UK Finance written submission - Treasury Select Committee Call for Evidence on the work of the Payment Systems Regulator (PSR)

4 May 2022

UK Finance is the collective voice for the banking and finance industry. Representing around 300 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation. We work for and on behalf of our members to promote a safe, transparent and innovative banking and finance industry.

We welcome the opportunity to provide a written submission to the Treasury Select Committee (TSC's) call for evidence on the work of the PSR. The banking and finance sector has evolved substantially in recent years, and new entrants and technologies have brought benefits for competition and consumers. During this time, regulatory change has also been a constant and dominant theme. We and our members believe that an open, constructive and collaborative relationship with policymakers is essential to achieve the optimal environment for firms to innovate and develop existing and new payment systems for the benefit of customers.

Payments are a fundamental part of the UK economy, ensuring businesses can accept transactions from their customers with ease and adequate protection from default risk. In this regard the emergence of a payments focused regulator has played an important role in supporting the sector and its customers through change.

Over the seven years since it became operational, the PSR has had successes and has taken on board extensive feedback from the payments industry. In this response, we highlight additional areas for improvement and reflect on its work in the particular areas raised of combating fraud and in reviewing the cards market.

1. THE PSR'S PERFORMANCE

Regulatory landscape:

To a degree, the PSR's performance is constrained by the wider regulatory landscape. As part of our response to the HMT's Payments Landscape Review call for evidence and the Future Regulatory Framework (FRF), we have argued that the enhanced Financial Services and Markets Act (FSMA) model proposed by HM Treasury in its work on the FRF should be applied not just to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA), but also to the Payment Systems Regulator and the Bank of England's regulatory functions in respect of payment systems.

This will allow for:

- **Clarity where there is regulatory overlap** - while the regulators' interaction is the subject of a Memorandum of Understanding (MoU), there is scope to rationalise and clarify their respective roles. In particular, the PSR as an economic regulator is independent in its duties and powers from the FCA's role as a conduct regulator, but this distinction has been blurred by both the overlap of their responsibilities and the governance of the PSR itself. **We would**

also like clarity on which regulatory initiatives the PSR leads, which it supports, the rationale for who leads on what and how this plays out.

Where the PSR positions itself as the lead regulator, it would be helpful if the PSR proactively sets out which regulators cover which elements (for example, in the context of industry considering how best to add appropriate friction in payments to help prevent Authorised Push Payments (APP) fraud). Not doing so gives rise to confusion for stakeholders as well as inefficiencies. By the same token, when the PSR is a supporting or joint regulator it would be helpful to understand where its scope begins and ends, and how it will interact with the lead/other regulators involved (some examples may include Access to Cash and future oversight of Open Banking).

There is also a need for greater coordination on changes to legislation, including reforms to EU-retained legislation; especially changes to the Payment Services Regulations. A change to the underpinning legislation during delivery of the New Payments Architecture (NPA) or renewal of the Real Time Gross Settlement (RTGS) system for example could be challenging for firms and customers.

- **Foundational principles of proportionality and cost-benefit analysis –** we believe that further promotion and development of payments networks is best achieved through competitive markets, and regulators should intervene only where they can address market failures in the interests of end users. It is vital that the PSR considers its previous interventions through a cost-benefit analysis (CBA) lens, to inform its approach on future interventions. This is particularly true of Open Banking and Confirmation of Payee - as well as development of the New Payment Architecture (NPA) proposals once complete. For Open Banking in particular it would be helpful to ensure mandates can be reformed to allow for the changes in the market over the past four years to ensure the initial agreed objectives are met.

- **Responsiveness at the heart of payments regulation -** there should be an increased role for industry input into the policy-making process, especially in the early stages. By the time regulators seek stakeholder views at the consultation stage, the range of possible policy options has often been narrowed down to one preferred approach and valuable stakeholder input on alternative approaches has been missed. Firms are close to their customers and have detailed market data and a wealth of expertise on implementing regulation, all of which could be used by regulators to improve their decision-making.

Performance to date:

The PSR has made interventions in the market that have helped fundamentally change the payments industry, and **has had notable recent successes**, including mandating the Confirmation of Payee service. However, its focus on very targeted and tactical issues (such as on APP fraud) could be seen as overlapping with other regulators, rather than the broad and longer-term strategic remit we would expect. Further, we are of the view that benefit would be gained from avoiding overlap between the PSR and the FCA, particularly where an issue should generally fit more naturally within the FCA's statutory objectives around conduct and customer detriments.

Additionally, mandating specific initiatives is **resource intensive** for the PSR, and therefore its preferred approach is now to drive change via industry, particularly via the UK payments scheme provider Pay.UK. The PSR should keep in view in what circumstances the approach to mandate via payment schemes is appropriate, what is achievable, how it can ensure transparency, and whether it is ultimately prepared to step in with its powers in support of its objectives if judged necessary.

We would like to see the PSR joining up its teams working on the New Payments Architecture, fraud, customer protections and account-to-account payments, as we believe these topics are inter-related and it is critical that they are considered holistically. We recognise that in some areas, such as the card acquiring market review, there has been a significant upskilling required for PSR to understand a highly complex market.

We also consider that the PSR should ensure the right level of focus of the **various needs of end-users**. Retail consumers are undoubtedly a key user of payments, but the PSR needs to always understand the two-sided nature of the market and recognise the needs and demands of retailers, utility companies and corporates as changes are built and not as an afterthought. For example, Request to Pay is a good solution but is unlikely to reach the adoption levels the PSR's Payment Strategy Forum (PSF) might have predicted.

<u>On specific items:</u>

- **Relationship with Pay.UK:** We are concerned that, in places, the interventions proposed by the PSR appear to confuse the roles of the PSR and Pay.UK. We see the role of the PSR to ensure that the market develops appropriately, for the long term competitive strategy and to undertake any specific regulatory requirements on industry, or for Pay.UK, in order to control identified risks to competition. This could be achieved through certain *ex ante* regulation to control risks and additionally through later interventions in the market. We do not think that mandating Pay.UK is always the correct mechanism to perform supervisory decision-making and undefined monitoring roles in the industry, even in their role as 'market catalyst'.

- **New Payments Architecture (NPA):** The UK is in the middle of a once in a generation change in its core interbank payment systems and there is **a significant need to move forward with more urgency** on the NPA. We have noted a positive shift in the PSR's approach in recent times, by delegating more decisions to Pay.UK and reducing the amount of micro-management of the programme which is welcome, but more could be done. We also recognise why the PSR and Pay.UK has separated out decisions on Faster Payments versus Bacs which has been helpful, but poses longer term strategic issues for the migration of Bacs across to the NPA.

  It is worth noting that it has been five years since the PSR's Payment Strategy Forum (PSF) published its blueprint for the 'Future of UK Payments', and we are still awaiting a credible delivery timetable which goes beyond the procurement phase of the NPA.

  The PSR can help determine clarity of scope and requirements with a focus on end user benefits and impacts including any disruption and migration costs. In particular, there is a need for clear, measurable proposals for the NPA, and to ensure participants have adequate opportunity to engage directly in the governance for the NPA programme. The NPA is one of the biggest infrastructure changes in the UK that directly affects their customers and will come at a considerable cost to the industry.

- **Open Banking**: We are supportive of the PSR working with government and other regulators on the appropriate regulatory framework for Open Banking initiated payments and envisage the PSR to have greater accountability in this area. Clarity will be needed on the role of the PSR and its areas of focus or potential intervention on Open Banking.

2. THE PSR'S ANNUAL PLAN FOR 2022/23

We welcome the PSR's open and consultative approach, in particular the opportunity to input into their first formal strategy published in January 2022. Overall, we agree with the PSR's observation that payment systems are working well. While the industry is supportive of the PSR's strategic priorities and outcomes, we hold the view that the PSR should focus its programme of work to the most important issues, outlined below.

There are issues the PSR rightly seeks to address, including APP fraud, risks to effective competition, and the need to support the payments sector to deliver new and improved services.

In addition, we believe the PSR can offer more assistance in addressing **fundamental and strategic questions for the payments industry** including:

- How we make the sustainability and long-term constitution of the payment systems as robust as possible
- How payment services deemed essential by society be provided in a way that is transparent, non-discriminatory and competitively neutral
- How we ensure the long-term protection of customers on a level playing field
- How we structure these changes in the most fair and equitable way for customers

We support the PSR's position recognising the importance of **competition as a driver of better outcomes**, although it should always examine evidence on consumer outcomes to ensure this is actually happening. It is important to note that the industry has moved forward with initiatives such as Access to Cash, to ensure that there remains viable and sustainable choice of payment. In line with the PSR strategy these have often focused on vulnerable groups and their needs.

We would urge caution with the PSR's stated aim of making account-to-account payments a realistic alternative to credit and debit cards. As part of this work, the PSR has said it will assess and begin to address any barriers to the widespread take up of account-to-account retail payments, work with other authorities on the future regulation of open banking, and address harms identified through the impact of card fees. While we are supportive of effective competition, we believe the PSR needs to consider the demand for account-to-account payments from payers and payees and note that the assertion that this will be a way to deliver cheaper solutions for merchants is untested, there needs to be a further understanding of how the commercialisation of that model will achieve scale in the market. We also believe further attention should be given to the need for card-like customer protections and fraud protections. Linked to this is the need to promote sustainable economic models for account-to-account payments, with all participants in the payments chain taking responsibility for the risks they create.

The PSR is right to identify that there are **competing priorities** on many of the payment issues. The acknowledgement that some degree of personal responsibility by users is part of the equation is important as with aligning the commercial interests of participants and users. Greater clarity is needed over the mooted intervention should the PSR feel the trade-offs are not delivering acceptable outcomes.

Finally, the PSR could help more on building the understanding of the cost of doing business, the economics of payment systems and creating new business models in the payments industry. This is not just the cost of innovating and implementing both mandatory and non-mandatory change, but ongoing costs for each transaction, the customer protections that apply and the emergence of newer payment systems. We believe the PSR can be helpful in building a more holistic cross-industry/regulator view of what is a complicated landscape.

3. THE PSR'S WORK IN COMBATTING FRAUD

The PSR has good intentions to drive solutions to combat fraud, collaborating with other financial services regulators. However, **focus has been on reimbursement and not enough priority is given to how prevention** can be incentivised. A reimbursement model means that even if the customer is compensated in full by their finance provider, the criminals that perpetrate these frauds still profit, and proceeds are reinvested to fund harmful and illegal activity such as terrorism, modern slavery, drug trafficking and human trafficking.

We would expect the PSR as an economic regulator to have a greater interest in pursuing prevention measures. Linked to this point, the PSR in our view has not given adequate weight to the concerns industry has raised about publishing reimbursement data, including the likely unintended consequences.

It also took too long for the PSR to acknowledge that other sectors must take their fair share of responsibility for fraud (telecoms providers, social media companies etc). We would have liked to have seen the PSR more proactively seeking collaboration across sector regulators, whilst recognising that the PSR does not have powers over other regulators.

Procedurally, it is concerning that the PSR has not published consultation responses from their February 2021 call for views on APP fraud before progressing their work and issuing a subsequent consultation in November 2021. To date, these responses have still not been published.

On its overlapping work with other regulators on fraud, the current FCA fraud reporting regime already requires every Payment Service Provider to submit APP fraud data on a semi-annual basis. While not all of the PSR's requested data is included in existing FCA requirements, a significant amount of the proposed requirements is, and therefore the PSR should be working with FCA to use the data reporting regime already in place rather than creating a dual reporting regime.

Authorised Push Payment fraud:

UK Finance believes there needs to be greater focus from the PSR on driving and supporting efforts to tackle scams at source, and we would like to see more decisive activity from the PSR in this space. We therefore encourage the **PSR to work with government and other regulators to develop a cross-sector, systematic and comprehensive approach to tackling scams**.

With losses due to APP fraud reaching £355.3 million in the first half of 2021, a substantial increase of 71 per cent when compared to the same period in 2020, the industry is keen to focus its attention and resources on the development of preventative measures. The PSR needs to expand its approach and look to support a conducive environment for appropriate data sharing so more antifraud innovation can be brought to market. **UK Finance has been working hard on an APP fraud strategy which we believe could help much of the thorny landscape of APP fraud**, however there's a need for further encouragement of the government and regulators to help the industry support this, enabling delivery through legislation and regulations, where needed and by supporting the very strategic and holistic approach UK Finance and its members are working on.

In our view, **legislation is needed** to produce better, more predictable outcomes for customers, industry and law enforcement. The Government has committed to an Economic Crime Bill in the next Parliamentary session, which will bring further measures to help tackle money laundering and the growth in fraud and scams. This would need to address the standards expected of the industry and customers, the liability issue and the development of a government endorsed funding solution for the compensation of victims.

However, we believe the **PSR is taking the wrong approach to legislation**. The PSR is currently focussed on an approach to change legislation so that they have the power to mandate Pay.UK to alter its own scheme rules. The PSR would then use those powers to ask Pay.UK to mandate wider reimbursement via the scheme rules.

To achieve a better outcome, the Economic Crime Bill should focus on **putting the Authorised Push Payment Contingent Reimbursement Model on a statutory footing**, setting out in primary legislation issues around liability and creating a framework to bring all retail banks and Payment Service Providers under the code. The code itself should be placed in secondary legislation to ensure it can keep pace to the evolve nature of fraud and scams.

We have also been concerned that the PSR's sustained emphasis on the publication of only financial services industry metrics distracts from the wider need for cross-sector stakeholders to acknowledge the part they play in enabling these scams. As fraud cases continue to grow, the importance of stepping up our combined efforts to encourage collaborative working to tackle these external enablers becomes ever more important. However, there is a **positive opportunity for payments developments** to play a progressively powerful role in combating APP fraud and this is something we want to see the PSR encouraging – elements include data sharing before the payment journey, enhanced data used within the actual journey and data analytics after the journey.

Confirmation of Payee (CoP):

CoP is a way of checking account details to give customers (both personal and business) greater assurance that they are sending payments to the intended recipient, helping to avoid misdirected payments being sent to the wrong account as well as offering another important tool to help in the fight against fraud. The PSR directed the UK's six largest payments providers to implement CoP, meaning that circa 90 per cent of Faster Payments and CHAPS transactions were in scope.

We see CoP as being a largely successful delivery and welcome the PSR's decision to help the industry implement and deliver CoP. However, it has not quite been the silver bullet envisaged by regulators. As above, there should be more focus on driving and supporting efforts to tackle scams at source, and we would like to see more decisive activity from the PSR in this space.

In any implementation, there is also a significant need for public authorities to consider unintended consequences and carefully balance technical requirements and access when introducing changes. In the case of CoP, off-the-shelf market solutions were arguably slower to develop than the PSR anticipated when it made its direction. This meant that, for a time, there was an unintended market differential and, whilst many smaller PSPs for competitive reasons have largely introduced it, it has not always been cost-effective for them to do so.

Whilst CoP provides customers with valuable peace of mind, our members have in the past highlighted that there are alternative measures to tackle the growth of APP fraud that may have better success than CoP. Investment is required in these measures, such as enhancing the ability of firms to exchange data about a payment during the customer's payment journey, and ongoing investment in CoP has had an impact on diverting valuable industry resource and attention from these projects.

3. THE PSR'S APPROACH TO PROMOTING COMPETITION BETWEEN PAYMENT SYSTEMS, INCLUDING CRYPTOASSETS AND DISTRIBUTED LEDGER TECHNOLOGY

It is widely acknowledged that distributed ledger technology (DLT) has the potential to disrupt payment, clearing, settlement and other related activities. Its introduction has provoked wider assessment of how digital currencies, based on new and on conventional technologies, can drive further innovation in the market. Government and regulators continue to play a key role in driving innovation in this space by helping firms to understand how new technologies can perform processes and deliver products and services in compliance with regulation and regulatory expectations.

The application of this technology to financial services and financial products has already driven multiple use cases. Key amongst these is the growing rise in cryptoassets, stablecoins and other privately issued digital assets and currencies. This has also driven central banks worldwide to consider what their role is in relation to these new forms of digital money and provoked investigation of the development of Central Bank Digital Currencies (CBDCs).

However, cryptocurrencies and potential widespread payment systems supported by DLT or wider cryptoassets are still at an early stage, currently with limited use cases, and therefore the opportunities to promote competition with established payment systems are limited. HM Government in conjunction with the Bank of England and the FCA is developing the regulatory regime for stablecoins, alongside the Bank of England's consideration of a UK CBDC.

The PSR has stated in its Annual Plan that it will monitor developments in the cryptoassets market, contribute to the CBDC Taskforce as appropriate and develop guidance on how new payment systems might be regulated in accordance with PSR objectives. We support the PSR's approach however note the use of stablecoins and CBDCs has the potential to grow significantly, so believe the PSR should broaden its view of potential competition in the market rather than the binary option between card and account-to-account payments.

The HMT announcement on its approach to this ecosystem was a good step to providing industry with greater clarity on how these products could be managed under existing regulation and it is essential that regulators establish clear pathways for the introduction of new technology and business practices and given the nascence of this market we largely agree with the PSR's current approach to monitor and engage where it is appropriate.

4. HOW WELL THE CARDS MARKET IS WORKING

Payments is an extremely competitive market. Consumer and merchant choice has increased rapidly in recent years, benefitting users by reducing the cost of acquiring and improving efficiencies in payment provision. While the distinctions between cash, cheques, interbank payments and cards are still generally relevant in the context of infrastructure, consumers now have an increasing number of ways to pay on these systems at checkout, including account to account payments, Buy Now Pay Later, traditional instalment credit and e-money. In order to maintain this hypercompetitive market and the associated benefits for consumers, regulators and legislative bodies should ensure all types of payment methods be treated in the same fair and even manner.

Overall, we believe the cards market is working well for all parties. There is a functioning commercial model in place, with all entities having aligned incentives to invest in the ecosystem. Retailers benefit from innovations such as contactless payments. Payers benefit from secure cashless transactions and a disputes mechanism.

As noted by the PSR, the cards market supports the majority of retail transactions for UK businesses. For consumers, the universality, flexibility and adaptability of the card payment proposition is paramount – which has allowed for its easy incorporation into other form factors (fobs/tags, mobile phones, watches, clothes and other wearable technology).

Cards play a habitual role in everyday life, with debit cards in particular, regarded as an important and trusted payment instrument offered as a standard component to a person's current account. Consumers understand that using their cards to pay – in particular credit cards – offers significant protection in the case of unauthorised transactions and purchase risk. In 2017, debit cards overtook cash as the most frequently used payment method for the first time; and since the Covid-19 pandemic, use of cards has only continued to grow, both continuing to replace cash transactions in store, and supporting the boom in ecommerce transactions.

For merchants, the card payment market also offers significant benefits – risk-sharing, fraud tools, connected services, sophisticated authorisation methods, data analytics, merchant portals, servicing, reliability and innovation. Increasingly merchants require sophisticated offerings and have a wide variety of needs, including payment methods accepted; choice of terminals and industry specific point of sale hardware; software and gateway integrations; and settlement times. Card acquirers have recognised that ease of integration with the merchant's wider requirements is fundamental to any payment proposition. There is also diversity of servicing, with new entrants offering faster onboarding and less fixed pricing structures as a means of attracting merchants who just need the ability to take card payments quickly.

The resilience and depth of the card payment market was demonstrated during the Covid-19 pandemic. Card acquirers provided a reliable and resilient service to the UK economy, supporting the acceleration of online spending and increasing contactless payment acceptance by volumes and transaction amounts. Acquirers have carried billions of pounds of retail insolvency risk and voluntarily implemented support packages, discounts, waivers and deferrals to support retailers during this very difficult time, and in many ways acted as an additional business support system alongside the bounceback loans and other government measures.

In 2018, the PSR commenced a market review into card acquiring services to consider whether they were functioning well for UK merchants, and ultimately consumers. UK Finance has engaged with the PSR throughout this process and for the most part it has been a constructive dialogue. However, a number of our concerns have not been addressed during this process including:

- **Evidence base and link from perceived harms to remedies**: we have concerns around the evidence base and methodology used; and we would argue that the four proposed remedies that are focused on comparison and technical interoperability, do not reflect the perceived harms that are primarily contractual in nature.

- **Narrow scope**: the acceptance market is evolving at a rapid rate, both on payment 'rails' (e.g. emerging acceptance of open banking and cryptocurrency) and on products (e.g. soft Point of Sale terminals). Any prescriptive remedies for card payments present a three-fold risk.
    - First, that onerous remedies on card rails will disadvantage market players in that segment compared to emerging payment acceptance.
    - Second, that a technical remedy such as POS interoperability between card acceptance providers will be outdated by the time it is implemented and prevent further innovation, and will hinder interoperability with other payment acceptance types.
    - Thirdly, that POS terminal leases still remain predominantly face-to-face merchant focussed, and POS interoperability therefore fails to consider if a merchant has complex ecommerce or omni-channel integrations.

  Mis-categorisation of market: the types of remedy the PSR is considering are more commonly seen in business-to-consumer (B2C) markets. Acquiring is a business-to-business (B2B) market, with merchants – excepting perhaps the smallest merchants – demonstrating high levels of commercial sophistication. In addition, acquiring is not a simple commodity market like electricity, but a more complex, differentiated proposition, in part reflecting the fundamental underlying complexity of card payments. Providers compete not just on price but also on quality/functionality.

  These factors will complicate the application of the PSR's remedies such as summary boxes and DCTs, which focus on facilitating price comparison. Moreover, the significant risk of applying the wrong type of remedy to a complex market is commoditisation of that market (i.e. race-to-the-bottom pricing); which then undermines other valuable aspects of provision. This is particularly true in an evolving market, where different market segments and players are offering different levels of merchant benefit (for example, Buy-Now-Pay-Later has demonstrated significant benefits in customer acquisition and retention, whereas traditional card acquiring offers robust protection against customer payment default or fraud).

5. THE PSR'S ROLE IN REVIEWING AND REGULATING CARD SCHEME AND INTERCHANGE FEES

Payments cost money to provide. This is often something overlooked by regulators, but this oversight further entrenches the difficulty of new service providers to thrive, because in turn it can make services based on interbank payments prohibitively expensive to provide. The cost of doing business and creating new business models in the payments industry is increasing. This is not just the cost of innovating and implementing both mandatory and non-mandatory change, but ongoing costs for each transaction. Each payment itself is a cost, both for direct and indirect providers.

Interchange fees in the card payments ecosystem is a key aspect to protecting customers and ensuring payments work not just in the UK, but also internationally. Interchange fees fund customer protections, fraud mitigation and innovation, as well as providing for interest-free periods which benefit customers and businesses alike. Fees received via interchange are in many cases a source of cost recovery rather than a revenue driver. For card issuers like banks or electronic money providers, funds received via interchange are used to cover payment guarantees, fraud risk allocation and customer protection procedures (i.e. chargeback rights), alongside usual business costs. This cost recovery facilitates innovation and a better experience for customers. It would be incorrect to assume interchange as a significant revenue driver for most payment service providers.

The caps on interchange fees introduced by the EU-retained Interchange Fee Regulation (IFR) were the product of what industry was assured were robust, open and fair calculations based on the optimum rate for interchange. Despite this, it should be noted that the caps have had a marked impact on some aspects of card issuing businesses. For example, some firms have seen significant impacts on the viability of their businesses, and in some cases have withdrawn products from the market.

Card systems have not only the commercial underpinning outlined above, but also decades of operating rule development and innovations which enable safety and service to develop together. The PSR needs to be careful in evaluating value for money – many of the advantages and accessibility of card systems for all users (including small merchants) is enabled by their history, commerciality and scale.

Any role allocated to the PSR to consider alteration in interchange fees should be carefully considered. Further restriction on interchange fees could lead to degradation of standards of service and/or withdrawal of products; two eventualities that are neither beneficial for consumers, nor a well-functioning payments sector.

If you have any questions relating to this response, please contact David Song or Briony Krikorian-Slade, via david.song@ukfinance.org.uk or briony.krikorian-slade@ukfinance.org.uk