure services that will support the processing of cheque images in the FCM. The following case study describes the design of the FCM tender and demonstrates that:

- it is technically feasible for an operator (or procurement group) to run a tender process for core services
- a large number of potential firms were interested in competing and said they could provide the services required, so competition is possible

### *Case study: Procurement for the FCM*

A programme Senior Sponsors Group (SSG) is overseeing the delivery of the FCM. It comprises direct and indirect PSPs in the Cheque & Credit (C&C) and Northern Ireland Cheque Clearing payment systems.

In October 2014, C&CCCL advertised the upcoming tender on its website and invited potential providers to register an interest. Several companies that had been engaged previously by the payments industry were notified about the advert.

In December 2014, the 47 parties who registered an interest were sent RFI documentation under non-disclosure agreements. In January 2015, 21 interested parties responded to the RFI.

The RFI evaluation team (consisting of the procurement group members, C&CCCL specialists and FCM project team members) shortlisted seven prospective providers. The evaluation team scored each response and considered the financial and security profile of each bidder. The SSG and the board of C&CCCL (which would ultimately be the contracting party for the new infrastructure) approved the shortlist.

The invitation to tender (ITT) documentation, setting out the detailed specification for a clearing solution, was sent to the seven shortlisted bidders.

[✂]

By running an open and competitive tender process, the SSG and C&CCCL were able to identify and select from a range of providers the one they judged to best meet their requirements.

<sup>69</sup> Lipis Advisors, *Payment system ownership and access models: Comparative analysis of 13 countries* (December 2015), page 29 available at [www.psr.org.uk](http://www.psr.org.uk)

- 4.34 The operators lack the incentive to hold competitive procurement exercises because:
- They are not profit-making entities and therefore have limited incentive to drive competitive outcomes from their suppliers. Instead, they simply pass on the cost of infrastructure provision to the direct PSPs.
  - Understandably, they place high importance on the operational integrity and resilience in core services. They are concerned that changing infrastructure introduces some degree of operational risk. Given the importance of the integrity of the payment systems, they therefore are reluctant to make changes, even if the benefits significantly outweigh the potential risk.
- 4.35 In the current arrangements, the direct PSPs – as the main users of the core services – have a role in encouraging operators to competitively procure these services. Some of the direct PSPs have positions on the operators' procurement Committees, so they can guide operators on decisions related to the procurement of core services. However, direct PSPs lack the incentive to encourage operators to hold competitive procurement exercises because:
- **A lack of incentive to change provider:** One potential outcome of competition is a change of provider. Direct PSPs believe it could be costly and risky to make changes to their internal systems to connect to a new provider (see paragraphs 4.125 to 4.129). Also, the cost of core services is low compared to the overall costs they incur to provide payment services. Therefore, a lower cost of core services may not be enough of an incentive for direct PSPs to pressure operators to shop around.
  - **Lack of competitive advantages for direct PSPs:** Under the current model, improved core services lead to lower costs or better services for all the direct PSPs. Therefore, no direct PSP has a competitive advantage over the others. Similarly, any innovation at central infrastructure level by direct PSPs does not give them a competitive advantage (or disadvantage) as all PSPs benefit – including indirect PSPs, which do not cover the upfront costs and could be in a better position to utilise the innovation.
- 4.36 We note that direct PSPs do shop around and use competitive procurement exercises where they directly procure infrastructure services from providers, such as non-core services like gateway solutions (see paragraph 5.24). For these services, direct PSPs can achieve a competitive advantage over their competitors for these services, so they have an incentive to shop around.
- 4.37 Overall, we find that there has been a lack of competitive procurement exercises for reprocurring core services. The operators (as the current procurers) do not shop around for core services and lack an incentive to do so. As a result, they are not fully informed about alternative – and potentially more efficient and innovative – infrastructure services.

## Value for money

- 4.38 In a well-functioning market, we would expect customers to receive good value for money. To assess whether the current market arrangements are delivering good outcomes for operators and PSPs, we examine the price and value for money that they get from VocaLink. We have not carried out a cost benchmarking analysis; instead we have used the views of stakeholders and other evidence to assess value for money.
- 4.39 We asked operators and direct PSPs about their views on VocaLink's prices and value for money for the provision of core services. The operators and many direct PSPs said they are satisfied with the value for money they receive from VocaLink, given the high quality of service it provides. (This included VocaLink shareholders and non-shareholders alike). One direct PSP thought that a provider offering a lower price would likely provide a lower quality of service.

- 4.40 In contrast to most, two direct PSPs (one shareholder and one non-shareholder) and some infrastructure providers perceived VocaLink's services to be expensive. They said this reflects VocaLink's old infrastructure architecture, which requires high maintenance and change costs. One operator, while satisfied with the value for money, noted that VocaLink's old architecture resulted in higher prices.
- 4.41 Operators and seven direct PSPs told us that the operators had been able to negotiate both financial and non-financial benefits in their contracts with VocaLink. They believed that these outcomes were similar to what could have been achieved with a competitive procurement exercise. However, one direct PSP said the creation of the PSR had improved the operators' ability to negotiate more favourably with VocaLink in the latest contract negotiations.
- 4.42 Operators said they achieved the following benefits in previous contract renegotiations with VocaLink despite not holding a competitive procurement exercise:
- **For Bacs:** BPSL told us that in 2008 it was able to negotiate a tariff reduction. In the 2014 renegotiation, it said it was able to achieve a [X] % tariff reduction from [X] with a cap on tariffs and no indexation applied until [X] and a discount on the annual service charge. It also negotiated some funding for strategic investment in core services development and the provision of a development fund by VocaLink for future developments. BPSL also negotiated an improvement in SLAs and infrastructure investment commitments, as well as improved contract provisions around IPR, termination rights and liabilities.
  - **For FPS:** In the 2014 contract renegotiation, FPSL said it used an external consultancy firm to run an independent cost analysis of VocaLink's cost base and forecast profit margin to give comfort the contract was of fair value. The consultancy firm reviewed all the cost elements in VocaLink's pricing model and, working with FPSL, removed some costs that were considered no longer appropriate in the context of contract renewal – for example, [X]. The consultancy firm also carried out a benchmarking analysis of VocaLink's profit margin on the FPSL contract. It compared VocaLink's forecast profit against the profit margin of four European providers to make sure that VocaLink's margin would not be excessive (after removing two providers – those with the lowest and highest margin). While six providers were identified only four were used for the benchmarking to reach the conclusion that the profit margin was in the [X] range. The final price was based on the output of the pricing model. FPSL said it also negotiated other price benefits – unit pricing economies of scale with growing volume and cost-effective improvements in the change request process – and improvements in the SLAs.
  - **For LINK:** Link Scheme told us that when it renegotiated the core services contract in 2007, it achieved a [X] price freeze in exchange for PSPs giving a longer notice period [X]. It also negotiated an upgrade of back office systems, specifically the implementation of a liability monitoring tool and a real-time enquire and dispute handling system.
- 4.43 However, six direct PSPs (both shareholders and non-shareholders) believed the operators (as the current procurers) could achieve better prices, and other benefits, if they used more competitive measures to procure the core services – for example, tenders. They said this could be achieved either by other providers offering lower prices or by VocaLink responding to competitive pressure. One direct PSP believed that the lack of competition for the provision of core services gives VocaLink market power, which has resulted in high prices for core services. It said this was shown by the higher price of VocaLink's central infrastructure services compared to its other products and services where VocaLink faces more competition.
- 4.44 Although there was no full competitive procurement exercise, Link Scheme was offered a price discount as a result of its closed RFI process (as noted in paragraph 4.30). Three PSPs said that VocaLink's RFI response was competitively priced. Link Scheme and one PSP added that the selection of VocaLink as preferred provider suggests VocaLink offers the best overall value for money (when considering other factors of service provision). However, Link Scheme acknowledged

that a competitor [X] offered a bigger discount of [X]%, compared with VocaLink's offer of [X]%.

4.45 We asked operators and direct PSPs if they had directly compared the value for money they receive from VocaLink for the core services with that of other central infrastructure providers (outside the LINK RFI process). Two operators and five direct PSPs said it is difficult for them to make direct comparisons as there are no other providers offering exactly these services. However, some operators and direct PSPs said they have used various other methods to consider whether they receive value for money from VocaLink:

- As noted, FPSL said it used a cost base analysis to ensure VocaLink was offering fair value, which included the benchmarking of VocaLink's profit margin (see paragraph 4.42). BPSL and FPSL also have contractual provisions for the right to be provided with an independent audit of VocaLink's services (including permission to go onto VocaLink's premises for those auditors). BPSL told us it has not found it necessary to exercise this right, while FPSL said internal staff ran an audit every year based on IASE3000 reporting.
- Two direct PSPs with international operations compared VocaLink's prices for core services to the prices they pay for core services in payment systems in other countries. They noted that differences in the services and transaction volumes mean they cannot compare the prices exactly. However, taking these differences into account, they believed VocaLink's prices were reasonable compared to some payment systems but higher than the SEPA payment system.
- Another direct PSP referred to VocaLink's pricing when bidding to provide central infrastructure for the FCM for cheques. It said this procurement exercise showed that VocaLink was not as competitive as other bidders.

4.46 Operators and some direct PSPs gave their views on the value for money they receive from VocaLink on change requests. This included change requests as part of the core services contract (requested by the operators) and change requests of individual direct PSPs for specific developments (that is, non-core services). The pricing of change requests is determined by an agreed 'day rate' and the number of work days required, therefore the resulting price can be negotiated around the work days required.<sup>70</sup> For change requests under core services, the operators and VocaLink agree the day rate during contract negotiations.

4.47 Four direct PSPs (all larger PSPs, three of which are shareholders) and one operator said VocaLink's pricing on change requests is fair. For change requests related to non-core services, six direct PSPs (including two smaller PSPs) told us that VocaLink's pricing is reasonable. Four direct PSPs said that VocaLink is willing to work with the operators or individual direct PSPs to find a cost-effective solution for a change request, even if it could have charged a higher price. One direct PSP said that VocaLink's pricing for change requests is competitive after accounting for risk premiums, given that the specific technical requirements for a change are uncertain at the time the quote is prepared. Two direct PSPs said that change request costs could be high initially, but they could usually negotiate a lower price.

4.48 However, one operator said the request process for small change requests could be made more efficient, which would result in lower costs (see paragraph 4.68).

4.49 We asked operators and direct PSPs if they were able to benchmark the value for money they receive for change requests. One operator and two direct PSPs said they use internal knowledge and expertise to evaluate VocaLink's proposed solution, the work days required and the resulting cost (based on the agreed day rate).

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<sup>70</sup> The day rate is the set charge per day of work that VocaLink uses to cost a change request.

4.50 In summary, most operators and direct PSPs believed they receive reasonable value for money from VocaLink. However, they told us it is difficult for them to directly compare VocaLink's offerings with other infrastructure providers given the specific features of the payment systems.

### **Our assessment**

4.51 We consider that it is difficult for operators and direct PSPs to assess the value for money they receive from VocaLink for core services without running a competitive procurement exercise to compare offerings from different providers. Without doing so, the operators and direct PSPs are not able to directly benchmark the prices and value for money that different providers can offer and therefore cannot determine if they could receive a better price.

4.52 Other methods that operators and direct PSPs use to judge value for money do not adequately compare what other providers could offer for Bacs, FPS and LINK:

- Audits of VocaLink prices or cost analyses show whether VocaLink is earning excessive margins, but these methods do not compare prices directly with those of other providers. Nor do audits consider if VocaLink could provide these services more efficiently. We asked the operators and direct PSPs if they monitored how VocaLink invested the revenue earned from their contracts in its activities. None knew how VocaLink allocated expenditure between core and non-core services. One operator receives quarterly investment reports on VocaLink's investment in its core services. FPSL said as long as VocaLink meets its SLAs to FPSL, it is not concerned about VocaLink's investment in core or non-core services because the cost analysis ensured that it is charged fair value for the service.
- Evaluating VocaLink's pricing for Bacs, FPS and LINK against the pricing for other payment systems is not a direct comparison, as provision of the services and market conditions can differ significantly between payment systems.

4.53 We acknowledge that, despite the lack of competitive procurement exercises, operators have negotiated price discounts in previous contract renegotiations with VocaLink. However, we believe it is difficult for them to judge the extent of these discounts compared with what potential providers could offer.

4.54 On the one occasion where an operator shopped around – the LINK RFI – Link Scheme was able to compare the offerings of the bidders and make a more informed judgement about each offering. As noted in paragraph 4.30, Link Scheme was offered financial and non-financial benefits through the RFI process and VocaLink was willing to respond competitively.

4.55 For change requests related to core services, we note that the costs are apportioned to direct PSPs depending on their relative size – larger direct PSPs pay more than smaller direct PSPs. As noted in paragraph 4.45, the larger direct PSPs told us they are satisfied with VocaLink's pricing (although most are shareholders of VocaLink), but the smaller direct PSPs did not provide us with views on this. However, two smaller direct PSPs told us they are satisfied with VocaLink's pricing for change requests related to non-core services (see paragraph 4.47). Despite these views, the operators and direct PSPs have not carried out a comparison of VocaLink's pricing on change requests with alternative providers.

4.56 VocaLink also appears to have been earning consistently healthy profits on its core services for Bacs, FPSL and LINK, which suggests that there could be scope for the operators (as the current procurers) to receive better value for money (see Annex 10).

4.57 VocaLink provided us with estimates of its internal rate of return (IRR), return on capital employed (ROCE) and weighted average cost of capital (WACC) on its core services from 2011 forecast out

to 2017.<sup>71</sup> (We caution that profitability analysis often involves judgements and assumptions. Our analysis is based on VocaLink's information without any adjustments). These estimates show that, on both an IRR and ROCE basis, VocaLink's core contracts have been earning profits of [X] over the past five years and is expected to earn profits of [X] for the projected period to 2017. This suggests persistent profitability for the core services provided by VocaLink.

- 4.58 Furthermore, VocaLink's own internal benchmarking of operating profit margins shows that [X] of its European competitors. The cost analysis for FPSL showed that VocaLink's forecast profit margin on FPS core services is within the [X] benchmark range compared with a number of its European competitors (after removing two providers – those with the lowest and highest margin). While six providers were identified, only four were used for the benchmarking to reach the conclusion (see paragraph 4.42).
- 4.59 Overall, while most operators and direct PSPs are satisfied, we do not believe that they are fully aware of what other providers could offer in terms of price, or whether VocaLink could offer a better price. This is because it is difficult for operators and direct PSPs to assess the value for money they receive from VocaLink compared with offerings of potential providers, given the lack of competitive procurement exercises by the operators.

### Quality of service

- 4.60 We would expect a well-functioning market to deliver good quality services that customers are happy with. We examine the quality of service provided by VocaLink to assess whether the current market arrangements are delivering good outcomes for operators and PSPs.
- 4.61 We asked the operators and direct PSPs for their views on the quality of service provided by VocaLink for the core services for Bacs, FPS and LINK. The operators and many direct PSPs (both shareholders and non-shareholders) were very positive about the quality of service. They stated that VocaLink's services had been highly resilient and stable. The direct PSPs said these are their main priorities given the significant impact that payment service outages can have on their customers. None of the operators or direct PSPs said they are dissatisfied overall with VocaLink's services.
- 4.62 VocaLink is contractually obligated to meet various SLAs defined in the core services contracts negotiated with the operators. If it does not, VocaLink is liable for financial penalties. These SLAs cover the provider's service provision in terms of system availability and performance of the:
- central clearing functions (payment processing and message transmissions)
  - communication channel interfaces (that PSPs and other users may use to connect into the central clearing)
  - back-office functions (such as reporting)
  - settlement functions

The SLAs also include measures of customer service, such as the percentage of service desk calls required to be answered within a certain time.

- 4.63 The operators and many direct PSPs told us that VocaLink had met or exceeded its SLAs for system availability and performance. They added that VocaLink had agreed to tighten these SLAs in past contract negotiations. Seven direct PSPs said the number of outages caused by VocaLink had been

<sup>71</sup> IRR and ROCE are the standard profitability measures used by the Competition and Markets Authority. These measures take into account the capital required to run a business. Therefore, it can give an economically meaningful measure of profitability on an ex-post basis when compared with WACC.

negligible, and were usually resolved efficiently without affecting customers. Five PSPs said that such problems had usually been caused by other parties (usually the PSPs themselves).

- 4.64 Two operators and six direct PSPs said VocaLink provided good customer and monitoring support and was responsive to their demands on both the core services and non-core services. One direct PSP added that on previous occasions, VocaLink had helped to resolve acute issues specific to an individual PSP.
- 4.65 VocaLink runs an annual internal customer satisfaction survey. The survey showed the majority of VocaLink's customers had been very satisfied with its service over the past five years – and more so since the introduction of its specialised customer engagement team in 2013.
- 4.66 Seven direct PSPs and one operator were also satisfied with VocaLink's quality of service for non-core services – CASS, Cash Individual Savings Account and Paym (mobile payment) services.
- 4.67 In contrast to most direct PSPs, one challenger PSP told us that the lack of competition dampened VocaLink's incentive to provide a more competitive service, and that there was better service provision in some other payment systems.
- 4.68 Two operators, two direct PSPs (both shareholders) and one infrastructure provider raised issues with certain parts of VocaLink's services. They said some back-office functions and related services needed to be upgraded or further developed, and that VocaLink had performed poorly at times when delivering major change programmes that have affected availability of related services. One operator did say that VocaLink had made some improvements in this area in the past few years. Another operator said the approach used to process smaller change requests could be made more streamlined or flexible – which should mean a more proportional delivery time and cost for smaller changes. For example, currently both large-scale changes and smaller enhancements have to go through the same rigorous development and testing process.
- 4.69 We compared data for the past five years on VocaLink's service provision in terms of system availability and performance of certain functions against the SLAs defined in the core contracts (see Figure 6). The functions we looked at were central clearing functions, communication channel interfaces, back-office functions, and customer service.

**Figure 6: Quality of service measures for Bacs, FPS and LINK**

[X]

- 4.70 During this period, VocaLink has met its SLAs for system availability and performance for the central clearing functions for Bacs, FPS and LINK.
- 4.71 When we looked at its performance for system availability and performance in other areas (such as back-office functions and communication channel interfaces), we found that VocaLink had always met these SLAs, with four exceptions:
- **For LINK:** On two consecutive occasions VocaLink did not meet its SLA for availability of a back-office function. [X]
  - **For FPS:** On two separate occasions VocaLink did not meet the SLAs for the availability of a communication channel interface used by indirect PSPs. [X]
- 4.72 VocaLink has met its SLAs related to customer service over the past five years.

- 4.73 Overall, the operators and direct PSPs have been satisfied with VocaLink's services in the past and performance against its SLAs particularly within the main functions of the core services. Some stakeholders raised a small number of issues related to VocaLink's back-office functions and change request processes.

### **Our assessment**

- 4.74 While VocaLink has met its SLAs, we note that these have been determined in circumstances where VocaLink faced limited direct competitive pressure. With more competition, the operators (as the current procurers) may be able to obtain higher service quality. VocaLink or alternative providers could be willing to deliver on more ambitious SLAs or improved service quality in other ways.
- 4.75 We acknowledge stakeholders' views that the benefits of higher service quality may be marginal, given the current high level.
- 4.76 However, there is evidence that VocaLink is willing to respond to competitive pressure in terms of service quality. This was demonstrated in its response in the LINK RFI process (which was not a full competitive procurement exercise but resulted in some competitive pressure). Our review of the LINK RFI process shows that VocaLink was willing to respond competitively and offer tighter SLAs in response to competitive pressure from another bidder (see paragraph 4.30). We note that the other bidder offered a higher SLA than VocaLink's initial offer.
- 4.77 Also, alternative providers that currently operate in other payment systems appear to provide a high quality of service. An international comparison of payment systems in 12 other countries showed that service quality is an important factor for those procuring central infrastructure services, and that providers are expected to demonstrate a track record of high-quality service to even be considered by those procuring the services.<sup>72</sup>
- 4.78 More competitive pressure would also increase VocaLink's incentive to address service issues identified by stakeholders that may not have been a priority for VocaLink (or the operators), such as issues relating to back-office or lower priority services (see paragraph 4.68). (Although, as noted in paragraph 4.95, VocaLink may be limited contractually in its ability to make changes to the core infrastructure unless authorised by the relevant operator.)
- 4.79 Regarding the views on VocaLink's support to individual direct PSPs experiencing issues, we note that it is in the interest of VocaLink and other direct PSPs that these issues are resolved quickly, as disruption to one direct PSP could lead to payment disruptions for other PSPs and the wider payment system.
- 4.80 Overall, there is evidence to suggest that more competition for the provision of infrastructure services can deliver benefits of higher service quality. Operators and PSPs could be more informed about what improvements in service quality they could receive from either VocaLink or alternative providers, such as higher SLAs or improved service quality in lower-priority areas of the core services such as back-office functions.

### **Innovation**

- 4.81 In a well-functioning market, we would expect competitive rivalry to incentivise firms to innovate in order to win new business, gain market share and increase revenues. We assess the level of innovation by VocaLink in the provision of central infrastructure services.
- 4.82 When asked, the operators and direct PSPs said long-term incentives to innovate in payment systems are centred on maintaining or increasing competitive advantage. This includes retaining or

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<sup>72</sup> Lipis Advisors, *Payment system ownership and access models: comparative analysis of 13 countries* (December 2015), page 32.



attracting customers and meeting their demands, responding to new growth opportunities, and reducing costs and prices. Other incentives were about improving resilience and security of payment systems, or meeting regulatory expectations.

- 4.83 We asked the operators, direct PSPs and VocaLink for examples of innovative developments in infrastructure services. Most operators and direct PSPs perceived VocaLink to be innovative and identified several examples of innovative developments that VocaLink has initiated. However, most of these developments have been in areas outside of the core services. These developments reflect VocaLink's commercial ventures, including:
- [redacted]
  - selling IPS product in the US and Singapore
  - ACH clearing for Bankgirot in Sweden
  - development of Zapp
- 4.84 Operators, direct PSPs and VocaLink gave limited examples of innovations in core services proposed by VocaLink (outside of general maintenance). VocaLink told us example of innovations in core services include:
- new payment services such as charity donations made via ATM, [redacted] and point of sale transactions through LINK
  - services such as fraud reporting on LINK transactions
  - Paym over LINK
  - Mobile phone top up at point of sale
  - The enabling of the independent ATM deploy model, which has been supported by LINK and VocaLink's operation
- 4.85 We note that none of VocaLink's proposals for core services innovation have come to fruition yet, except for Bacs charity donations.
- 4.86 An operator and three direct PSPs highlighted examples of VocaLink's involvement in other innovations within or around core services, such as the initial design and build of FPS, LINK's ATM charity donations service, and the development of CASS and Paym. The operator and two PSPs acknowledged that these developments were collaborative efforts (involving VocaLink, the operators and other parties) and that some may not have occurred without government pressure.
- 4.87 Operators and direct PSPs had mixed views about whether VocaLink could innovate more in core services.
- 4.88 One operator, two direct PSPs, and two downstream infrastructure providers believe VocaLink lacks an incentive to innovate more in core services. These stakeholders think this is due to a lack of competition for the provision of core services and the fact that more profit could be made on innovations in other commercial areas.
- 4.89 The operators and several direct PSPs think VocaLink's ability to innovate in core services is limited by the demands of its customers. Two operators and four direct PSPs noted that the operators ultimately determine what developments are carried out within core services, outside of general maintenance. Two of these direct PSPs think this prevents VocaLink, albeit necessarily, from making changes or innovating in core services beyond the demands of the operators. Two other

direct PSPs think the operators' demand for investment in core services is related to resilience and operational efficiency rather than innovative developments. Meanwhile, seven direct PSPs do not demand significant innovation in the core services because they either see the provision of these as a standard utility-type service, or see additional innovation as unnecessary to their business strategy.

- 4.90 Two direct PSPs said VocaLink's ability to innovate in core services may be limited because this innovation tends to require collaboration between several parties (VocaLink, the operators, PSPs and potentially other bodies).
- 4.91 There were no concerns among operators, direct PSPs and infrastructure providers about VocaLink, and the core services it provides, hampering innovation or changes in payment infrastructure. An operator and a direct PSP noted that VocaLink has been proactive and helpful when operators have proposed concepts for developments in core services in the past, providing its expertise and knowledge to develop efficient, cost-effective solutions. Examples include the Secure Hash Algorithm update (to enhance security protocols) and enabling the new FPS technical access solutions to connect to the central infrastructure. Six direct PSPs noted that VocaLink has worked on non-core developments for them, citing the examples of mergers between PSPs and solutions to address banks' ring-fencing requirements.
- 4.92 Downstream infrastructure providers (fintechs) told us that they do not think the central infrastructure inhibits innovation in other areas of the payments value chain.<sup>73</sup>
- 4.93 Overall, most direct PSPs and operators consider VocaLink to be innovative. While there are mixed views about whether VocaLink could be more innovative in the core services, VocaLink is not seen to be blocking innovation in payment systems.

### Our assessment

- 4.94 There has been some innovation in the core services, but major changes have been largely government driven, such as the creation of FPS, CASS and the FCM for cheque imaging. VocaLink has not independently driven much innovation in the core services, particularly when compared with its innovation outside the UK (such as those identified in paragraph 4.83).
- 4.95 VocaLink is contractually limited in its ability to make changes to core services, as any changes require agreement from the operators.
- 4.96 We reviewed information provided by the operators on proposed changes to the core services logged through VocaLink's change request procedures over the past five years. The majority (81%) of change requests were for minor enhancements to existing products and services. A small number (5% [X]) related to new products and services or were a major enhancement to existing services, but half of these have not progressed. Two operators identified VocaLink as initiating [X] of the change requests over that period [X] of which related to a new service, suggesting VocaLink was driving that innovation. VocaLink did not appear to block any of the change requests.
- 4.97 However, it has been highlighted in past reviews by government and other regulatory bodies that more could be done to encourage innovation in UK payment systems without regulatory action (see paragraphs 3.71 to 3.90). We have previously acknowledged difficulties in collaborative innovation in the core services. In our 2014 consultation<sup>74</sup> we found that the UK payments industry lacked effective industry-wide strategy development, co-ordination and planning. This led us to

<sup>73</sup> We do not consider here the issues related to access to payment systems. These issues are considered in our Market Review into Supply of Indirect Access

<sup>74</sup> PSR CP 14/1: A new regulatory framework for payment systems in the UK (November 2014) – pp. 4-27, available at: <https://www.psr.org.uk/psr-publications/consultations/consultation-paper-141>

establish a new process for industry strategy-setting through the industry-led Payments Strategy Forum. The Forum will determine and drive strategic priorities.

- 4.98 We acknowledge that innovation in core services is driven largely by the demands of the operators, as the current procurers on behalf of the direct PSPs. We recognise that the operators and direct PSPs lack an incentive to innovate or shop around for more innovative services (as noted in paragraphs 4.34 to 4.35). We also find that common ownership between operators and infrastructure providers by some direct PSPs reinforces this inertia (see paragraph 6.73).
- 4.99 This lack of shopping around – through competitive procurement exercises – suggests that operators (in their current role as procurers) are not exposed to potential innovations in core services (which could be new services or enhancements of the current services). Such activity would let operators compare providers' offerings, and give other providers the opportunity to offer new or enhanced services.
- 4.100 To consider the types of additional innovation we could potentially have, we asked some European infrastructure providers about more advanced services they offer in other payment systems that are currently not available in the UK. Some examples included:<sup>75</sup>
- cloud-based flexible capacity, which allows processing and storage capacity to be scaled up and down depending on users' needs at certain times
  - enhanced user interfaces for data management and queries that are more flexible and configurable to the needs of individual PSPs, or enable on-line self-service queries and analysis
  - request to pay, where a corporate user sends a pack of payment requests to its bank, which are then presented to the paying banks to trigger the payment cycle
  - e-archiving, featuring a central archiving and retrieval functionality for storing transaction details and accompanying invoice details
- 4.101 The payments industry is always evolving, with technological advances (such as enhanced data processing and biometrics), new entrants along the value chain (such as fintechs) and other drivers of change that can affect future demand for payment services and for the central infrastructure underlying those services (see Annex 4: Drivers of change). If those procuring infrastructure services don't shop around, they will not realise the potential use and benefits of these innovations in technology and services.
- 4.102 VocaLink's incentive to anticipate potential innovative developments within core services to meet the *future* demands of PSPs will be dampened by the lack of competitive procurement exercises. Over the last few years VocaLink has identified and proposed to the operators and direct PSPs some potential areas for innovation in core services, such as [§<] and point of sale transaction through LINK, but VocaLink has developed more innovations in non-core areas (see paragraphs 4.83 to 4.84).
- 4.103 VocaLink provided us with its recently developed vision for the future of the UK payments industry, which suggests that VocaLink is giving consideration to the potential for future innovation, and competition, in the UK payment systems. In its vision, VocaLink considers potential changes, such as the introduction of single access points for PSPs, a move to harmonised message standards, a change of VocaLink's ownership and a change in the role of operators. VocaLink also notes the benefits for innovation from greater competition through tendering.
- 4.104 Overall, there has been limited innovation in core services in the past, with major changes driven by regulatory intervention. VocaLink's incentive to innovate in UK core services is dampened by the

<sup>75</sup> We note that VocaLink may also be able to provide some of these services.

operators' (as the current procurers) lack of demand for innovative services and a lack of competitive pressure, because the operators, as the current procurers, do not shop around.

### Potential competitors for core services

- 4.105 To understand whether VocaLink is subject to competition and if there is potential for competition, we examined the scope for alternative providers to offer core services for Bacs, FPS and LINK.
- 4.106 We asked operators and direct PSPs whether there was sufficient choice in providers of core services. They told us that they do not think there are many other providers that could compete against VocaLink to provide the Bacs, FPS and LINK core services. However, their views about potential competitors differ between the three payment systems.
- 4.107 **For Bacs:** BPSL and three direct PSPs noted that the Bacs central infrastructure services have rich functionality (the Bacs Direct Debit and Direct Credit services, Direct Corporate Access channel and the messaging and reporting services). They told us that other existing providers (such as those operating in SEPA) offer a leaner set of services and operated on different messaging standards to the proprietary Standard 18 messaging standard format used in Bacs. The three PSPs believe that other providers may not be able to offer all the services required for Bacs. BPSL also told us that other providers are not actively trying to offer central infrastructure services for Bacs, while one direct PSP does not think other providers would be interested in Bacs because of the proprietary Standard 18 messaging standard format.
- 4.108 **For FPS:** Seven direct PSPs did not think there were any credible alternative providers to VocaLink and, as for Bacs, none that are based in the UK and could provide the same quality of service and handle the transaction volumes. Three of these direct PSPs thought that the real-time functionality of FPS would be difficult for other providers to offer. In contrast, FPSL and one direct PSP commented that there are other international infrastructure providers that could potentially compete against VocaLink. FPSL added that the functionality of FPS's central infrastructure services is not particularly complex.
- 4.109 **For LINK:** Link Scheme and ten PSPs thought there were some potential competitors to provide LINK's central infrastructure services, notably companies that provide infrastructure for card payment systems, given the similarities in the functionality. But half of these thought other providers may not be suitable because they have: incomplete functionality required for LINK central infrastructure services; conflict of interests in their business strategies; or no established connectivity with PSPs in LINK, so PSPs would be required to migrate their connectivity to a new provider which involves costs and risks (see paragraphs 4.125 to 4.126).
- 4.110 When asked, ten direct PSPs noted that greater competition for the provision of infrastructure services, in general, could lead to better value for money, lower costs, enhanced quality of service and more innovation. They added that this should not be to the detriment of resilience or the security of payment systems.
- 4.111 We asked a number of domestic and non-domestic infrastructure providers if they would consider competing against VocaLink for the Bacs, FPS and/or LINK core services. Several central infrastructure providers we spoke to expressed an interest in competing for certain payment systems, and three believed that they could do it at a competitive price. For each payment system, the number of providers that said they would be interested in competing was:
- Bacs – six providers
  - FPS – six providers
  - LINK – four providers

- 4.112 These prospective providers said that they already have some of the capabilities and functionality necessary (including real-time functionality) and would also be willing to develop the additional capabilities needed to meet the specific functional and technical requirements. Two providers told us that they could offer the full service required for FPS and LINK, respectively. One of these said it had participated in the initial build-and-run FPS tender process in 2005.
- 4.113 Two providers could not say with certainty what functionality they would need to develop without first knowing the detailed technical specifications of the payment systems. Two providers said that they are less interested in offering bespoke services as they would want to take advantage of potential economies of scale.
- 4.114 Some providers we spoke with that offer downstream services, including gateway solutions and payment initiation solutions, are not interested in providing core services, which are not their main business focus and speciality.
- 4.115 Central infrastructure providers identified some barriers to entry and expansion in the market for the provision of services for Bacs, FPS and LINK, such as the lack of competitive procurements and the perceived 'closed shop', given the cross-ownership between the operators and VocaLink. These and other potential barriers to entry are discussed in paragraphs 4.150 to 4.175. The providers told us they do not know the detailed requirements of the operators or have an avenue to showcase their potential offerings.
- 4.116 In summary, most operators and PSPs perceive there to be limited alternative providers to VocaLink for Bacs, FPS and LINK, based on their current set of requirements. However, we have identified several potential providers interested in competing to provide these services, though factors including the lack of competitive procurement exercises and awareness of technical specifications have prevented them from competing.

### **Our assessment**

- 4.117 Potential providers do not appear to have much opportunity to show their interest in competing to the operators (as the current procurers). Nor do potential providers appear to have much clarity around the functionalities they could potentially offer, relative to what is required, and how the costs and risks involved with switching could be addressed (as such information is generally made available during competitive procurement exercises).
- 4.118 The market for the provision of central infrastructure services is a global one. VocaLink already has interests in other jurisdictions, such as Sweden and Singapore, as do other infrastructure providers such as Equens. There is also evidence to suggest there are other potential providers that could be interested in competing against VocaLink:
- Our review of potential providers that offer similar infrastructure services for domestic interbank payment systems in other countries suggests there are at least ten who could potentially compete for UK core services (see paragraph 3.45). Several of these providers told us they are interested in competing.
  - There could be additional providers that could compete against VocaLink for the LINK core services beyond those [X] providers shortlisted in the RFI process (as noted in paragraphs 4.26 to 4.29).
  - There have been a number of providers that registered interest in participating in domestic and international tenders, for example the FCM, Cash ISA, and Singapore's and Australia's immediate payments solution. Some of those that participated told us they are interested in competing for Bacs, FPS and LINK.

- Providers generally seem to be interested in expanding their business. For example, Visa Europe stated in its latest investors report that it is looking to innovate and differentiate its product and service offerings.

- 4.119 Our review of information provided by VocaLink shows that it is aware of the potential competitive threat of other providers, and suggests that it has been, and should be, willing to respond to potential competitive pressure.
- 4.120 For example, internal documents show VocaLink noted the risk of losing the Bacs and FPS contracts when they were due for renewal in 2015. [38].
- 4.121 Furthermore, while the LINK RFI was not a full competitive procurement exercise, VocaLink responded competitively (as noted in paragraph 4.30). Internal documents also showed that VocaLink has previously considered the risk of potential competition if there was greater interoperability in UK payment systems in the future. VocaLink's response was to invest in developing its own capabilities to handle more flexible and interoperable standards. More recently, VocaLink's vision for the future of UK payment systems outlines how VocaLink, and the industry, might respond to potential developments in the UK payment systems (including greater interoperability).
- 4.122 Overall, the lack of market testing or competitive procurement exercises reinforces the operators' and direct PSPs' perception that there are no alternatives to VocaLink. However, there is scope for a number of alternative providers to compete against VocaLink, and that VocaLink should be willing to respond to more competitive pressure.

### **Barriers to switching infrastructure provider**

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- 4.123 Customers can drive effective competition by comparing different firms' products and services and switching to those that best suit their needs. We consider whether there are barriers to switching infrastructure provider that may inhibit effective competition.
- 4.124 We considered the potential barriers, including:
- the potential costs and risks of changing PSPs' systems to switch provider
  - other potential barriers related to intellectual property rights (IPR) and other contractual provisions

Each of these considerations is outlined below.

### **Potential cost and risks of changing PSPs' systems**

- 4.125 The operators, many direct PSPs and four infrastructure providers believed that there were significant costs and risks associated with switching central infrastructure provider. They told us that the costs for PSPs that have direct technical connectivity to switch to a like-for-like provider relate to testing their technical connectivity to the new central infrastructure. They believed these costs could include the parallel running of the two central infrastructures for some period of time to ensure the migration of PSPs' connections and processes to the new central infrastructure are working properly, which would involve careful planning. Operators, six direct PSPs and an infrastructure provider identified two main risks. One risk is disruption to central services during the migration (adversely affecting payment services to PSPs' customers). The other risk is that the new provider's service turns out to be lower quality than VocaLink's.
- 4.126 Operators, three direct PSPs and two infrastructure providers noted that the difficulties involved with migrating PSPs to a new provider differ depending on the payment system:

- **For FPS and LINK** they believed it would be very complex for direct PSPs to switch to different providers because these systems are running 24/7 and have high transaction volumes. However, this would be less of an issue in LINK for those providers with established connectivity to PSPs. One said it is likely the PSPs would need to build a separate technical connectivity to the new provider to test and run in parallel because they felt it would not be possible to change the connectivity in a system with no downtime.<sup>76</sup>
- **For Bacs** they perceived that the very large number of service-users – PSPs and corporate users – that directly connect into the central infrastructure and the rich functionality of Bacs would complicate the migration.

- 4.127 Around ten direct PSPs added that these costs and risks would be greater if the technical specifications for, and interfaces with, the new central infrastructure had to change. This is because it would have a larger impact on what PSPs need to change in their internal systems.
- 4.128 Operators, ten direct PSPs and an infrastructure provider believed that there would need to be a good business case for switching infrastructure providers given the potentially high costs and risks involved. One operator said that a price discount offered by other providers would not be sufficient to outweigh the perceived costs and risks of switching provider. One direct PSP said it considered switching its infrastructure provider for C&C, but the migration costs were higher than the cost savings it would achieve. Operators, ten direct PSPs and an infrastructure provider also questioned the rationale for switching away from VocaLink, given that VocaLink has provided a high quality of service to date and has knowledge and experience in running the central infrastructure. Two direct PSPs noted that the willingness of direct PSPs to switch providers would be influenced by the other IT projects or initiatives of the PSP (which may be of a higher priority) that may leave limited resources to carry out the migration.
- 4.129 However, two direct PSPs and two infrastructure providers said they thought that migrating to a like-for-like service would be relatively straightforward for them, involving a change in the IP address of the physical connection. One international infrastructure provider noted that a large-scale migration of PSPs to a different infrastructure provider is manageable with solid project management and support processes in place. This infrastructure provider had successfully carried out a large-scale migration of a payment system with 24/7 connectivity. Three direct PSPs noted that a phased migration process could help reduce the risks involved. One operator suggested that a centralised access utility that acts as an intermediary between PSPs and the central infrastructure provider could help reduce this potential barrier to switching, as only the utility would need to make changes when switching provider.

### Our assessment

- 4.130 We recognise the potential costs and risks associated with changing PSPs' internal systems to connect to a new central infrastructure provider. It is also important that the business case considers the financial and non-financial benefits from switching providers. These benefits could result, for example, from the latest technological advancements such as improvements in security and fraud prevention, or from more sophisticated message standards introducing additional functionality within payment systems, resulting in improvements to banking services.
- 4.131 We requested from direct PSPs high-level estimates for the cost of changing their internal IT systems to support a switch of central infrastructure provider for Bacs, FPS and LINK. Most direct PSPs we spoke to were not able to provide this, as they said it is difficult to estimate these costs without knowing the specific scenario and assumptions, and running a full business case study. Four larger direct PSPs gave high-level estimates ranging from £5 million to £15 million for a switch to a like-for-like service from a different provider. Another large PSP estimated that a

<sup>76</sup> In LINK, most PSPs have established technical connectivity to MasterCard and Visa, which reduces the cost and risks of switching to either of these companies if they were to replace VocaLink as central infrastructure provider.

switch that would only require testing of the new connection, with no changes to a PSP's internal systems, which would cost around £0.3 million to £0.5 million.

- 4.132 In the transition to the SEPA euro clearing system, there was migration of PSPs' transaction volumes between infrastructure providers. Numerous PSPs migrated payment volumes to a new SEPA-compliant alternative provider (for example, Belgian banks migrated to a new proposition for which STET is the provider, while some banks in Germany and Italy migrated from their national providers to a pan-European provider such as EBA Clearing).<sup>77</sup> This demonstrates that it is possible for PSPs to make changes to their internal systems and migrate their transaction volumes between different providers.
- 4.133 We also note the potential for using middleware infrastructure – such as message translation software – for an interim period that could reduce the costs of switching providers. The new FPS technical access solutions have been developed in this way (see paragraph 5.16). The use of message translation services allows PSPs to use their current internal systems to interact with providers operating on different standards. This would mean that a 'big bang' migration (where all PSPs needed to implement internal changes at the same time) would not be needed. The PSPs could use message translation services for a period to shield themselves from making immediate changes to their internal systems. They could then implement the transition at a suitable time – for example, when they next refresh their internal systems. There may be costs and risks involved in introducing message translation software, but these costs and risks should not be significantly different to those related to switching gateway providers, which PSPs have been willing to do (see paragraph 5.13).
- 4.134 The risks involved with switching providers could also be mitigated with proper planning and testing. As discussed in paragraphs 5.30 to 5.33, direct PSPs are concerned about the risk of service disruption when switching gateway providers, but several were still willing to switch because there was an overall benefit.
- 4.135 Overall, it is difficult for the PSPs and operators to anticipate what costs and risks would be involved in changing PSPs' systems to enable the switch of provider, without running a competitive procurement exercise.<sup>78</sup> This exercise would enable them to understand both the costs and benefits of switching providers.
- 4.136 We note that stakeholders raised the move to a common messaging standard as a priority area for the Payments Strategy Forum, and that the Forum is assessing the business case for this as part of its deliberations.

## Other barriers

### LINK

- 4.137 Under the current arrangements, Link Scheme identified a number of barriers to switching, including the allocation of IPR and other contractual arrangements.
- 4.138 Link Scheme noted that currently Vocalink owns the IPR of the operating rules for the central infrastructure provider, the brand and the LIS5 message standard used in LINK. It said this is an added complication should Link Scheme and its members switch provider, because changing the brand and message standard is costly. Or, if it continued to use the LIS5 message standard, Link Scheme said it would need to obtain a licence and ensure Vocalink maintains the messaging standard.

<sup>77</sup> Lipis Advisors 'Payment system ownership and access models: comparative analysis of 13 countries' (December 2015) – p 29

<sup>78</sup> As noted in paragraph 4.29, in the LINK RFI, the costs and risks of switching were given high-level consideration.



- 4.139 Link Scheme added that the current contractual arrangement presents a barrier to switching. The arrangement is a single Network Members Agreement (NMA) between VocaLink and the PSPs in LINK. Link Scheme commented that the current NMA is a low protection contract compared with a typical commercial outsourcing contract. It does not include any provisions for renewal or review of the contract, nor any termination or exit provisions that would require VocaLink to assist in switching to a new provider. This agreement can only be terminated if all 38 members terminate at the same time. Link Scheme said that, to switch to a new central infrastructure provider, all 38 PSPs in LINK would need to agree a coordinated termination of the NMA and switch, which would be difficult. [redacted].
- 4.140 Link Scheme said that it is in the process of making a number of changes to its governance and operational structure to become fully independent from VocaLink and which should make it easier to switch providers (see paragraph 6.46). This involves, amongst other things, looking to introduce new governance and core services contractual arrangements. Link Scheme has told us that it has established an incorporated entity, called the Link Scheme Limited (LSL), which the PSP members have identified as the operator. It proposes that this entity will have a governance structure more like BPSL and FPSL as opposed to the current Network Members Council (NMC). As part of these changes, Link Scheme said it is negotiating the allocation of various IPR among VocaLink, the PSPs, and Link Scheme Limited and also responsibilities for TUPE liabilities. Link Scheme is also looking to replace the current NMA arrangement with a new commercial contract for core services that would be between this new operator (LSL), the PSP members, and the central infrastructure provider. Link Scheme said the new contract will explicitly allow LSL (the new operator) to terminate the contract at the end of its term and run a competitive procurement process.
- 4.141 [redacted]. We are told that the outcome of these negotiations and the contract provisions, as they currently stand, would be sufficient to enable the new operator to switch provider in the future if desired. It added that these provisions are now broadly similar to those in BPSL's and FPSL's contracts.

### ***Bacs and FPS***

- 4.142 BPSL and FPSL do not believe that they would be restricted in switching to a new provider due to the allocation of IPR. Both operators own the IPR for the functional specifications of the core services. BPSL said it had negotiated into its current contract the rights to transfer in some IPR from VocaLink, which it believes should make switching to another provider easier. This includes the IPR for the functional specifications and a licence to use the [redacted]. It also negotiated a provision that VocaLink must negotiate a fair price for other IPR when the contract is terminated. However, in Bacs, VocaLink owns the IPR associated with the technical specification and source code for the core services. VocaLink has informed us in FPS, the software for the central infrastructure is provided by FIS. FPSL told us that it is not concerned about this because it believes other providers should be able to build or acquire these relatively easily. For both FPS and Bacs contracts, VocaLink is contractually obliged to hold the up-to-date source code for the payment system in escrow.
- 4.143 Both BPSL and FPSL think that their existing contracts' termination and exit plan provisions are sufficient to enable a switch to a new provider. These provisions require VocaLink and the operator to agree a detailed exit plan (either by a certain date and/or after notice of termination) about how the migration to another provider would work. The provisions also outline the framework for what these detailed exit plans should cover, such as VocaLink providing assistance, staff and other resources during the switching process. The operators noted that it is difficult to determine the details of an exit plan in advance as the precise nature of the exit and migration requirements would depend on the circumstances at the time of termination. One operator's exit plan provisions give the operator (or its new infrastructure provider) the opportunity to purchase some of VocaLink's assets associated with the core services for that payment system, such as the [redacted].

### Our assessment

- 4.144 In our view, the governance and contractual arrangements structure of LINK appear to prohibit a switch in provider. The bilateral structure of LINK's core services contract between VocaLink and all PSPs (rather than with a legally incorporated entity), the current contractual arrangements, the lack of allocation of IPR and the lack of termination, exit and liability provisions in the contract appear to prohibit a switch in provider.
- 4.145 The changes proposed by Link Scheme associated with changes to its governance and operational structure to becoming legally independent of VocaLink should help address these barriers and make it easier to switch in the future. This includes establishing an independent entity with a new governance arrangement as the operator, [§] and replacing the current NMA with a commercial contract between the new operator and the infrastructure provider. The new contract is expected to include all necessary clauses [§] which we expect to enable a switch of provider in the future. We acknowledge that this is planned and that a separate legal company has been set up for LINK. However, at the time of publishing this report, Link Scheme has not yet made the governance and operational changes to become a legally separate entity to VocaLink.
- 4.146 We note that BPSL and FPSL's exit plan provisions provide some detail around what these detailed exit plans should cover. We also agree that certain specific details may not be determined without knowing the circumstances of the exit. The desire of one operator to agree a detailed exit plan before giving notice of termination suggests that it may not be satisfied with the level of detail covered in its other exit provisions. We also note that the date for agreement of the detailed exit plan has passed and that the operator said it plans to work on the detailed exit plan in the coming year.
- 4.147 If detailed exit plans are not agreed (in so far as is possible) in advance of termination, it could be difficult to negotiate these with an unsuccessful provider. Even though the contracts have clauses that require VocaLink to negotiate reasonably in determining the exit plans, it may still be possible for VocaLink to delay or frustrate these negotiations if it wanted. One operator [§] also noted that negotiating a detailed exit plan takes some time.
- 4.148 Overall, the current LINK contract arrangements and provisions are a barrier to switching. The proposed actions associated with Link Scheme's changes to its governance and operational structure to become independent of VocaLink (such as changes to contractual arrangements and governance arrangements) should help to address this barrier.
- 4.149 For the Bacs and FPS contracts, based on the evidence seen, it is unclear whether the existing provisions in each contract and the IPR and termination and exit provisions are sufficient to enable a switch in provider, which dampens the competitive pressure on VocaLink. This also applies to the provisions in the new proposed LINK contract.

### Barriers to entry

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- 4.150 If other firms face difficulties in entering and competing in a market, the incumbent firms do not face the threat of new entry and so may have little incentive to provide competitive prices and services. We assess whether there are barriers to entry inhibiting effective competition in the context of providing infrastructure services for Bacs, FPS and LINK.
- 4.151 Prospective providers identified several potential barriers, including:
- the lack of competitive procurements
  - the ownership arrangements between VocaLink, the operators and some PSPs
  - the messaging standards used

- the location of data centres
- the bundled set of core services that must be provided

Each of these barriers is outlined below.

### **Lack of competitive procurements**

- 4.152 Several providers [ ] said they are interested in providing the core services for the Bacs, FPS and/or LINK payment systems, but they have not been invited to submit proposals outside of the original build and run tender for FPS and the recent LINK RFI process. None of the providers who gave evidence in this review had directly approached the operators about providing the core services, outside of the above invitations. The operators said that they have never been approached except on one recent occasion in late 2015. One operator added that providers have the opportunity to approach them at international forums or events.
- 4.153 However, one provider explained that it had not approached the operators because it was not in its interest to do so. The provider perceived the provision of core services in the UK interbank payments systems as a closed market, given the lack of open tenders, and that the operators had no appetite to switch providers. Two providers stated that it was difficult to know with certainty what services it could provide for a payment system without knowing more details about the technical specifications and requirements that are provided in procurement exercises.

### **Our assessment**

- 4.154 As noted in paragraph 4.25, there has been a lack of competitive procurement exercises to re-procure for core services. Without competitive procurement exercises – and the information typically provided in these exercises (such as technical requirements and functional specifications) – other providers cannot determine with certainty if and how they can provide these services. We would not expect other providers to have adequate incentives to independently approach the operators, as the current procurers, to offer their services if they consider this a closed market.
- 4.155 There is evidence to suggest that there is a high likelihood of potential providers competing in a tender. As noted in paragraphs 4.111 and 4.118, there appears to be a number of providers globally that could compete, including those providers that told us they are interested. Also, the consistent profit that VocaLink earns on the provision of core services suggests other providers should have an incentive to enter a procurement exercise (see paragraphs 4.56 to 4.58).
- 4.156 Overall, we conclude that the lack of competitive procurement exercises is a barrier to entry that prevents potential providers from competing in the market for provision of Bacs, FPS and LINK core services.

### **Ownership arrangements**

- 4.157 We conclude that the common ownership of the operator and the infrastructure provider by some direct PSPs deters some providers from entering the market for the provision of core services. We consider this barrier in detail in paragraph 6.73ii.

### **Messaging standards**

- 4.158 Another barrier noted by providers is the messaging standards used by Bacs, FPS and LINK. The Bacs system uses its proprietary Standard 18 messaging standard. FPS uses its own implementation of the ISO8583 standard (used in global card systems) and the Standard 18 messaging standard for Direct Corporate Access. LINK uses its LIS5 standard, which is its own implementation of the ISO8583 standard.

- 4.159 Four providers said that the harmonisation of messaging standards to those used internationally (in particular changing Bacs and FPS to use the ISO20022 standard used in Europe and elsewhere) would encourage more competition from international providers, as many of them already use this standard. In its corporate strategy documents, VocaLink noted that the UK standards afford it protection from potential competitors and that moving to ISO20022 would level the playing field. Several providers, and two direct PSPs, also noted that this would promote interoperability, making it easier for PSPs to migrate their connectivity to other providers with benefits for competition. One provider said it would not be interested in competing for UK interbank payment systems unless the ISO20022 standard was adopted.
- 4.160 Two providers (that currently provide core services in other countries) and an operator observed that message translation software is available that providers can use to address the issue of operating on different message standards. One of these providers added that it was not concerned about the type of message standard used by the UK interbank payment systems, and that payment systems worldwide use a variety of different message standards.
- 4.161 We note that in May 2009 the Payments Council's Standards Policy Group outlined the following benefits of common international messaging standards:
- i. **Reduced operational cost:** Common messaging standards between schemes (irrespective of payment instrument) will greatly improve operational efficiency and system flexibility, and reduce indirect costs, such as back-office system maintenance and support.
  - ii. **Reduced cost of compliance and risk management:** Common standards will reduce indirect, non-value adding costs associated with operational and legal compliance testing and maintenance. They will facilitate improved liquidity and collateral management with reduced technical complexity in a cross-scheme and network environment.
  - iii. **Improved integrity at less cost:** Common standards are a foundation for enabling improved cross-scheme integrity, or for one message format to be conveyed across multiple schemes or networks.
  - iv. **Greater service provider choice at reduced cost:** Aligning domestic standards with open standards widely used in other regions and based on modern technology will improve the range and choice of service providers that can support the UK payments industry. Greater competition between service providers is likely to drive down cost.
  - v. **Faster, cheaper industry innovation:** Common standards will create a more cohesive collaborative cross-scheme basis to develop concepts more rapidly and cost effectively by re-using and extending common services, reducing time to market and avoiding service replication.
  - vi. **End users' benefits:** Common standards for payments aid straight-through processing and simplification of back-office operations. Common, richer format standards will also aid reconciliation as part of accounts receivable processing, which in turn improves cash management operations liquidity.

### Our assessment

- 4.162 While there are a few potential providers that are willing to support the relevant UK message formats, some providers are deterred from entering because they operate on different messaging standards than those used in the UK payment systems. We note that alternative providers could have little potential to reuse any Standard 18 processing capabilities or the FPS and LINK implementation of ISO8583, which would deter them from developing these capabilities to enter. Also, VocaLink has acknowledged (in internal documents) that the UK message standards are a barrier to competition for international providers, but that it is willing to respond competitively to the threat if this barrier is removed (see paragraph 4.121).

- 4.163 The use of message translation software is not uncommon and could be used to address this barrier to some extent and to facilitate a transitional period. However, this may not fully remove the barrier, as the need to use such software may increase the costs for those providers that do not already operate using the required bespoke message standard. This additional cost may make them less competitive in a procurement exercise, or make it harder for them to meet some SLAs.
- 4.164 The lack of interoperability – that is, technical standards and operating rules (including messaging standards) that are common to other payment systems – inhibits competition and increases the incumbency advantage of the provider. It could also inhibit the transition to alternative models such as competition in the market with multiple providers (see Annex 5: Alternative payment system models). We recognise that different market structures and procurement models are possible in the future. Further consideration needs to be given to the appropriate mechanism of examination of potential alternative models, such as competition in the market. The Payments Strategy Forum is doing some work on this in its work stream on simplifying access to markets. However, more work needs to be done in this area.
- 4.165 In its work on simplifying access to markets the Payments Strategy Forum will also be examining the type of messaging standard to be adopted, which could include common international messaging standards and other technical standards and operating rules more broadly. We note the number of wider benefits of common standards, as outlined in paragraph 4.161.
- 4.166 Overall, we find the lack of common international messaging standards in the UK deters some providers from entering the market for the provision of core services and inhibits competition.

### Location of data centres

- 4.167 Some infrastructure providers [36] believe there is a requirement to have data centres located in the UK and that this is a barrier to entry. They said they would need to use their data centres located outside of the UK to be able to compete effectively, taking advantage of economies of scale. If they could not do this, and had to establish data centres in the UK, they said this would drive up their cost and they would not be able to offer a competitive price. One infrastructure provider added that in Europe, there are infrastructure providers that use data centres located in different countries to where the services are being provided under the SEPA model. This is not a concern for those infrastructure providers [36] that have data centres established in the UK.

### Our assessment

- 4.168 The Bank of England told us it does not explicitly require the data centres of a provider of a recognised UK payment system to be located in the UK or for the provider to be legally incorporated in the UK. The Bank would require the provider to comply with relevant laws and acceptable risk management standards and allow the Bank to adequately supervise the UK payment system and/or PSPs.
- 4.169 We note that if a provider has data centres located in a country outside the European Economic Area (EEA), there is a legal requirement to demonstrate that the country's data protection laws are adequate. In late 2015, the EU Court of Justice made a ruling that it is no longer lawful to make transfers of data under the US Safe Harbour arrangement.<sup>79</sup> This ruling does not prohibit the transfer of data to the US or another country outside of the EEA, just that the owner of the data

<sup>79</sup> This refers to the EU Court of Justice's decision made in reference to US 'Safe Harbour' arrangement that it is no longer lawful to make transfers on the basis of the EU-US Safe Harbour framework. See Court of Justice of the European Union Press Release No 117/15 'Judgment in Case C-362/14 Maximilian Schrems v Data Protection Commissioner' (6 October 2015), available at: <http://curia.europa.eu/jcms/upload/docs/application/pdf/2015-10/cp150117en.pdf>

that is processed in a country outside the EEA needs to ensure that the existing arrangements for data protection in that country are adequate.<sup>80</sup>

- 4.170 While the location of data centres does not appear to be an issue, we note that two infrastructure providers, in addition to VocaLink, have data centres located in the UK. Also, several infrastructure providers have data centres within the EEA – some of which provide cross-border data processing services within the EEA.
- 4.171 We are aware that, in the past, network latency (the time taken to move data between points) was considered a potential issue for real-time synchronous payments if data centres were located too far apart. However, given improvements in telecommunications technology in recent years, this may be a diminishing concern.
- 4.172 Overall, we do not consider that the location of data centres should be a barrier to entry.

### **Bundled core services**

- 4.173 One provider suggested that the bundled set of core services provided in UK payment systems is a potential barrier to entry. That is, in the UK the provider supplies central clearing services and a number of back-office and value-added services (for example, reconciliation and reporting services) as the core set of services. This provider noted that providers in other countries in Europe do not provide such a rich set of services, but only the central clearing and settlement services. They do not provide back-office and value-added services centrally, and therefore may not be able to provide all the services required for the core contract for the UK payment systems.

### **Our assessment**

- 4.174 This concern was not raised by other providers that we spoke to. Also, other potential providers told us they are interested in providing the core services for Bacs, FPS and/or LINK (see paragraph 4.111). It is possible that other potential providers may also be deterred from entering if required to provide the full suite of services. However, we are mindful that limiting what can be included as part of the core services would conflict with a desire to promote innovation in core services: we want competing infrastructure providers to develop and offer new value-added services. We note that greater interoperability and simpler connectivity arrangements may allow for a change in arrangements where more than one firm provides different components of the core services.
- 4.175 In our view, the package of core services should reflect the current and future needs of service-users and be procured via a competitive procurement process. This should help to make sure that the extent of bundling in core services, and what services are included in the bundle, best meet the needs of service-users.

### **Conclusion**

- 4.176 We find there has been a lack of periodic competitive procurement exercises held. The operators do not shop around and lack an incentive to do so, while direct PSPs lack an incentive to encourage the operators to shop around (we consider these incentives in detail in paragraphs 6.73i to 6.73iii). Most operators and direct PSPs are satisfied with the value for money, quality of service and innovation they receive from VocaLink. However, they are not fully informed about alternative – and potentially more efficient and innovative – infrastructure services. Furthermore, VocaLink is not subject to direct competition.

<sup>80</sup> This is pending on more clarity at the EEA level on what constitutes an adequate level of protection when transferring data to third countries. The EU Court of Justice stated that the national supervisory authorities, when dealing with a claim, must be able to examine whether the transfer of a person's data to a third country complies with the requirements laid down by the relevant legislation.

- 4.177 The lack of competitive procurement exercises by the operators is a barrier to entry that prevents potential providers from competing. However there is evidence that a number of potential providers are interested in competing and the consistent profit that VocaLink earns on the provision of core services suggests providers should have an incentive to enter a procurement exercise. We also identified VocaLink's ownership arrangements (this is discussed in paragraphs 6.21 to 6.34) and the lack of common international messaging standards in Bacs, FPS and LINK as barriers that deter some potential providers from entering. We note that the lack of interoperability (including common messaging standards) with other payment systems may also limit competition in the current structure and could also inhibit the transition to alternative models.
- 4.178 We consider the current LINK governance and contractual arrangements are a barrier to competition. However, the proposed actions by the Link Scheme associated with changes to its governance and operational structure to become independent of VocaLink should help to address these. For Bacs and FPS, based on the evidence we have seen, it is unclear whether the contract provisions are a barrier, but in our view it is important that these provisions do not inhibit a switch of provider.
- 4.179 It is difficult for the PSPs and operators to anticipate what costs and risks would be involved in changing PSPs' systems to enable the switch of provider without a market testing and competitive procurement exercise. These exercises would enable them to understand both the costs and benefits of switching providers.
- 4.180 In our view, the extent of bundling of core services, and what services are included, should reflect the current and future needs of service-users and be procured via a competitive procurement process.
- 4.181 We do not consider that the location of data centres should be a barrier to entry.

# 5

## Competition in the provision of other infrastructure services

In this chapter we examine the effectiveness of competition in the provision of gateway services and other infrastructure services. We have considered:

- the current state of competition
- barriers to switching
- barriers to entry

We find that there appears to be effective competition in the provision of gateway solutions and payment service providers (PSPs) seem to have sufficient choice in providers. The costs and risks of switching providers do not appear to be insurmountable barriers. VocaLink does not appear to benefit from a competitive advantage due to its role as the central infrastructure provider, but it is unclear if certain Bacs accreditation processes are a barrier to entry for potential Bacs gateway providers.

### Introduction

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- 5.1 In this chapter we assess whether there is effective competition in the provision of other infrastructure services at the boundary between PSPs and the central clearing functions of payment systems, where VocaLink also provides infrastructure services such as gateway solutions.
- 5.2 We consider a theory of harm that VocaLink, as the central infrastructure provider, can shut off certain markets to potential competitors of other infrastructure services. This would restrict competition in these areas, to the detriment of PSPs and their customers.
- 5.3 The other infrastructure services we will look at are:
- telecommunication lines
  - Bank Reference Database Services (BRDS), in particular the Extended Industry Sort Code Database (EISCD), which contain information used to validate and route payments
  - gateway solutions and services, which are typically the entry point to the communication channel between the PSP (or third-party service provider) and the central clearing infrastructure, and connect to the payment system
- 5.4 We noted that for telecommunication lines, stakeholders (including infrastructure providers) didn't raise any issues about competition in the provision of these services, and there are several providers in this area.
- 5.5 For BRDS, VocaLink is the only provider (under a separate contract to the core central infrastructure services) and all inter-bank payment systems except LINK use their services. However, stakeholders did not raise any issues about competition in the provision of these services



and we don't know of any infrastructure providers interested in competing for them on a standalone basis.

5.6 Some providers were concerned about competition in the provision of gateway services, as VocaLink provides central infrastructure and some Bacs accreditation services.

5.7 Therefore, our focus in this chapter is on competition in the provision of gateway solutions. However, a change in central infrastructure provider could affect whether the solutions provided by VocaLink (such as BRDS) need to be provided by the same entity as the central infrastructure provider (for example, as a package) and, if not, how the two would work together. We note that it is important that an incumbent provider of any overlay or related services is not able to embed themselves as a monopoly provider following a change in the central provider. It may seek to exploit such a monopoly position if this is not properly addressed as part of a competitive procurement exercise.

5.8 To consider competition in the provision of gateway solutions, we assess:

- the current state of competition
- barriers to switching
- barriers to entry

5.9 We then give our overall conclusions.

### Current state of competition in gateway solutions

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5.10 PSPs use a range of solutions depending on their requirements and on the payment system they want to access. They may:

- build their gateway infrastructure entirely in-house
- buy an off-the-shelf or commoditised gateway product (typically under licence from the vendor) and host it on their own system. They might also customise the product themselves
- use fully outsourced gateway solutions, where a provider hosts and runs them

5.11 If they buy solutions, the choice of provider can vary within each payment system depending on what they need. We outline these below.

### Bacs

5.12 The choice available to a PSP for its gateway provider (for obtaining direct technical access) depends on the communication channel it uses to connect to the Bacs central infrastructure. There are three channels:

**Bacstel-IP** is typically used by indirect PSPs and corporates with smaller volumes of transactions, and is input-only. (They can submit payment instructions but don't get output information, which PSPs use to debit and credit customers' accounts.) A gateway solution for Bacstel-IP must pass accreditation and be supplied by a Bacs Approved Software Supplier (BASS). Currently 18 BASS

software providers offer approved Bacstel-IP solutions.<sup>81</sup> VocaLink doesn't, but runs the BASS accreditation service for BPSL. VocaLink approves the solutions that pass accreditation.

**The Enhanced Transmission Service (ETS)** is a high-speed, high-capacity channel, where transmissions travel between a PSP and VocaLink over a VocaLink network. This is an input-output channel typically used by PSPs with many transactions. There are only two providers of ETS gateways, one of which is VocaLink.

**The SWIFTNet Transmission Service (STS)** is similar to ETS: a high-speed, high-capacity channel, where transmissions travel between a PSP and VocaLink over the SWIFT network. It is an input-output channel typically used by PSPs with many transactions. As PSPs use SWIFT, they can choose from many providers of SWIFT-certified solutions to connect to that network; VocaLink doesn't offer SWIFT solutions.<sup>82</sup>

- 5.13 Direct PSPs in the Bacs system need to connect using either ETS or STS because they get output information from the central infrastructure to debit and credit customers' accounts. Some indirect PSPs get Bacs output directly – direct technical access – so must also use either ETS or STS.
- 5.14 Indirect PSPs and corporates that only need an input channel can choose between the three channels to submit payment instructions (here, indirect PSPs get their Bacs indirectly from VocaLink, via their sponsor bank). For example, some organisations that submit very high volumes use ETS or STS. Indirect PSPs and corporates can also submit indirectly through their sponsor bank or using a Bacs bureau service.

### Faster Payments Service (FPS)

- 5.15 The choice of FPS gateway provider depends on the way a PSP connects to the central infrastructure:
- Direct PSPs buy solutions that they host on their internal IT systems. There are three providers, including VocaLink.
  - VocaLink provides a fully outsourced (or managed) gateway solution, offering direct technical connection to FPS to one indirect PSP.
  - Direct Corporate Access (DCA) via Secure-IP is typically used by indirect PSPs and corporates with fewer transactions.<sup>83</sup> It's based on Bacstel-IP and is input only. Solutions for Secure-IP must pass accreditation, similar to BASS approval. There are six providers of approved Secure-IP solutions.<sup>84</sup> VocaLink does not provide them, but runs their accreditation (similar to the BASS accreditation service).
- 5.16 More gateway solutions are being developed for FPS (known as new FPS technical access solutions) that aim to make it easier and cheaper for direct and indirect PSPs to connect to the FPS system.<sup>85</sup> About ten providers, including VocaLink, have said they will offer them.<sup>86</sup>

<sup>81</sup> A list of these providers is published on the Bacs website: [bacs.co.uk/Bacs/SoftwareSuppliers/ApprovedSoftware/Pages/Index.aspx](https://www.bacs.co.uk/Bacs/SoftwareSuppliers/ApprovedSoftware/Pages/Index.aspx).

<sup>82</sup> A list of these providers is published on the SWIFT website: [swift.com/about-us/partner-programme/swift-certified-applications/swift-certified-applications-finder](https://www.swift.com/about-us/partner-programme/swift-certified-applications/swift-certified-applications-finder).

<sup>83</sup> File Input Module (FIM) channel is another channel available to indirect PSPs, but it is not used by any of them. Therefore we do not consider it here.

<sup>84</sup> BPSL manages the approval process on Secure-IP on behalf of FPSL. A list of these providers is published on the Bacs website, available at: [bacs.co.uk/Bacs/SoftwareSuppliers/ApprovedSoftware/Pages/Index.aspx](https://www.bacs.co.uk/Bacs/SoftwareSuppliers/ApprovedSoftware/Pages/Index.aspx).

<sup>85</sup> The new FPS technical access solution is discussed in more detail in our report *Access and governance of payment systems: the operators' progress and areas for ongoing focus* (15 December 2015), available at: [psr.org.uk/psr-publications/news-announcements/access-and-governance-report](https://www.psr.org.uk/psr-publications/news-announcements/access-and-governance-report); and on the FPS website: [fasterpayments.org.uk/access-payments/economics-new-access-model](https://www.fasterpayments.org.uk/access-payments/economics-new-access-model).

<sup>86</sup> These providers are listed on the FPS website: [fasterpayments.org.uk/access-payments/economics-new-access-model](https://www.fasterpayments.org.uk/access-payments/economics-new-access-model).

## LINK

- 5.17 Here, gateway solutions are the software products that route a PSP's ATM transactions to the appropriate payment system (LINK, MasterCard or Visa). PSPs can either:
- buy a solution that they host; there are at least six providers, although VocaLink is not one
  - use a fully outsourced solution, known as a Certified Service Bureau (CSB); there are at least nine CSBs, including VocaLink

## PSPs' views

- 5.18 A few PSPs told us that the solutions they need can differ significantly depending on their size and geographical reach, the kind of operations they run and their resources and expertise.
- 5.19 PSPs usually either:
- buy a commoditised gateway product and customise it to integrate the solution with its systems or needs
  - use fully outsourced solutions – some use a mix of customisation and outsourcing of solutions for different payment systems
- 5.20 One built its gateway solutions entirely in-house.
- 5.21 Six PSPs that fully outsource a solution said this option offers lower cost, lower complexity and better functionality compared with what they could develop in-house. Five PSPs that build or customise in-house said this offers greater control over the operation and functionality of their infrastructure and can be cheaper with large transaction volumes. Two PSPs also noted that buying a solution means the provider rather than the PSP is responsible for updates and compliance with operators' rules and technical standards.
- 5.22 Overall, nine PSPs and three providers said there was good competition in the provision of gateway solutions. They offer different types of gateway solutions which ranged from fully outsourced services to customised products that PSPs host themselves.
- 5.23 However, they noted that the degree of this competition varies between payment systems:
- **Bacs:** Two PSPs and three providers believe the provision of Bacs solutions is a mature market, and PSPs have a choice of provider. For Bacstel-IP, one PSP and a provider noted the large number of BASS software providers. However, one provider said that most Bacstel-IP transactions are processed using software from just two providers. For STS, one PSP noted that PSPs can use any SWIFT-certified provider for solutions, of which there are many. In contrast, two noted that there are only two providers of ETS gateways, one being VocaLink.
  - **FPS:** Two PSPs said several providers offer solutions that PSPs host on their systems. In contrast, others thought competition in FPS solutions has been limited, particularly in outsourced (managed) solutions, which only VocaLink provides.<sup>87</sup> Some said this element of the FPS market will open up as new FPS technical access solutions make it easier for PSPs to connect to the FPS central infrastructure.<sup>88</sup> Those PSPs considering the new FPS offerings are

<sup>87</sup> This refers to VocaLink's solution, previously known as the Faster Payments Managed Services solution, which only one indirect PSP used for direct technical access to FPS.

<sup>88</sup> Although one provider suggested that FPSL has delayed these solutions coming to market.

in early discussions with providers including VocaLink.<sup>89</sup> No PSPs were worried about the number of Secure-IP providers for DCA services.<sup>90</sup>

- **LINK:** Three PSPs and one provider noted that there are several providers offering different gateway solutions and that solutions vary depending on PSPs' differing requirements (see paragraph 5.18). Four PSPs said that not all can meet the requirements of each PSP, but there is still enough choice.

- 5.24 PSPs select their provider by open or closed tender. Most have teams and policies for the procurement of gateway solutions (and other products and services).
- 5.25 Seven PSPs said that the key factors in selecting a provider were resilience, quality of service and value for money. Four PSPs think VocaLink's role as the central infrastructure provider is a positive factor when considering VocaLink's gateway solutions. They believe VocaLink has greater expertise in the provision of downstream infrastructure that connects to the central infrastructure.

### Our assessment

- 5.26 There appears to be effective competition in the provision of gateway solutions and PSPs have enough choice of provider.
- 5.27 PSPs use a range of gateway providers – not just VocaLink – within each payment system, including across ETS and STS for Bacs. There is also evidence that PSPs can choose from several providers in each payment system.

**In Bacs,** PSPs can use 18 BASS software providers and numerous gateway providers to connect to SWIFTNet and STS. While there are only two providers of ETS solutions, they compete against providers of STS for PSPs needing input-output channels (as they will choose between access via ETS or STS). They also compete against both BASS and STS providers for business that only needs an input channel (and do not directly receive output), to the extent that customers view these channels as interchangeable.

**In FPS,** there are three providers of gateway solutions used by PSPs, and six providers of Secure-IP solutions for the DCA service. Further competition is expected, with about ten potential providers of the new technical access solutions (including the three offering hosted FPS gateway solutions). Some PSPs are considering using providers other than VocaLink.

**In LINK,** there are at least 15 providers, ranging from hosted to fully outsourced solutions.

- 5.28 PSPs typically appear to obtain gateway solutions in a competitive manner and try to find the offer that best suits them. While some believe VocaLink's solutions benefit from it being the central infrastructure provider, they either do not use VocaLink, or noted that other providers may offer better solutions.
- 5.29 Five PSPs did not select VocaLink because its solution did not meet all their needs; one even left for another provider for the same reason.

### Barriers to switching

- 5.30 We asked if there were any barriers to PSPs switching gateway providers.

<sup>89</sup> These propositions are in the early stages of development.

<sup>90</sup> Some concerns were raised about the DCA channel with respect to access to FPS. These issues are explored in our *Market review into supply of indirect access*

- 5.31 Five PSPs told us that it is technically possible to switch providers. However, over half the PSPs we spoke to thought the costs and risks involved in switching providers could be a barrier. These costs – changing internal IT systems and testing the new connection, and the risk of disruption of service to customers – could outweigh the benefits.
- 5.32 Three PSPs wouldn't consider switching as they haven't had any issues with their current solutions. This is particularly true of several PSPs' solutions for LINK (or ATM and cards processing generally), which have been in place for decades. However, a few of these PSPs occasionally review their solutions.
- 5.33 Four PSPs and one infrastructure provider said that, because of the costs and risks involved with changing providers, they would only consider switching if external developments warranted a significant change to their systems. This could be a significant upgrade or standard change within a payment system, a merger with another company, or a change in business strategy that affects how they connect to payment systems.
- 5.34 However, six smaller PSPs have recently switched to a new provider, are currently doing so, or will consider it in the near future. While it is not a decision to be taken lightly and they would not do it often, they said the benefits (such as better prices and/or quality of service) outweighed the costs and risks involved.
- 5.35 No other barriers to switching providers were identified. We asked PSPs about the intellectual property rights (IPR) and security protocols and standards for gateway solutions. Three said the provider typically owns the IPR, but did not feel it was a barrier to switching. Seven PSPs set the security protocols and standards (incorporating the operators' requirements where relevant) that solutions need to meet, and none said it was a barrier to switching.

### **Our assessment**

- 5.36 We conclude that the cost and risk of switching gateway providers is not an insurmountable barrier. There are costs and risks involved with switching, but PSPs have switched when they wanted to. Four have recently switched or are in the process of doing so for a positive business case.

### **Barriers to entry**

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- 5.37 We assess whether VocaLink may be able to foreclose the market for the provision of gateway solutions by creating barriers to entry. We also want to assess if there are other barriers that could affect competition in this area.
- 5.38 Two providers think VocaLink has a competitive advantage in providing solutions. They believe PSPs (and other users such as corporates) view VocaLink's solutions as better, more resilient and/or higher quality because it provides the central infrastructure services these gateways connect to.
- 5.39 For Bacs, two providers said that because PSPs decide between using Bacstel-IP, ETS and STS to connect to the central infrastructure, VocaLink's ETS is also in competition with both STS and Bacstel-IP.
- 5.40 Two providers noted that VocaLink may have an advantage in developing new gateways, such as the new FPS technical access solution. VocaLink, as the central infrastructure provider, would have first sight of technical specs related to interfacing with the central infrastructure. VocaLink could make this available to its commercial business area before other gateway providers and bring its propositions to the market sooner. One provider said it has had struggled to get technical specifications needed to develop solutions for [X] held by VocaLink channels.

## BASS accreditation

- 5.41 Some providers identified Bacs-specific barriers to entry, as VocaLink runs the accreditation process for BASS software providers for Bacstel-IP (i.e. it approves them).
- 5.42 Two providers were worried about the lack of transparency around the BASS accreditation process, including the standards and technical specifications used for accreditation. Bacs Payment Schemes Limited (BPSL) determines them, but it's not clear if VocaLink applies them consistently and could even make it difficult for other providers to get solutions approved. One gave an example where its solution failed despite having previously been approved and without any change to the solution or the accreditation standards and specifications. The provider amended the solution, which was approved after re-testing.
- 5.43 One provider was worried that the cost of Bacs accreditation for Bacstel-IP acts as a barrier to entry. It believed it should be clearer what VocaLink's costs of accreditation cover. The provider added that, while the BASS accreditation cost has not changed, it has deterred some from wanting approval.
- 5.44 In contrast to these views, two providers and a PSP – including one of the providers that raised concerns – noted that, while prospective infrastructure providers must ensure they meet the accreditation standards and specifications, this has not been a barrier to them entering the market.

## Our assessment

- 5.45 There is little evidence to suggest that VocaLink benefits from a competitive advantage as central infrastructure provider due to a perception that it offers better solutions or could bring solutions to market sooner. The direct PSPs use a range of providers (not just VocaLink) and several operate within each payment system and across the channels within Bacs and FPS. Some want to offer the new FPS technical access solutions and are looking at several providers.
- 5.46 However, it is unclear whether the Bacstel-IP accreditation process blocks potential providers. VocaLink's ETS competes with the other ETS provider's solution, but also against STS and to some degree Bacstel-IP (for indirect PSPs and those needing input-only solutions). Thus VocaLink may have an incentive to block potential Bacstel-IP providers by making the accreditation process difficult. As to the extent that VocaLink has been successful in market foreclosure, plenty of Bacstel-IP and STS providers do compete in this area. This level of competition also suggests there is little profit for VocaLink to foreclose the market to potential Bacstel-IP gateway providers looking to enter it.
- 5.47 BPSL is responsible for setting the cost of BASS accreditation services, not VocaLink. This means VocaLink can't use accreditation costs to foreclose the market to potential Bacstel-IP providers. However, the cost of accreditation may still stop some. This cost has not changed for a long time, so may not be frequently reviewed.
- 5.48 The evidence is not conclusive, so we would like to consult further on whether other potential providers have been deterred from entering as a Bacstel-IP provider because of the accreditation process or costs.
- 5.49 We acknowledge that the perception that VocaLink (in its capacity as the provider of certain accreditation services for gateway solutions) may be able to foreclose the market, could weigh on potential providers' perceived likelihood of their successful entry into the market and therefore their incentive to incur the costs involved with trying to enter. One example of a positive development in addressing these perceptions is FPSL's accreditation service for the new FPS technical access solutions. Given that VocaLink plans to compete in this space, FPSL has decided to use an independent third party to provide the accreditation services. We expect this will help

address perceptions that VocaLink is able to foreclose this particular market or has a competitive advantage.

## **Conclusion**

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- 5.50 Overall there appears to be competition in the provision of gateway solutions.
- 5.51 The evidence shows that PSPs have enough provider choice and don't all use the same provider.
- 5.52 The costs and risks of switching gateway providers do not appear to be a barrier. While PSPs do not switch often, they've done so when there has been a positive business case for it.
- 5.53 VocaLink does not appear to gain a competitive advantage for gateway solutions due to its role as the central infrastructure provider. But it's not clear if Bacstel-IP's accreditation process blocks potential providers. Therefore, we would particularly welcome further views on this issue.

# 6

## Ownership and control of payment systems

### Introduction

In this chapter, we examine the ownership and governance arrangements of VocaLink and the operators by PSPs to understand how this affects competition in the provision of central infrastructure services.

We assess how PSPs exercise control over the decisions made by the infrastructure provider and the operators through existing governance arrangements. We will try to establish whether this may result in a lack of competitive pressure on VocaLink.

We also examine stakeholder's views on VocaLink's current ownership arrangements.

We find that a relatively small number of banks own and control the Bacs, FPS and LINK payment systems and the infrastructure provider – VocaLink – for these systems and they are also their main users. We find that because the largest members of the operators have ownership interests in VocaLink and are able to exert control over both entities, the level of competition for the provision of central infrastructure services is reduced. This is because:

- PSPs see the ownership and control of the infrastructure services provider as a way of ensuring security and resilience and introducing competition for infrastructure services may introduce a degree of risk.
- Common ownership creates perceptions amongst other potential infrastructure providers that this is a closed market.
- Shareholder PSPs have invested in protecting their investment in VocaLink, which earns stable profits from core services contracts. These same PSPs are also responsible for deciding whether to change infrastructure, and have a disincentive to expose VocaLink to competition that may put these assets and profits at risk.

- 6.1 In this chapter we analyse VocaLink's and the operators' ownership and governance arrangements, and how they affect competition in the provision of central infrastructure services for Bacs, FPS and LINK.
- 6.2 PSPs with direct access to payment systems (Direct PSPs) are also, in most cases, the owners<sup>91</sup> of the operators of those systems. Bacs, FPS and LINK have evolved as collaborative networks, run by not-for profit entities, and owned or governed<sup>92</sup> by PSPs themselves (banks and building societies). The same PSPs also own VocaLink – the infrastructure provider for Bacs, FPS and LINK. This group of PSPs are also the largest users of these payment systems.
- 6.3 The co-operative nature and the vertical effects of these arrangements lead to concerns about larger PSPs' control and influence over payment systems. This is especially true if they stand to benefit from this control at the expense of other PSPs.<sup>93</sup>
- 6.4 In addition, the rules of payment systems and procurement of the infrastructure provider are determined by Boards of Directors appointed by the owners – the large direct PSPs.<sup>94</sup> We therefore

<sup>91</sup> Guarantors for Bacs and FPS and members for LINK.

<sup>92</sup> Bacs, FPS and LINK are membership organisations and have no shareholders.

<sup>93</sup> PSR MR 15/2.1 Final ToR, p. 10.

<sup>94</sup> see paragraphs 6.24, 6.37 and 6.43.



consider whether the overlapping ownership of VocaLink and the operators by large PSPs may hinder competition for infrastructure provision.

- 6.5 We want to promote competition and ensure payment systems are operated in service-users' interests. As mentioned in Chapter 4, in a competitive market, infrastructure providers would need to continue to offer a competitive service and price to attract and retain operators and/or PSPs.
- 6.6 In this chapter we consider the extent to which the alignment of incentives between VocaLink, the operators and direct PSPs may affect competition in the provision of central infrastructure services.
- 6.7 In this chapter we analyse:
- ownership of VocaLink and the operators of Bacs, FPS and LINK
  - corporate governance and decision making at VocaLink and at the operators
  - stakeholder views on VocaLink's ownership arrangements
  - possible effects of the current ownership and governance arrangements on the market for the provision of central infrastructure services

## Ownership of VocaLink and operators

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- 6.8 Currently, 13 PSPs are VocaLink shareholders, with five of them jointly owning more than 85% of the shares. In the rest of the chapter, we will be referring specifically to these five PSPs as they are by far the largest users of these systems by transaction volume and this gives them greater weight in voting at Board meetings (see paragraphs 6.40, 6.45 and 6.50<sup>95</sup>). These PSPs put forward Directors who are appointed to VocaLink and the operators' Boards (see paragraphs 6.24, 6.37 and 6.43). The largest four out of these five PSPs control the VocaLink Operational Oversight Committee (OOC).<sup>96</sup>
- 6.9 Bacs Payment Schemes Limited (BPSL), the Bacs operator, is a company limited by guarantee and does not have shareholders. Every member guarantees the company by an amount not exceeding £10. BPSL currently has 16 members, which are banks and building societies from the UK, Europe and the US. Ten of these are also shareholders of VocaLink, including its five largest shareholder PSPs.
- 6.10 Faster Payments Scheme Limited (FPSL), the FPS operator, is a private company limited by guarantee. The liability of each member is limited to £1. FPSL currently has ten member organisations which are banks and building societies from the UK and Europe. Eight of these are also shareholders of VocaLink, including its five largest shareholder PSPs.
- 6.11 The operator of LINK – the Link Scheme – is not a company. Link Scheme's governing body is the LINK Network Member's Council (NMC), which is supported by the Link Scheme Executive. The NMC is composed of 38 members. Thirteen of these are also shareholders of VocaLink, including its five largest shareholder PSPs.
- 6.12 Table 1 shows the various shareholder PSPs that own VocaLink and whether they are members of BPSL, FPSL and LINK.

<sup>95</sup> The big five have 80% of the transaction volume of FPS, 63% of the transaction volume for LINK and 86% of the transaction volume for Bacs.

<sup>96</sup> The Link Scheme has no board of Directors as all 38 members have weighted voting rights. Therefore, no PSP, including the largest five banks, can appoint board Directors.

**Table 1: Ownership of VocaLink and operators of Bacs, FPS and LINK**

VocaLink shareholder	31 Dec 14 VocaLink shareholding (%)	Bacs Payment Schemes Limited	Faster Payments Scheme Limited	LINK Network Members Council
AIB Group (UK) Plc.	0.84	Member		Member
Barclays Bank Plc.	15.18	Member	Member	Member
Bristol & West Plc. <sup>97</sup>	0.69			Member
Coventry Building Society	0.73			Member
HSBC	15.91	Member	Member	Member
Lloyds Banking Group	25.1	Member	Member	Member
CYBG Plc.	3.24	Member	Member	Member
Nationwide Group	4.34	Member	Member	Member
Santander Group	7.74	Member	Member	Member
The Co-operative Bank Plc.	3.31	Member	Member	Member
The Royal Bank of Scotland Group	21.4	Member	Member	Member
Virgin Money Plc.	0.79	Member		Member
Yorkshire Building Society	0.73			Member

Source: VocaLink, BPSL, FPSL 2014 annual reports; LINK website

Note: Citibank and Danske Bank are the only non-VocaLink shareholders who are direct members of Bacs and FPS, and so are entitled to nominate Directors of BPSL and FPSL. The LINK NMC has 38 members in total, 15 of which are part of banking groups that are VocaLink shareholders.

- 6.13 The table above shows that VocaLink and the operators have common ownership. This means that the operators and VocaLink have the same PSPs as members and shareholders respectively – and these parties are also their users. This common ownership is not necessarily an issue in itself. However, there could be a conflict of interests because VocaLink’s shareholder PSPs are the main users of these systems, as well as being the owners/members of the operators. This may result in decisions being taken at the operator level that reduce the competitive pressure on VocaLink. As owners of both the provider (for example, VocaLink) and the contracting bodies for the central infrastructure services for the three payment systems (such as the operators), the PSPs have an interest protecting their investment in VocaLink by making sure that the operators procure these services from VocaLink.

## Corporate governance and decision-making processes at VocaLink and at the operator level

- 6.14 To understand whether the current ownership arrangements for the operators and VocaLink outlined above can affect competition in the market for infrastructure services, we first need to establish whether PSPs control VocaLink and the operators through their ownership. By assessing their control, we will be in a position to determine the extent to which these PSPs, especially the five largest shareholder PSPs, are able to control the operational decision making of both the operators and VocaLink.
- 6.15 The Enterprise Act 2002 defines ‘control’ as not limited to a shareholding conferring more than 50% of the voting rights (also known as ‘legal control’), and may include situations that fall short of outright voting control. Section 26 distinguishes three levels of interest referred to as control (in ascending order):

<sup>97</sup> Part of the Bank of Ireland Group

- a. The ability to materially influence the policy of a company (known as 'material influence').
  - b. The ability to control the policy of a company (known as 'de facto' control).
  - c. A controlling interest in a company (known as 'de jure', or 'legal' control).
- 6.16 We are interested in all three levels and treat them all as equivalent when it comes to establishing control.<sup>98</sup> For these purposes, we examine the ownership structure and corporate governance of both VocaLink and the operators to understand how decisions are made, who makes these decisions and who appoints decision makers.
- 6.17 Table 2 shows the PSPs' shareholding and the Board positions held at VocaLink and the operators.

**Table 2 VocaLink shareholders and their involvement in the governance of Bacs, FPS and LINK**

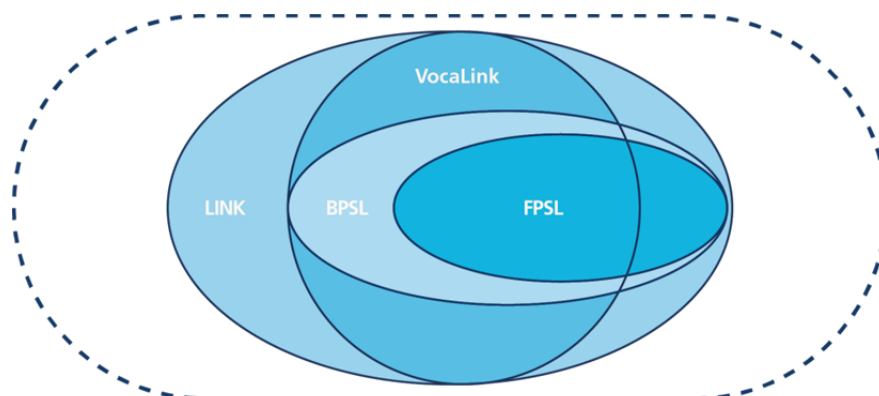
VocaLink shareholder	31 Dec 14 VocaLink shareholding (%)	VocaLink Board	Bacs Payment Schemes Limited	Faster Payments Scheme Limited	LINK Network Members Council
AIB Group (UK) Plc.	0.84		Director		Member
Barclays Bank plc.	15.18	Director	Director	Director	Member
Bristol & West Plc.	0.69				Member
Coventry Building Society	0.73				Member
HSBC	15.91	Director	Director	Director	Member
Lloyds Banking Group	25.1	Director	Director	Director	Member
CYBG Plc.	3.24		Director	Director	Member
Nationwide Group	4.34	Director	Director	Director	Member
Santander Group	7.74	Director	Director	Director	Member
The Co-operative Bank Plc.	3.31		Director	Director	Member
The Royal Bank of Scotland Group	21.4	Director	Director	Director	Member
Virgin Money Plc.	0.79		Director		Member
Yorkshire Building Society	0.73				Member

Source: VocaLink, BPSL, FPSL 2014 annual reports; LINK website

Note: Citibank and Danske Bank are the only non-VocaLink shareholders who are direct members of Bacs and FPS, and are therefore entitled to nominate Directors of BPSL and FPSL. The LINK NMC has 38 members in total, 15 of which are part of banking groups that are VocaLink shareholders.

- 6.18 In Figure 7 we provide a graphical representation of the PSPs involved in the governance of the operators of VocaLink.

<sup>98</sup> For the concepts of material influence and de facto control, see paragraphs 4.14 - 4.29 of CMA2 Mergers – the CMA's jurisdiction and procedure. See Section 26(3).

**Figure 7: Direct PSPs involved in governance of operators<sup>(a)</sup> and VocaLink**

(a) Governance defined as the possibility to appoint a director on the operators' board. LINK is governed by the NMC, which is composed of all direct member PSPs

- 6.19 Table 2 and Figure 7 illustrate that there is a considerable overlap in terms of the PSPs that sit on the VocaLink Board and the PSPs that sit on the Board of the operators. In particular, it is clear that the five largest shareholder PSPs are also represented in the membership and on the Board of all the operators.
- 6.20 In Annex 2 and Annex 3 we outline the corporate governance and the decision-making process of VocaLink and the three operators respectively. In paragraphs 6.21 to 6.51 we provide a summary of this assessment.

### Overview of VocaLink's corporate governance

- 6.21 VocaLink Holdings Limited is a private company limited by shares. It has 18 institutional shareholders (or 13 banking groups). The main shareholders are Lloyds Group, Barclays Bank, Royal Bank of Scotland Group, Santander and HSBC with a combined issued share capital of around 85%.<sup>99</sup>
- 6.22 Shareholders have voting rights at the company's annual general meeting on a number of reserved matters, such as the issue of share capital, changes to the company's terms of reference, and other decisions that have been referred to a shareholder vote by the Board of Directors or the Board's various Committees.<sup>100</sup> Given that the five largest shareholder PSPs have a combined voting power of over 85%<sup>101</sup>, any matter referred to a shareholder vote could be decided by a consensus among these shareholders without taking into account the views of other shareholders.<sup>102</sup> We have no evidence that this has happened in practice.
- 6.23 The Board is responsible to shareholders for the ongoing management of the group's businesses. Membership Board of the VocaLink Holdings Limited Board includes six representatives appointed by shareholders. Each shareholder is entitled to nominate a Director, with voting then taking place for candidates.<sup>103</sup> The final list of shareholder Directors is composed of the six candidates who get the highest number of votes. In practice, this process usually means that five out of the six shareholder Directors on the VocaLink Board are the nominees of the largest five banks (Lloyds, RBS, HSBC, Barclays and Santander); the sixth shareholder Director is drawn from one of the smaller shareholders (currently Nationwide).

<sup>99</sup> *Competition and collaboration in UK payment systems*, London Economics final report (29 October 2014), paragraph 2.1.2. <http://www.fca.org.uk/static/documents/psr/london-economics-report-on-competition-and-collaboration-for-the-psr.pdf>

<sup>100</sup> *Articles of Association*, paragraph 15.2.

<sup>101</sup> Voting rights is based on the "2014 Voting Rights" data based on 2013 retail volumes provided by Bacs on 1st September 2014.

<sup>102</sup> Shareholders' votes, for example at annual general meetings, are capped at 24.99% of the total votes cast to limit the voting power of the largest banks; [https://www.accenture.com/t20150706T061438\\_w\\_/us-en/\\_acnmedia/Accenture/Conversion-Assets/DocCom/Documents/Global/PDF/Dualpub\\_6/Accenture-Review-Governance-Ownership-UK-Payment-Systems.pdf](https://www.accenture.com/t20150706T061438_w_/us-en/_acnmedia/Accenture/Conversion-Assets/DocCom/Documents/Global/PDF/Dualpub_6/Accenture-Review-Governance-Ownership-UK-Payment-Systems.pdf)

<sup>103</sup> *Articles of Association*, paragraph 22.2: Appointment of Directors.

- 6.24 The Board also includes three independent non-executive Directors, two executive Directors (the chief executive officer and chief financial officer) and an independent chairman.<sup>104</sup> The Board has the power to appoint and remove the chairman and executive Directors. The three independent non-executive Directors (including the chairman) are appointed by the chief executive in consultation with the chairman and with the Nominations Committee, which is made up of representatives that include Directors who have been nominated by the shareholders. While the composition of the Committee includes three independent Directors, in practice the quorum for meetings of the Committee is made up of two members. This means that the shareholder Directors could influence the appointment of the independent Directors.
- 6.25 Currently, the Board has reserved a number of matters for its approval, namely: approval of interim and final financial statements, approval of the annual report and accounts, as well as Board structure, size and composition (including appointments and removals).<sup>105</sup> The Board may also delegate some of its powers, authorities or discretions to various Committees. These could be made up of participants that include shareholder Directors. Committee decisions are referred back to the Board for final approval.
- 6.26 According to the Articles of Association, all decisions are made by a majority vote of the Directors attending the Board meeting. Voting at the Board is based on one Director, one vote.<sup>106</sup> The quorum necessary for the transaction of any Board business is five or more Directors present in person and entitled to vote, of which three must be shareholder Directors. The same procedure is followed at Committee meetings.<sup>107</sup>
- 6.27 We do not know the PSPs weighting in Board decisions because we have been told that voting patterns are not recorded and decisions are taken by consensus. However, when we look at the attendance records given to us by VocaLink and the quorum,<sup>108</sup> Board decisions are almost always approved by quorum where the majority of Directors present are those nominated by the largest five shareholders. This demonstrates the influence the five largest shareholder PSPs have on VocaLink's decisions.
- 6.28 This pattern of control with respect to decision making (by reference to shareholder appointed Directors and to minimum quorum of attendance) is also true of decisions made within VocaLink's Committees. It is worth noting that all Directors (including shareholders and independent non-executive Directors) are subject to director's duties as set out in the Companies Act 2006.<sup>109</sup> This is reinforced by the *Directors' Handbook* and a periodic external audit on the effectiveness of the Board.
- 6.29 Given the above, we conclude that the five biggest shareholders of VocaLink have control of the company. Current levels of Director attendance at Board level give these five banks a majority when it comes to decision making. Even when there is a full complement of nine Directors at Board meetings, these five banks, along with the sixth shareholder bank, could vote together and use their influence on the Board to refer contentious decisions to a shareholder vote where they have an 85% majority if they vote together as a block.
- 6.30 Such control could give the largest shareholder PSPs an advantage over minor/non-shareholder PSPs in terms of pricing or service developments. However, all PSPs use the service on the same terms as decided by the operator.

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<sup>104</sup> 'Independent' is defined in VocaLink's Articles of Association as "not having been employed by or acted as a consultant for any shareholder in the last three years or having an interest directly or indirectly in any contract with VocaLink of any shareholder (including being employed by or acting as a consultant to any third party who has entered into a contract with a shareholder) which would cause the Director to not be able to act independently in the best interests of the company at all times".

<sup>105</sup> Articles of Association, paragraphs 21(1) to 21(23).

<sup>106</sup> Source: articles of association

<sup>107</sup> Generally, the quorum is two Directors.

<sup>108</sup> The quorum necessary for the transaction of any business of the Board should be five or more Directors present in person and entitled to vote, of which three must be shareholder Directors.

<sup>109</sup> Section 170-177

- 6.31 The control exercised by the Directors of the five largest shareholders is felt to a greater extent within the Operational Oversight Committee<sup>110</sup> (OOC). The OOC's purpose is to:
- Protect the integrity of Bacs, FPS and LINK (the 'core services') and maintain contracted service levels.
  - Maintain a level of core service investment that will allow VocaLink to re-tender for the core services contracts when they expire.
  - Ensure that the continued resilience, integrity and viability of the core services are not put at risk.
- 6.32 The majority of the OOC members are directly appointed by four out of the largest five shareholders. The OOC is currently composed of six shareholder Directors and one non-independent director. Of the five shareholder Directors, four are appointed by four of the main shareholders. The quorum for the Committee is three members, two of which must be shareholder Directors (or their nominees/representatives). The shareholder Directors therefore have control of the decisions of this committee.
- 6.33 Should the OOC (acting by a majority) reasonably consider that the Board has not, or is unlikely to, carry out a decision made by the Committee, then the Committee may escalate the issue to the shareholders as a reserved matter. The Committee do not have authority to escalate any matter to shareholders which, if implemented, would require a change to the core services contracts. In these instances, such decisions would have to go through the Board.
- 6.34 Given that the five largest shareholder PSPs control 85% of the distribution of votes amongst VocaLink's shareholders, the OOC is essentially controlled by the five largest shareholders, as they have the ability to pass or block any recommendation brought forward by the OOC. As such, the largest shareholder PSPs can use their control on this Committee to reinforce the alignment of incentives created by common ownership to ensure the stability, reliability and resilience of the service being provided.

### Overview of the operators' corporate governance

- 6.35 **Bacs Payment Schemes Limited** As mentioned earlier, BPSL is a not-for-profit company limited by guarantee and doesn't have shareholders. Instead, it has 16 members. The five largest VocaLink shareholders are also the largest processing members of BPSL.
- 6.36 The company is managed by a Board of Directors who may exercise all the powers of the company. A quorum is attained at a general meeting of the Bacs Board when at least one independent director and other Directors making up half of eligible votes are present.
- 6.37 The Board makes decisions on issues such as: the operation of the service, infrastructure provider contracts, and the resilience of the service. The Board is made up of a managing director/chief executive, two independent Directors (including the Board Chair and the Chair of the Audit and Risk Committees), and 12 non-executive Directors nominated by the members. Each of the 16 members has the same right to nominate a representative on the Board.<sup>111</sup> Only one director can be appointed for the same group.

<sup>110</sup> The Committee should include four shareholder Directors or their nominees and three shareholder representatives who have experience in operational management, systems architecture/design, project management and security.

<sup>111</sup> *Articles of Association, Bacs, Article 43 (a).*

- 6.38 The independent Directors, including the chairman, are appointed by the Board based on the recommendation of the appointment committee (which includes Directors from the five largest member PSPs).<sup>112</sup>
- 6.39 The Board may also delegate any of their powers to any single director or to a committee as decided by the Board. Committees have to contain at least one director and may include a mixture of other Directors or non-Directors.
- 6.40 Issues that come up at a Board meeting are decided by a vote, with the Board allocating a total of 1,000 votes to Board Directors who are nominated by members. These 1,000 votes are allocated to each member on the basis of the number of transactions carried out by that member in the preceding year. For resolutions to be carried, they need the support of at least 75% of all votes cast. Going by transaction volume, the five largest shareholder PSPs will have a combined voting majority of 90%<sup>113</sup> on the Board. If they vote together as a block, this means that decisions on the Board cannot proceed unless it has their backing.

### ***Faster Payments Scheme Limited***

- 6.41 The FPSL is a private, not-for-profit membership company limited by guarantee. It doesn't have shareholders. The scheme has ten member organisations, including the five largest shareholders of VocaLink.
- 6.42 The company is managed by a Board of Directors, which makes key decisions regarding the business of the company at FPSL Board general meetings. The Board makes decisions on matters such as: the operation of the service, innovation opportunities and the development of additional services.
- 6.43 The Board is composed of three independent Directors (including the chair), one independent executive Director and ten non-executive Directors. The ten non-executive Directors are appointed by the ten members.<sup>114</sup> The independent Directors are appointed by the Board based on the recommendation of an appointment committee, which includes Directors from the member banks.<sup>115</sup>
- 6.44 The Board may delegate any of its powers, authorities and discretions (with or without power to sub-delegate) to any single director, or to a committee as decided by the Board. Committees have to contain at least one independent director and may include a mixture of other Directors or non-Directors.
- 6.45 A quorum is attained at a Board general meeting when there are 75% of members present who together account for at least 50% of the total clearing volume of the system for the year before and should include at least one independent director.<sup>116</sup> Resolutions are decided on by a vote as indicated by a show of hands. A decision is considered to have been made when 75% of members are in favour, provided the 75% of members account for at least 50%<sup>117</sup> of the clearing volume of the system. The five largest shareholder PSPs together have a combined transaction volume of 80% if they vote together as a block.<sup>118</sup> Therefore, because only the five largest shareholder PSPs

<sup>113</sup> Transaction volume is based on the "2014 Voting Rights" data based on 2013 retail volumes provided by Bacs on 1st September 2014 and the data provided by PSPs for the indirect access review.

<sup>114</sup> [www.fasterpayments.org.uk/governance/Board-Directors](http://www.fasterpayments.org.uk/governance/Board-Directors)

*Articles of Association*, Article 15.1 – each member shall be entitled to appoint one director. Only one director for each group.

<sup>115</sup> According to the FPSL articles of association, 'independent' means a director who the Board, upon the recommendation of the Appointment Committee, determine to be independent in character and judgment and whose relationships or circumstances are unlikely to affect, or appear to affect, the director's judgment. For these purposes, the following relationships or circumstances shall, unless otherwise determined by the Board, be presumed to preclude a director's independence.

<sup>116</sup> *Articles of Association*, Article 21.8 (i), Faster Payments Scheme Limited.

<sup>117</sup> *Articles of Association*, Article 21.8 (iii), Faster Payments Scheme Limited.

<sup>118</sup> Transaction volume is based on the data for 2014 provided by FPS for the infrastructure market review and the data provided by PSPs for the indirect access review.

can get over the hurdle of the 50% clearing volume rule, decisions on the Board can't be approved unless it has their backing.

### **The Link Scheme**

- 6.46 The Link Scheme (which operates the LINK payment system) has no Board of Directors as it is not a legally incorporated company. There are 38 members. The rules of the LINK payment system are controlled by the Network Members Council (NMC). The NMC has an independent, non-executive chairman who has no voting rights. The secretariat is given by the Link Scheme Executive, which is composed of VocaLink employees. The NMC is considering a restructuring of the governance and operational structure of LINK in order to become independent of VocaLink. It has established a new corporate entity called Link Scheme Limited (LSL), incorporated in December 2014, to support this restructure and, ultimately, to act as a fully enabled operator of LINK.
- 6.47 The governance of the LINK payment system is effectively laid out in the Network Members Agreement (NMA)<sup>119</sup>, between VocaLink Limited and each current member of the network. The NMA sets out the participation of each member in the Link Scheme and LINK Network. More detail can be found in Annex 3.
- 6.48 The power to take policy decisions within the current system lies with the NMC, which uses a system of weighted votes to take decisions about the Link Scheme. All 38 members of the Link Scheme are voting members of the NMC and any one of them can submit proposals to a meeting of the NMC.
- 6.49 Once the decision has been made by the applicable majority, the NMC may delegate any of its powers to any committee or group consisting of members of the NMC, members' representatives or other individuals from outside the NMC who are recognised by the NMC, for example, representatives of issuer partners and reciprocity partners.
- 6.50 Decisions made by network members may only be made by ballot. The Link Scheme requires a 50% to 60% majority agreement before operational decisions can be passed. Currently, 75% of the total votes are allocated on the basis of LINK transaction volumes. The remaining 25% of votes are divided equally amongst all the network members. Individual network member votes are capped at 15% (RBS is currently capped in this way). Changes to the NMA require an 80% supermajority.
- 6.51 This gives roughly 60% of the voting power to the larger banks, 20% to the smaller issuers and the remaining 20% to the acquirers only. This means that, in effect, the larger banks can control the operational decision making of the NMC, but not changes to the NMA. Currently, the largest five banks hold approximately 52%<sup>120</sup> of the total vote on the NMC. Given that decisions only require a 50% to 60% majority to be passed, it is clear that the banks, and the largest five shareholder PSPs in particular, have a decisive influence when it comes to the decisions made on behalf of the NMC if they vote together.

### **Stakeholder views on VocaLink's ownership**

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- 6.52 To help us assess how VocaLink's ownership and governance arrangements may affect competition in the provision of central infrastructure services, we asked stakeholders for their views on the benefits and drawbacks of the current arrangements. We considered the feedback given by a variety of stakeholders, including:
- PSPs

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<sup>119</sup> The latest version of the NMC is dated 19 March 2015.

<sup>120</sup> Transaction volume is based on the data for 2014 provided by LINK for PSR fees project sent on 2nd September 2014



- other providers of infrastructure services
- VocaLink
- operators

### **Stability, security and resilience of service**

- 6.53 As mentioned in paragraph 4.61, a number of PSPs, including shareholders and non-shareholders alike, said that the current ownership arrangements produce benefits in relation to stability, security and resilience. These stakeholders attributed these benefits to the alignment of incentives between VocaLink and its users, explaining how this is facilitated by owners of VocaLink also being its users.
- 6.54 A majority of PSPs expressed a positive view on the quality of service provided by VocaLink. Each of the five largest VocaLink shareholder PSPs referenced the high level of service availability provided by VocaLink. Data submitted by the operators confirms that VocaLink exceeded its availability service level agreements across all three payment systems over the period July 2014 to July 2015.

### **Alternative arrangements**

- 6.55 A range of stakeholders identified benefits that could be achieved with alternative ownership arrangements, while others expressed concerns about the potential risks of alternative models.
- 6.56 Some technology providers said that including non-banks in VocaLink's ownership would increase VocaLink's incentives to improve its service provision, offer additional value-added services and be more responsive to end user needs. This is because these providers think that payment services are not a priority for owner banks. One alternative provider of central infrastructure services noted that it had benefited from a change of ownership as it is now able to expand into areas its previous bank owners would not have supported.
- 6.57 Independent ATM Deployers' (IADs) views on alternative ownership arrangements for VocaLink and LINK were mixed. Some proposed separation to promote greater competition or innovation. One suggested that VocaLink should become a publicly listed company; while another said that it opposed independent private ownership of VocaLink because security and reliability might be compromised. Two also proposed that the lack of competition could be tackled by the operator running regular tenders for the central infrastructure contract.
- 6.58 Two non-shareholder PSPs said that independent owners might focus on profit to the detriment of system-wide integrity or value for money.
- 6.59 Many shareholder PSPs said that, in principle, they would not rule out alternative ownership models for VocaLink, but they would need strong reassurance that the interests of owners remain aligned with those of its users, especially in terms of stability, security and resilience. One provider mentioned that contractual obligations would need to be in place to ensure that the system continues to be as robust as it is now. An operator commented that, if VocaLink's ownership were transferred, it would want to increase VocaLink's financial obligations (such as liability and indemnity insurance requirements). The shareholder PSPs felt that the current requirements are only acceptable because of the overlap of ownership of VocaLink and the operators.
- 6.60 Two shareholder PSPs and one operator, expressed reservations about transferring the ownership of VocaLink, especially if it was to hedge funds or private equity investors.

## Alternative providers' perceptions

- 6.61 In paragraph 4.153 we mentioned how potential central infrastructure providers think they would be at a competitive disadvantage against VocaLink. This is because its shareholder PSPs, which also own and control the operators, would always select VocaLink to be the provider in a procurement exercise. This perception is reinforced by the fact that the operators have not considered other providers in the past. Only the recent LINK RFI process helped to alter this perception.
- 6.62 Providers had mixed views about whether the vertical ownership arrangement of VocaLink is a barrier to entry.
- 6.63 Several providers thought they would be at a competitive disadvantage against VocaLink because its shareholder PSPs own or control the operators, so they would always select VocaLink to be the central infrastructure provider in a procurement exercise. One provider said that it previously perceived VocaLink's ownership as a barrier to entry, especially as the operators had not considered other providers in the past. However, this provider said it would be willing to compete and place a bid if the operators were to hold a competitive tender. They said they had been reassured to an extent by the recent LINK RFI process.
- 6.64 In contrast, two providers do not see VocaLink's ownership as an issue – they believe that the customer will choose the best offering. One of these providers gave the example that, despite VocaLink's SEPA Clearing and Settlement Mechanism offering, most UK banks used other providers because they felt they had a better offering than VocaLink.

## VocaLink's view

- 6.65 VocaLink's internal strategic documents refer to the company's dependence on profits and revenues related to the provision of core services for Bacs, FPS and LINK. [X]
- 6.66 Nevertheless, VocaLink's independent Ownership and Governance Review notes that there is a global trend towards the break-up of vertically integrated companies and the outsourcing of suppliers. This is due to a shift from investment in tangible assets to investment in intangible assets. Vertical separation may create opportunities for cost savings and efficiency improvements.
- 6.67 The Review considers five alternative ownership models and concludes that the most suitable alternatives involve the existing owners divesting down to a non-controlling stake. This is because any arrangement in which the existing shareholders retain a controlling stake stops VocaLink from operating independently of its main customers. Divesting to a non-controlling stake should also ensure that specialist knowledge is retained at Board level. This may relieve stakeholder concerns regarding potential issues during the transition to a new ownership structure. The Review also states that operational independence would allow VocaLink to identify, select and finance innovations that have the greatest potential to deliver value to all users of payments. It should strengthen VocaLink's incentives to maximise shareholder value by competing in the market for the provision of payment systems infrastructure.

## Our assessment

- 6.68 On 30 April 2015 PSR General direction 5 (Governance) took effect. This requires that the operators of Bacs, C&C, CHAPS, FPS and LINK take all reasonable steps to ensure that none of their Directors is also a director of one of their system's central infrastructure providers. This measure was put in place following our policy statement in March 2015. The consultation leading to that statement identified that Directors appointed to interbank operators' Boards may face conflicts of interest. (For example, a director sitting on the Board of an operator and a central infrastructure provider could have access to information that may compromise the integrity of the operator's tendering processes which the central infrastructure provider might participate in).

- 6.69 We note that, whilst this measure is now in place, the issues that have been identified in this chapter relate to broader *organisational* incentives. The focus of General Direction 5 is removing the risk, or perception, of specific *individual* conflicts of interest.
- 6.70 In line with the concept of control as defined in the Enterprise Act 2002, our analysis shows that the five largest members of the operators (who are also the five largest shareholders of VocaLink) are able to control the overall strategy and decision-making of the three operators.<sup>121</sup> Therefore, the five largest PSPs have control over the operators of Bacs, FPS and LINK. Further detail on the operators' governance arrangements can be found in Annex 3.
- 6.71 For both FPSL and BPSL, this control by the five largest members may only be restricted in cases where resolutions involve the public interest. This is because independent Directors have an ability to block proposals put forward by members in limited circumstances, for example, when these are deemed not to be in the public interest.<sup>122</sup> We have no evidence that any public interest issues have come up in the past. As a consequence, we have no evidence that the independent Directors have blocked any initiatives on the basis of public interest.
- 6.72 Overall, from our assessment of the corporate governance and the decision-making process of VocaLink and the three operators, it seems that a small number of PSPs, in particular the five largest, control operational decision making for these entities. This means that these five PSPs control decisions regarding the appointment of the central infrastructure services provider for the Bacs, FPS and LINK payment systems and decisions regarding the operational integrity and resilience of the service delivered by VocaLink.

### ***Effects of current ownership and governance arrangements on the market for the provision of central infrastructure services***

- 6.73 The fact that PSPs, and in particular the largest members of the operators, have ownership interests in the infrastructure provider (VocaLink), are able to exert control over both entities and are also the users of the systems, is likely to reduce the level of competition in the market for the provision of central infrastructure services. This could happen for at least three reasons:
- i. Overlapping ownership arrangements create an alignment of incentives. PSPs could see this as crucial for delivering stable, secure and resilient services. Owner PSPs may believe that any change in the existing arrangements would increase the chance of operational disruption occurring, exposing them to unacceptable risks or costs. This could lead to a lack of motivation to shop around.<sup>123</sup> As a result, existing arrangements may be kept in place despite the benefits that could be gained from alternative providers in terms of price and service offerings. Such inertia is reinforced through the control that the five largest PSPs exert on VocaLink's OOC. The OOC is responsible for safeguarding stability and resilience and for ensuring that VocaLink is capable of re-tendering the core service contracts. While it may be comforting to the PSPs to know that security and resilience is prioritised, this arrangement reduces their incentive to encourage the operators to shop around, reinforcing the inertia.
  - ii. Current ownership and governance arrangements discourage alternative providers of central infrastructure services to enter the UK market. Potential providers perceive that the operators would not seriously consider alternative propositions as owners/members of the operators are also the owners of VocaLink. In other words, alternative providers perceive the current market is closed.<sup>124</sup> This reinforces VocaLink's incumbency advantage.

<sup>121</sup> Further detail on the operators' governance arrangements can be found in Annex 3.

<sup>122</sup> 'Public Interest' means; in considering whether a matter concerns the Public Interest, a matter concerning the Company, the payment system and/or the payments industry for the long-term benefit of the UK, its citizens and businesses as a whole, with particular emphasis on customer needs, competition, innovation, reducing barriers to entry in the payments industry and limiting systemic risk.

<sup>123</sup> See also paragraph 4.25

<sup>124</sup> See also paragraphs 4.152 and 4.153

- iii. VocaLink's ownership arrangements may induce the owner PSPs, particularly its main shareholders, to protect their previous investment in VocaLink. VocaLink's services have different levels of positive and negative profitability, [§]. This competition may cause VocaLink to lose at least one or more of these contracts, negatively affecting its financial performance. [§].
- 6.74 Stakeholders do not agree about the best ownership and governance model for central infrastructure provision. Some mentioned changing ownership arrangements could provide better incentives for improving VocaLink's service provision, including offering additional value-added services and being more responsive to wider end user needs.
- 6.75 However, despite the conflict of interest issues we have discussed, most stakeholders (especially shareholders) have identified the alignment of incentives between VocaLink, operators and owner PSPs as a major strength. In fact, they are concerned that different arrangements for provision of central infrastructure services would compromise the security, reliability and resilience of the service provision.
- 6.76 In practice, however, the operators' reluctance to shop around is reinforced by the aligned incentives. This inertia ensures that existing arrangements stay in place to protect the stability of the system. This is despite possible benefits from alternative arrangements in terms of price and service offerings. While we acknowledge that stability and resilience are essential features of payment systems, and crucial to their end users, we believe that competition could provide further benefits.
- 6.77 In particular, the alignment of incentives between VocaLink's owners and its users is not the only mechanism through which a high quality, stable service can be delivered. One example, at least for Bacs and FPS, is the Bank of England's supervision of recognised payments systems under the Banking Act 2009.<sup>125</sup> The Bank assesses each recognised payment system annually against the CPMI-IOSCO *Principles for financial market infrastructures*. The operators of Bacs and FPS are required to disclose a summary of their self-assessments against these principles. Under Principle 17, BPSL and FPSL are required to identify plausible sources of operational risk; both internal and external. They also mitigate their impact through the use of appropriate systems, policies, procedures, and controls. The goal of this principle is to ensure a high degree of security and operational reliability. Principle 17 should underpin the delivery of a high quality of service by operators to PSPs, regardless of the outsourced provider's owner.
- 6.78 Also, providers of central infrastructure services, such as VocaLink, have a strong incentive to deliver a high quality of service regardless of their ownership structure. This is because the reputational risks associated with failing to deliver a high quality of service could harm the financial viability of the company and seriously damage its chances of success when competing for new business, nationally and internationally.
- 6.79 As such, security, resilience and quality of service can still be delivered using ownership arrangements that do not rely on the overlap of ownership and governance between the provider of central infrastructure services and its users, all of which would relieve stakeholder concerns.
- 6.80 It is also our view, based on the feedback from potential alternative providers, that current ownership arrangements not only lead to inertia but also represent a barrier to alternative central infrastructure providers entering the market. Some providers think they would be at a competitive disadvantage against VocaLink because of its common ownership. They feel that the operators would be more inclined to select VocaLink in a procurement exercise. Therefore, there is little incentive for these providers to incur the costs of participating in the procurement exercise. We also find that common ownership incentivises the PSP-appointed Directors of operators to stay with the 'in-house' solution, as outlined in paragraph 6.73iii.

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<sup>125</sup> LINK is not currently a recognised payment system.

- 6.81 We also have evidence suggesting that the VocaLink Board are aware of the consequences that using alternative providers of central infrastructure services could have on its own financial viability. Considering that VocaLink is an asset owned by PSPs, including the ones represented on the Board, we think that the operators of Bacs, FPS and LINK have an incentive not to make any procurement decisions that could undermine VocaLink's financial viability.
- 6.82 We acknowledge the arguments made in VocaLink's ownership and governance review. Their conclusion included that the most suitable alternative ownership arrangement appears to be one of divestment to a non-controlling stake. Despite stakeholders' concerns, the review suggests that the impact of operational disruption on VocaLink's reputation and finances will be a strong incentive for it to maintain high standards of reliability under any new arrangement.

## Conclusions

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- 6.83 We found that PSPs, in particular a small number of large PSPs, own and are on the Board of Bacs, FPS and LINK as well as VocaLink. This common ownership is not necessarily an issue in itself. However, there could be a conflict of interests as VocaLink's shareholder PSPs are the main users of these systems, as well as being the owners/members of the operators. This may result in decisions being taken at the operator level that reduce the competitive pressures on VocaLink. To determine whether common ownership could affect competition, we examined the ownership structure and corporate governance of VocaLink and the operators to understand whether the largest PSPs control them.
- 6.84 We find that the five largest shareholder PSPs have control over the decision making of VocaLink. This is because full Board decisions are usually ratified by quorum where the majority of Directors present are those nominated by the largest five shareholder PSPs. The level of control exercised by these Directors is even greater within VocaLink's OOC. The OOC is responsible for safeguarding stability and resilience and for ensuring that VocaLink is capable of re-tendering the core service contracts. While it may be comforting to the PSPs to know that security and resilience is prioritised, this arrangement reduces their incentive to encourage the operators to shop around. However, there is no suggestion that large shareholder PSPs benefit from this control at the expense of minor shareholder PSPs and/or non-shareholder PSPs.
- 6.85 A similar analysis for the operators found that these five shareholder PSPs combined hold a voting majority on the Boards of BPSL, FPSL and LINK respectively as a result of their transaction volumes. This means they have control over decisions regarding the appointment of the central infrastructure provider for the Bacs, FPS and LINK payment systems.
- 6.86 We find that because the largest members of the operators have ownership interests in the VocaLink and are able to exert control over both entities, the level of competition for the provision of central infrastructure services is reduced. Along with the factors outlined in paragraph 4.34, we believe that this is because PSPs believe that any change in the infrastructure provider would increase the probability of operational disruption occurring. To avoid this, they are likely to be inclined to retain the existing provider, despite the possible benefits of changing provider. Alternative arrangements could still ensure security, resilience and quality of service because of oversight from the Bank of England and providers own need to preserve their reputation. Also, the fact that the owners/members of the operators own VocaLink as well creates a perception amongst other potential providers that the operators would not seriously consider alternative providers. Finally, greater competition for the provision of these services could negatively affect VocaLink's financial viability. So, to protect their investment in VocaLink, shareholder PSPs have an incentive not to subject VocaLink to greater competition. These views have been reinforced by the feedback we have received from stakeholders.
- 6.87 We note that VocaLink's review of its ownership and governance concludes the conclusion that the most suitable alternative ownership arrangement appears to be one of divestment to a non-controlling stake. This is in recognition of the global trend towards separation between owners of infrastructure and users. In particular, we note their conclusion that any arrangement in which the

existing shareholders retain a controlling stake may stop VocaLink from operating independently of its main customers.

# 7

## Interim conclusions

### Introduction

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- 7.1 Over time, the ownership and governance arrangements of UK payment systems have been partially changed to create incentives that promote competition and innovation. However, it is unclear whether the right incentives exist within the current ownership model.
- 7.2 While the UK is perceived to have good payments infrastructure, as outlined in Chapter 3, major innovations in payment systems, such as Faster Payments, are a result of regulatory or government intervention, rather than any market forces.
- 7.3 Many reviews by government and other regulatory bodies have argued that the incentives are not right. They have identified common ownership as an issue and while there have been many sequential reviews, these have all sought to tackle the same questions.
- 7.4 In 2000, the Cruickshank report found that the Bacs and LINK payment systems had profound competition problems, inefficiencies and lack of innovation.<sup>126</sup> It noted that these systems were mutually owned and controlled by a few large banks, and that common ownership and governance represented an obstacle to innovation.<sup>127,128</sup>
- 7.5 In 2003, the OFT reviewed the developments in the payment systems industry since the Cruickshank report. The review noted that in Bacs the operator was about to be separated from the central infrastructure provider, as suggested in the Cruickshank report.<sup>129,130,131</sup> However, it also noted that the proposed separation seemed unlikely to have the desired effect, because the ownership profile of operator and infrastructure provider would remain the same.<sup>132</sup>
- 7.6 Subsequently, two working groups – set up by the OFT-chaired Payment Systems Task Force – considered incentive issues relating to the Bacs and LINK payment systems, respectively. Both recommended measures to increase the independence of the operators and their Board Directors from the owning banks.
- 7.7 As set out in paragraph 3.89, the Bacs access and governance working group examined the negative impact of the common ownership of the infrastructure provider on competition and innovation. In March 2006, it recommended changing the objectives of Bacs Directors to ensure that they promoted the interests of the operator – not the member banks who appointed them. This involved changing the operator's objectives to include promoting efficiency and innovation in payment systems, and responding to user and market needs.

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<sup>126</sup> Cruickshank report, executive summary.

<sup>127</sup> Cruickshank report, paragraph 3.124, p83.

<sup>128</sup> Cruickshank report, paragraphs 3.125 to 3.127, p83.

<sup>129</sup> FT658, UK payment systems – An OFT market study of clearing systems and review of plastic card networks (May 2003) – paragraph 2.5, p15.

<sup>130</sup> Some of the self-regulated changes related to the governance of the payment system operators. See OFT658 paragraphs 1.17 to 1.20, p4.

<sup>131</sup> See the Cruickshank report, paragraphs 3.210 and 3.214 to 3.214, pp99-100.

<sup>132</sup> See OFT658, paragraph 1.44, p9.

- 7.8 The LINK access and governance working group recommended widening the membership of its Board. Not all its recommendations were implemented, for example, widening the membership to non-market participants.
- 7.9 Neither of these changes to governance proved fully effective. The government<sup>133</sup> made it clear that the current system was not adequately meeting objectives to promote and develop new and existing payment systems, and to facilitate competition. It noted the slow pace of innovation, which in some cases (such as the multiple delays in setting up FPS) may have led to significant losses to the UK economy.
- 7.10 In 2012/13, the Treasury proposed creating a new and independent regulator of payment systems – the PSR. The PSR would ensure that the governance and operation of the payment systems is not a barrier to competition in the provision of payment services, and in the wider UK financial services market.<sup>134</sup>

## Initial findings

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### Competition in the provision of central infrastructure services

- 7.11 In Chapter 4, we established that the operators and PSPs can have important roles in encouraging central infrastructure providers to become increasingly efficient and innovative, without compromising resilience. They can make sure that providers are subject to competitive pressure. At present, operators can do this by running competitive procurement exercises on a regular basis. Such shopping around enables operators (as the current procurers) to compare different providers and their proposals. It can also encourage potential infrastructure providers to make more attractive propositions in terms of quality, and drive them to become more efficient and innovative. Under the current arrangements, direct PSPs have a role to encourage operators to run competitive procurement exercises to procure central infrastructure services.
- 7.12 We found that none of the operators of Bacs, FPS or LINK have run competitive procurement exercises for providing central infrastructure services in the past 12 years, apart from the initial build and run tender for FPS.
- 7.13 A lack of competitive procurement exercises means that operators are not exposed to alternative – and potentially more efficient and innovative – infrastructure services (particularly if the operators are not proactively seeking these). It also implies that the current provider is not subject to competitive pressure. Consequently, while making sure that it performs to the requirements and standards set by the operators to serve the UK market, the incumbent provider has limited incentives to propose ways to be more efficient and innovative.
- 7.14 Lack of competition and innovation are of detriment to end users in the form of higher prices and less innovative services.
- 7.15 We conclude that there is currently no effective competition in the provision of central infrastructure services. We now discuss the reasons for our finding.

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<sup>133</sup> *Setting the strategy for UK payments*, HM Treasury, July 2012.

<sup>134</sup> HMT Consultation Opening up Payments, p 10 and 16, paragraph 3.20 and 4.7.



### ***Lack of competitive procurement exercises***

- 7.16 **Operators do not shop around** – The operators of Bacs, FPS and LINK currently contract for central infrastructure services. We identified the lack of competitive procurement exercises as major barriers to entry that prevent other potential providers from competing. This seems to be due in part to a lack of interest and incentive among operators and direct PSPs to engage in such activity.
- 7.17 Also, the larger direct PSPs – who can control operators’ decision making regarding the procurement of central infrastructure services – do not directly gain from competition in central infrastructure because any benefit from it would not give them a competitive advantage over other PSPs. Changing provider comes with risks to stability, but no competitive advantage over their rivals.
- 7.18 Operators do not directly benefit from competition because they are not profit-making entities and simply pass on costs to the direct PSPs. They also have no incentive to encourage competition. On the contrary, competition introduces an element of risk that operators might overrate.
- 7.19 This lack of incentive discourages operators from proactively seeking superior central infrastructure services by re-procuring. Instead operators, without a profit motive, may place disproportionate weight on avoiding the risks associated with any major changes to the infrastructure.
- 7.20 **Other providers are not able to enter because of the lack of competitive procurement exercises** – We found that VocaLink has faced limited direct competition in providing central infrastructure services for Bacs, FPS and LINK. Despite several providers being interested in becoming involved, they have not been approached to show their interest, with the exception of the recent LINK Request for Information Process.
- 7.21 Providers see the provision of central infrastructure services in the UK interbank payment systems as a closed market. Lack of competitive procurement exercises suggests that operators have no appetite to switch providers.
- 7.22 This not only reduces providers’ incentive to approach operators with their proposals, but also makes it more difficult for them to do so. Indeed, providers cannot actively approach operators with their offerings because they do not know with certainty what services they could provide for a payment system. They would need to know more about its technical specifications and requirements. Such information generally only becomes available through competitive procurement exercises.
- 7.23 Lack of engagement between operators and potential providers of central infrastructure services implies that operators are not exposed to alternative propositions that could benefit end users. Most operators and direct PSPs are satisfied with the value for money, quality of service and innovation that they receive from VocaLink. However, it appears that the operators and direct PSPs, as customers, are not regularly fully informed of the better outcomes, particularly for new service offerings, that they might be able to achieve if there were more competition. This is because the operators have not shopped around – they have not run competitive procurement exercises that would enable them to directly compare VocaLink’s offerings with those of other providers that could be more efficient and innovative.
- 7.24 This lack of engagement also means that the current provider is free from significant competitive pressure. Consequently, it has no reason to propose more efficient and innovative use of the infrastructure even if the operator was interested in their doing so.

### ***Current ownership arrangements***

- 7.25 Providers are deterred from entering the market because of existing ownership arrangements and the perception of VocaLink’s competitive advantage. Potential providers perceive that they would be at a

competitive disadvantage against VocaLink because its shareholders also own and control the operators. They also perceive that operators would be more inclined to select VocaLink as the central infrastructure services provider in a procurement exercise.

- 7.26 We have found that the largest direct PSPs can exert control over the decisions of the infrastructure provider and operators through the current governance arrangements. However, we did not find any specific examples suggesting that VocaLink's shareholders benefit from current ownership arrangements or that these are detrimental to non-shareholders.
- 7.27 We found that common ownership between operators and infrastructure providers by direct PSPs reinforces the inertia described in paragraph 7.16. Direct PSPs see the ownership and control of the central infrastructure services provider as a way of ensuring security and resilience, but this reduces their incentives to shop around. For instance, VocaLink's Operational Oversight Committee, which is responsible for ensuring stability and resilience, is controlled by the four largest PSPs that are also represented on the operators' Boards. Moreover, this committee is responsible for ensuring that VocaLink is capable of re-tendering its core service contracts. We know this committee has extensive powers, including the ability to refer any matter as a reserved matter and subject to a shareholder vote, thereby ensuring that owners retain control. While this may reassure the PSPs that security and resilience will be prioritised, the arrangement dampens their incentive to shop around.
- 7.28 In addition, greater competition for the provision of central infrastructure services would negatively affect the financial viability of VocaLink. Therefore, owner PSPs have an incentive to protect their previous investment in VocaLink by not subjecting it to competitive pressure.
- 7.29 We note that VocaLink's own review of its ownership and governance recognises that there is a global trend towards separation between owners of infrastructure and users. This has been characterised by dilutions in ownership shares and, in some cases, divestment remedies being recommended by regulators. VocaLink's submission suggests that if the existing owners divested to a non-controlling stake, the company would also be better placed to attract the resources required for it to be more competitive. By being both more innovative and competitive, VocaLink would be able to create opportunities for cost savings and efficiency improvements, thereby generating value for all its customers.

### ***Interoperability - message standards***

- 7.30 **Some providers are deterred from entering the market because of the different message standards currently adopted by Bacs, FPS and LINK** – several providers of central infrastructure services mentioned different message standards as a barrier. They explained that the harmonisation of message standards with those used internationally (e.g. ISO 20022) would help many international providers to enter, because many of them already use these standards. One provider explained that it would not be interested in competing for UK interbank payment systems unless the ISO 20022 standard was adopted. VocaLink's internal documents also confirm that the use of message standards other than ISO 20022 helps them to protect their position in the market. We note that the lack of interoperability (including common message standards) with other payment systems may also limit competition in the current structure and could also inhibit the transition to alternative models.

### ***LINK's contractual arrangements and provisions***

- 7.31 We also consider that the current contractual arrangements and provisions for the LINK core services contract are a barrier to switching. Currently, there is a single contract between VocaLink and all the direct PSPs, [38].

- 7.32 However, Link Scheme is looking to make changes to its governance and operational structure to become legally independent of VocaLink that should help to address this barrier. The proposed changes include establishing an independent entity as the operator, introducing new governance and core services contractual arrangements and allocating IPR and liabilities between the parties. The new contract is expected to be between the new operator and infrastructure provider and incorporate commercial provisions for termination and exit plans. We acknowledge that this is planned and that a separate legal company has been set up for LINK. However, at the time of publishing this report, Link Scheme and VocaLink are not yet fully separate entities.

### **Competition in other infrastructure services**

- 7.33 We conclude that there is competition currently in the provision of gateway solutions.
- 7.34 The evidence indicates that PSPs may have sufficient choice of providers for the gateway solutions they require. There are a number of providers offering solutions that PSPs can choose, depending on their individual requirements, and not all PSPs use the same provider.
- 7.35 The costs and risks associated with switching gateway providers do not appear to be insurmountable barriers. While PSPs do not switch providers often, the evidence shows that they have been able to do so in the past when supported by a positive business case.
- 7.36 Looking at barriers to entry, VocaLink does not appear to benefit from a competitive advantage in the market for gateway solutions because of its role as a central infrastructure services provider. However, it is unclear whether the Bacstel-IP accreditation process is a barrier to entry for potential providers.

## 8 Potential remedies

- 8.1 Competitive pressure encourages potential infrastructure providers to make more attractive propositions in terms of quality, and drives them to become more efficient and innovative. In the absence of competitive pressure the current provider has limited incentive to control costs and provide cheaper services. Lack of competitive procurement exercises means operators are not exposed to potentially more efficient and innovative infrastructure services. This will translate into higher prices and less innovative services for end users.
- 8.2 As a result of our interim findings, we are considering remedies in a number of areas in order to make the market work better.
- 8.3 In this chapter, we set out our thinking on remedies to address the problems we have found. We would like stakeholders' views to help us develop these remedies. For each proposed remedy, and for the package as a whole, we welcome your views on:
- whether the remedy would be effective in addressing the problems we have identified
  - the relevant potential costs and benefits that we should consider
  - whether the remedy may give rise to unintended consequences and how these might be prevented or mitigated
  - whether there are alternative remedies that would be equally as effective as the proposed remedy but that would be less costly and/or intrusive
  - the implementation issues we should consider (including timing)
- 8.4 A full list of consultation questions can be found in Annex 8.
- 8.5 Our initial thoughts on potential remedies focus on three main areas:
- competitive procurement of core infrastructure services for Bacs, FPS and LINK
  - interoperability
  - ownership of VocaLink

### Key principles for considering remedies

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- 8.6 As discussed in our guidance<sup>135</sup>, we have a range of options that we could explore in developing the potential remedies. Some of these are actions we can take, and some are actions we can ask others to take. They include:

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<sup>135</sup> PSR PS15/2.2 Market Reviews, *Market Studies and Market Investigation References Guidance, A guide to the PSR's Powers and Procedures (Markets Guidance)* (August 2015)

- making new, or amending existing, directions
- making directions on specific participants or categories of participant, with reference to governance arrangements for infrastructure providers
- requiring the disposal of all or part of an interest in an infrastructure provider in relation to a regulated payment system
- making recommendations for further industry initiatives or enhanced industry self-regulation
- making proposals to the Bank of England, FCA or Prudential Regulation Authority as appropriate
- publishing guidance
- asking the Competition and Markets Authority to consider investigating the market(s)

8.7 When deciding on our remedies – both individually and as a package – we will consider:

- a. **Effectiveness:** The remedy must address the problem(s) we have identified and be practicable to implement, monitor and enforce. We will take account of current laws and regulations, as well as those expected in the near future. We will also consider the way in which the remedies interact with each other.
- b. **Proportionality:** The remedy needs to solve the problem(s) we have identified in a way which is no more onerous than necessary. For example, if there is a choice between two equally effective remedies, we would choose the option that is least intrusive. The remedy should also not produce disadvantages which are disproportionate to its aim.
- c. How the remedy (or package of remedies) fits in with the PSR's other policies and actions relevant to the provision of infrastructure services.

8.8 For example, in relation to the latter we note the ongoing work of the Payments Strategy Forum in respect of end users' needs and simplified access to markets. The Forum is expected to publish a preliminary report in July 2016 and its final strategy in October 2016. The outcomes of these work streams are relevant to our consideration of the remedies – in particular, who we address the remedies to and the timing of their implementation. Recommendations by the Forum that have an impact on the future structure and role of the existing operators may affect both the implementation and longer-term developments in the market, as we explain further in this chapter.

8.9 We now summarise the aim of the potential remedies and how we anticipate they will address the problems we have found.

### **Our initial thinking on potential remedies**

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8.10 The focus of this review has been assessing the current UK arrangements. There are, of course, many alternative ways to structure payment systems and we have set out some of these in Annex 5. The remedies we are proposing aim to improve the conditions for infrastructure competition and innovation, without precluding the possibility any of these alternative structures from developing in the future.

8.11 We have identified four potential remedies that are proposed as a package. We welcome stakeholders' feedback on the effectiveness and proportionality of the remedies package if one or more were excluded.

### **Remedy 1: Competitive procurement exercises**

- 8.12 We propose a remedy that competitive procurement exercises are undertaken before current contracts for central infrastructure services come up for renewal, or at the next break clause in a contract. We expect this to increase competition in the provision of central infrastructure services, thereby benefiting service-users by introducing cheaper, more efficient and innovative service offerings than are available under the current arrangements. We note that some PSPs in Europe benefit from more advanced service offerings, such as: cloud-based flexible storage capacity, enhanced user interfaces for data management and queries, and the facility for users to track and trace individual payments (as outlined in Chapter 4). We also found that, when VocaLink was subject to some competitive pressure through the LINK request for information process, it offered a price discount of approximately [3<] % and improved SLAs.
- 8.13 To ensure an open, transparent competitive procurement exercise, and to maximise the potential numbers of interested parties taking part in any tender exercise, we would require:
- i. **The development of a strategy for procuring infrastructure:** We recognise that this is the first time these services will have been competitively re-procured. Therefore, we must ensure that the products and services involved best reflect the current and future needs of service-users, and take advantage of the latest developments in technology. We expect the industry to consult with its users in the development of the strategy. We expect that, as part of the development of the strategy, there would be a need for a review of the services that should be provided in the core contract. We anticipate that the Payments Strategy Forum's work on end users' needs will clarify the services required, and we propose that the procurement strategy should take account of the outcomes of that work. We also expect the market for the provision of infrastructure services to be tested before a final ITT is issued to make sure the availability of service provision options are well understood.
  - ii. **The running of a competitive procurement exercise that is open and fair, and based on best practice:** To be successful, a competitive procurement exercise must be credible. Only then will interested parties be willing to incur the cost involved in submitting a proposal. We expect that any procurement exercise will balance requirements for resilience and stability (such as allocation of liabilities in the event of any failure) without unduly inhibiting competition. We welcome thoughts on what the selection criteria might be.
  - iii. **Any procurement exercise to be monitored by an independent person:** The competitive procurement exercise would be audited by a third party to reassure prospective bidders that due process has been followed and the selection criteria correctly applied. We expect the relevant regulatory authorities will have the ability to intervene if they are not comfortable an appropriate process has been followed.
- 8.14 Additionally, to effect a remedy, we propose that:
- i. **Current contractual arrangements are in place to ensure that VocaLink is obliged to enable transition to a new provider:** It is important that current arrangements are clear on ownership of intellectual property and terms for licensing it. We also expect operators to satisfy themselves that current contract terms will allow them to transfer to another provider, and that any exit plans are completed and in place.
- 8.15 Under the current structure these remedies would apply to operators of FPS, Bacs and LINK, however this may change once the Payments Strategy Forum has developed its strategy. For instance, an alternative body to the current operators may be considered more appropriate. We welcome feedback on whether the operators are best placed to undertake the procurement. We also welcome views on the timing of the procurement exercises for each of the payment systems, and whether there would be benefits and/or detriments if the timing of these were coordinated. We note that the timing and the range of services procured, as well as who procures these services will be influenced by the outcomes of the Payments Strategy Forum's work.

**Remedy 2: Interoperability**

- 8.16 We provisionally found that the lack of common international message standards in the UK acts as a barrier to entry for some potential infrastructure providers. In paragraph 4.164 we note that the lack of commonality of other technical standards and operating rules may also inhibit competition and increase incumbency advantage of the current provider. It could also inhibit the transition to alternative models such as a market with multiple providers, such as those set out in Annex 5. There may also be wider benefits of increasing commonality of operating rules and standards for interoperability between UK systems, which could help improve security and resilience.
- 8.17 As part of our remedies package, we propose that a common international message standard is adopted for FPS, BACS and LINK to facilitate greater choice of infrastructure provider and to facilitate the development of alternative market models for payments and increase resilience. The Payments Strategy Forum, in its work on simplifying access to markets, will be examining the type of message standard to be adopted.
- 8.18 Adoption of a new message standard for the central infrastructure will require PSPs to make changes to their own internal system to process the new standard. It is unlikely that migration from legacy message formats to a new message format can be efficiently undertaken at the same time by all PSPs, because the investment required to update their systems simultaneously would probably be significant. A phased approach that facilitates migration gradually is therefore desirable. We recognise that the business case driving the rate of change may vary with the PSP's circumstances. Global banks, for example, may have a more compelling justification to migrate their systems based on overarching corporate requirements, while other domestically focused banks may prefer to migrate at a much slower speed.
- 8.19 The decision on what format to use to send and receive messages would be based on the business case of the individual participant. We expect PSPs can make use of message translation services in the interim, before they update their own internal payment systems during this transition period.
- 8.20 A transition period is appealing because, if managed correctly, it allows change to be managed efficiently, easing the investment case for each PSP. However, long migration periods must be avoided because this will delay users receiving the full benefits.
- 8.21 The Payments Strategy Forum will analyse the business case of moving to a common message standard such as ISO 20022, but we welcome stakeholders' feedback on the timing and potential costs of moving to common international message standards. Under the current structure this remedy will apply to the operators and PSPs, but as outlined in paragraph 8.15 this may change following the Payments Strategy Forum's work.
- 8.22 There may be other aspects related to technical standards and operating rules that inhibit interoperability and, in turn, competition between infrastructure providers. We recognise that some of these may be required to meet specific user needs. We welcome feedback on whether any other aspects of the technical standards or other rules may act as barriers to entry for potential infrastructure providers.

**Remedy 3: Ownership of VocaLink**

- 8.23 A third aspect of the proposed remedy package is the divestment by the direct PSPs of their interest in VocaLink to address potential bidders' perceptions of the likelihood of winning any potential tender, as well as the inertia arising from common ownership. We also consider that independent ownership of VocaLink may be more conducive to supporting an evolving payment system market that may arise in the future.
- 8.24 If divestment was undertaken with competitive procurement, careful consideration would need to be given to what services are currently provided by the incumbent provider that may still be needed by service-users in the future – for example, value-added services. It is important that the

incumbent provider is not able to embed themselves as a monopoly provider of any overlay services following divestment. It may seek to exploit such a monopoly position if this is not properly addressed as part of a competitive procurement exercise.

- 8.25 We also note that the central infrastructure provider has a unique position in its access to significant data on payment transactions and [X]. This needs to be carefully considered as, amongst other potential concerns, a change in ownership or provider may lead to foreclosure of commercial opportunities (such as data analytics) to other innovative providers.
- 8.26 We welcome feedback on the form of any divestment of ownership by the direct PSPs in Vocalink, including:
- i. who should be required to divest their shareholding
  - ii. whether the divestment should be full or partial
  - iii. if partial, to what level should an individual PSP shareholding be reduced
  - iv. if partial, whether the total shareholding held by PSPs should also be limited
  - v. if partial, whether it should be below a material influence level
  - vi. whether changes to Board composition should also be stipulated
  - vii. alternative solutions not listed above
- 8.27 We also seek feedback on the timing of the required divestment. Given the intended aims of the remedy (see paragraphs 8.23 to 8.25), any divestment should be sufficiently ahead of the procurement exercise that is part of the remedy package we are recommending. We also welcome views on the divestment process, including purchaser suitability criteria and the need for regulatory oversight. In particular, we recognise that security and resilience are paramount, and that measures need to be in place to safeguard these.

#### **Remedy 4: LINK**

- 8.28 A potential remedy would be to put in place measures that ensure the separation of ownership of the functions of LINK from Vocalink and that the outcomes from the LINK governance review are implemented (see paragraph 7.32). We acknowledge that this is planned and that a separate legal company has been set up for LINK. However, they are not yet fully separate entities. We consider it important that this legal separation is completed for the same reasons as the divestment remedy proposed.

### **The future of the payment systems market**

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- 8.29 In proposing the potential remedies, we recognise that they are focused on the issues identified in this market review, which had its focus on the overlapping vertical relationship and common ownership of the operators and the infrastructure provider. It is not our intention, by proposing these remedies, to signal that the present three-party structure (in terms of structure and arrangements) of PSP, operator and infrastructure provider should continue indefinitely. We are open-minded about future arrangements, recognising that there may be scope for change while continuing to bring benefits overall (for example, through collective purchasing).
- 8.30 We want our remedies to be effective in any structure that may develop in the future. For example, we note that one of the current work streams of the Payments Strategy Forum is considering the issue of potential simplification of the operators. Therefore, we expect the work of the Forum to inform the future structure of the payments industry. In addition to this, as part of



this review, some parties have also raised the possibility of bilateral contracts between PSPs and infrastructure providers as an alternative to the current contracting arrangements. While this was not the focus of this review and therefore our potential remedies, we do not rule out that this could be an effective competitive model, further work would need to be done to understand the pros and cons of bilateral contracting and removing the collective purchasing model.

## Other alternatives

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- 8.31 We considered other options that we do not currently intend to pursue, but we welcome feedback from stakeholders on these.
- 8.32 To reduce VocaLink's incumbency advantage and maximise the potential number of interested parties in a competitive procurement exercise, we considered:
- a. **Ring fencing and separating the core contract function from other 'elective' or 'value-added services' provided by VocaLink, to enable more providers to compete for the contract:** We acknowledge that VocaLink provides a number of ancillary services that are not critical for central clearing.
- 8.33 We acknowledge that this is a more radical option and may reduce a degree of flexibility in the services that infrastructure providers are able to offer under core services. We also acknowledge it may be difficult to monitor and enforce.
- 8.34 We also considered whether there needs to be more transparency around the accreditation of third party providers for Bacs gateway solutions that are currently provided by VocaLink. There have been some claims that potential providers have been deterred by the accreditation process and cost. We welcome feedback on whether measures should be taken to ensure greater transparency of the accreditation process for Bacs.

## 9

# Next steps

During the next phase of this market review, we will:

- continue to engage with relevant stakeholders, including a consultation on the interim report
- consider in more detail the different forms of remedy that could be adopted, taking into account the responses to our interim report
- publish the final report, setting out our findings
- consult on any proposed remedies

### Stakeholder feedback

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- 9.1 We would like your views on this interim report, including our conclusions and the need for remedies and, if so, your views on what form it should take. A full list of consultation questions can be found in Annex 8.
- 9.2 Please send your comments (in either electronic Word and PDF versions) by 21 April 2016 to [infrastructurereview@psr.org.uk](mailto:infrastructurereview@psr.org.uk)

Or in writing to:

Infrastructure Review Team  
Payment Systems Regulator (15<sup>th</sup> floor)  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

### Further work planned

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- 9.3 We will also continue to develop our thinking on whether we should implement remedies, and if so, what remedies would be most effective in promoting competition, innovation and the interests of service-users.
- 9.4 We will consider your comments to this interim report and further work when preparing our final report.

### Final report

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- 9.5 We expect to publish the final report in the summer 2016. The final report set out our findings and conclusions. If appropriate, we will consult at the same time, or subsequently, on any proposed remedies.
- 9.6 We will then, if appropriate, consult on any proposed remedies or actions.

