PAYMENTS COUNCIL

RESPONSE TO TRIPARTITE CONSULTATION ON FINANCIAL STABILITY AND DEPOSITOR PROTECTION

General Comments

The Payments Council has a particular interest in ensuring that, whatever protections are put in place to manage a stricken bank, these should not interfere with the operations of the payment system.

It follows that this response concentrates, as did Payments Council's response to the previous paper, on practical implications for the payments systems (Bacs, CHAPS, Cheque and Credit ("C&CCC") and FPS) of the proposals in the Chapter. The overarching message is that any new measures must not damage the existing agreements put in place to protect members of payments systems against the failure of a participant. In addition, we will recommend that there is a specific power to protect the payment system against actions by those operating a special resolution regime.

We note that the Government intends to introduce legislation to a very tight timescale. Given the complexity of the subject matter, we are concerned that this could lead to legislation whose implications have not been fully thought through and which could, in time, give rise to unintended consequences. We would prefer less speed and more time for reflection.

We have a particular interest in payment scheme oversight and have a special section on that issue. We particularly ask that new arrangements take account of the role of the Payments Council in looking at the integrity of the payment schemes with whom it has a contractual relationship.

We will not comment on every aspect of the White Paper as there are parts of less relevance to us.

Chapter 3

The first sections of Chapter Three are concerned with information requirements. We ask whether it is intended that payment schemes should also be requested to provide information in appropriate circumstances. If it is, then we believe that there should be an explicit statutory gateway through which the information can pass.

POLICY ON PAYMENT OVERSIGHT

Statutory Framework for Regulation of Payments

For many years, the major UK payment systems have been overseen by the Bank of England. In 1997, this role was formally articulated for the first time, in the Memorandum of Understanding which established the Tripartite Group; but oversight has remained extra-statutory.

The White Paper now proposes that oversight of payment systems is brought within a new and flexible legislative framework. We understand that the Tripartite's focus is on the framework by which payment business is conducted ie the core payment schemes (in industry terminology), not on the technical infrastructure which processes the payments. We will refer to payment schemes in this response to keep the distinction clear.

Current Governance of Payment Schemes

There are a number of separately incorporated scheme companies whose Boards have responsibility for running one or more individual schemes, linked by a common method of operation or common member base. The shareholders of these companies are regulated businesses ie the major banks which use the clearing schemes.

Since March 2007, the major scheme companies have been associated through a generic contract with the newly formed Payments Council. The generic contract provides for the passage of information between contracted scheme companies and the Payments Council; in certain, tightly defined circumstances, the Council may give direction to the Board of a scheme company. But this essentially relates to strategic developments and innovations. It does not imply any control over the operational responsibilities of the Boards for running their schemes day-to-day.

Justification for Statutory Regulation

Whilst the White Paper outlines some perceived advantages of introducing an element of statutory oversight, we must record that we see no evidence that the absence of a statutory base has to date caused any problems either for overseer or payment schemes. Those whom run payment schemes appreciate the quality of the contacts with the Bank of England and the openness of their dialogue. The Bank of England's annual oversight reports have scored the main UK payment schemes well against internationally accepted criteria – in particular, the core principles for systemically important payment systems. Where schemes have been judged not to meet any particular criterion, they have a good track record in responding positively; subsequent oversight reports have indicated that steps have been taken to ensure that the criterion has been met. Most importantly, the overall resilience and integrity of the payment schemes and their supporting infrastructure have been excellent. The Bank of England has also played a role in ensuring that schemes meet the criteria for designation under the Settlement Finality Directive.

So we do not consider that there are any significant regulatory issues, let alone any which only a legislatively backed framework would fix.

Indeed, we could envisage a provision which simply regularised in statute the current role played by the Bank of England.

Objectives of Regulation

If, however, there is to be legislative provision, we believe that it should follow the following principles:

a) **Proportionality**: the operational track record of payment schemes is good and the degree to which there is any regulatory intervention should reflect this. In addition, there are many payment schemes, even under the aegis of the Payments Council which offer specialist services for a niche market in payments. Such schemes do not deserve the same degree of regulatory oversight as the major payments schemes which form part of the national infrastructure. There should be a distinction in the application of regulation between payment schemes with a system-wide reach and the niche schemes.

b) **Flexibility**: schemes will change their scope and their procedures in response to changing customer demand and changing technology: any regulatory framework should not inhibit these changes or the speed at which they can be made.

c) **Focus**: any regulation should be focused on ensuring the continued integrity and reliability of existing payment schemes. It should focus on schemes, not the technical infrastructures by which payments are processed in accordance with scheme rules.

d) **Avoidance of Duplication**: following the standing-down of the OFT Payment Systems Task Force, the industry has created the Payments Council which looks at efficiency, integrity and innovation in payment schemes. In its first year, the Council has operated alongside the Bank as overseer, with no apparent duplication of effort. This should be the same goal under any new arrangements. The Council also has a useful role in promoting co-ordination between scheme companies.

We believe that the following approach would deliver these objectives. We would hope that as much of the detail as possible will be left to secondary legislation or regulatory rules and that the text in the legislation will be kept to a minimum, to preserve flexibility and to preserve the ability for speedy amendment.

Authorisation

As noted above, payment schemes can be grouped into a single scheme company, under the governance of a single Board. This has proved a sensible way of arranging scheme business and has also helped with arrangements such as the Default Agreements, where it has been important to prevent problems in one scheme affecting the conduct of payment business elsewhere.

We also noted that, within any scheme company, there can be several payment schemes of different shapes and sizes whose impact on economic or financial life varies significantly. We suggest that any focus of regulation should be on the scheme company, rather than an individual scheme. This is especially important if the legislation requires an entity to be authorised. A focus on the scheme company would facilitate a proportionate approach and would ensure that greater regulatory attention is paid to those parts of the payment system with the greatest economic and financial impact.

If scheme companies are to be authorised, we suggest that any requirements should follow as closely as possible the BIS core principles for payment systems.

We would expect that a scheme company would need to satisfy criteria for authorisation. These would concern:-

i. Appropriate arrangements for the efficient, secure and reliable conduct of payments business.
ii. Appropriate management of risk.
iii. Appropriate contingency arrangements.
iv. Appropriate default arrangements.
v. Membership rules which ensure that only people fit and proper to be members of a payment scheme are admitted to it and which permit fair and open access.
vi. Appropriate governance procedures which are effective, accountable and transparent.

We believe that these are the criteria which the payment companies in contract to Payments Council currently meet.

We do not think it appropriate for a regulator to impose additional conduct of business rules on participants, over and above the rules of the schemes. These will either be duplicative of the scheme procedures or will relate to relationships between members of the scheme and their customers which are already covered by other regulatory provisions.

As noted above, members of payment schemes will be already authorised through other routes. This reinforces our belief that a light regulatory touch is entirely appropriate, in the oversight of payment schemes.

Choice of Regulator

The White Paper indicates that consideration is being given to a division of responsibility for payment system oversight between the FSA and the Bank of England (depending on whether the scheme is perceived to be relevant to financial stability).

Our initial view is that a division of responsibility between two regulators could cause issues of duplication and potential confusion. We note that, under present scheme arrangements, one scheme company in particular is likely to run a scheme which is relevant to financial stability and one which (at present) is not. We could envisage a means by which specific schemes (as opposed to scheme companies) were carved out from regulatory supervision by one regulator and "awarded" to another. There is perhaps a precedent in the regime for wholesale money market supervision under the old Financial Services Act 1986. But we do not think that any separation of regulatory supervision will be slick and simple to achieve in a statutory framework. We certainly would look for assurance that there was no chance of double-jeopardy in any event.

If it is decided that the practical obstacles to splitting regulatory responsibility are too great, then we would suggest that the natural home for the system-wide schemes would be with the Bank of England. Our principal reason is pragmatic; this would involve the least change in current arrangements and the FSA would not need to develop afresh a new expertise. We also note that it is more usual for oversight to be placed with a central bank - this is certainly the model elsewhere in the EU – and this may make it difficult for the Bank to disengage completely from payment issues.

Were the decision to be to move responsibility to the FSA, we would of course offer assistance to them in developing the right sort of relationship with the schemes.

Immunity for the Bank of England

The paper asks whether the Bank of England should enjoy statutory immunity in connection with its financial stability role. We would have no objection to such a provision which mirrors the provisions made for other regulators in different statutes. We note that this protection would not extend to the Bank's role as settlement bank for the payment schemes or for them as participants in the payment schemes.

We would ask the Government to consider whether the status of the payment schemes needs to be made clear in the legislation, in particular their responsibility to continue to process payments from the customers of a failing bank. It is possible that those who feel themselves disadvantaged by the introduction of an SRR may decide to look for other bodies from which to seek compensation. It is possible that the operators of payment schemes may be their target. It would be helpful to know whether the Tripartite views such a challenge as feasible and whether some statutory or regulatory protection for the schemes could be provided.

Stricken Banks and their impact on the Payment System

The Government:

1. *proposes legislation to introduce a special resolution regime for banks.*
   If the stricken bank is a settlement Member of a payments system it must be made clear that that bank is still making and receiving payments as normal and that it will continue to be in a position to settle its payments at the Bank of England. If a settlement Member fails to settle, the provisions of the current settlement agreements will be invoked and the failed bank will be excluded from the system. If the operators of a payments system believe that a stricken bank threatens the integrity of their system, they will continue to be entitled to suspend it. It also needs to be made clear that if the stricken bank is explicitly put into administration, receivership or if it becomes insolvent (even temporarily) it will be subject to exclusion from the systems, according to the systems' current rules.

   Agency banks (considerably more numerous than settlement Members) rely on the settlement Members to settle their positions in the systems. If the stricken bank is an agency bank but operating under a SRR it must similarly be made clear that it is still operating to make and receive payments as normal on behalf of its customers and that its settlement Member will be protected if it continues to settle on its behalf. Even though payments systems have no direct control over agency banks the failure of an agency bank could put significant operational strain on a payments system.

   Operating as above maintains the payments systems' normal treatment of the stricken bank as a going concern. If the Authorities need to give direction to the systems to vary the way they would normally treat a Member bank or an agency bank the necessary statutory powers for the Authorities and protections for the systems must be in place.

2. *proposes legislation to give the Authorities the power to direct and accelerate transfers of banking business to a third party, in order to facilitate a private sector solution.;* and

3. *proposes legislation to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a "bridge bank".*
   Protection of depositors' accounts appears as a top priority, in order to maintain depositors' confidence and to reduce the risk of a run. It is not clear whether there would be a distinction between wholesale and retail deposits. Part of this protection is to maintain depositors' ability to continue normal banking business. This would require existing IT systems to be kept in place in the stricken bank, presumably under the control of the resolution regime operator. It is questionable whether a US-style bridge bank would work in the UK, except possibly in the case of a relatively monoline-type business such as a small building society.

   The following are important to the payments industry:

- it is unlikely that a mass of banking details can be transferred quickly, even under a streamlined system offering the simplest form of bank account. Would the Authorities waive the normal account opening procedures and KYC rules? *They will have to if this approach is to work and the institutions involved would expect a formal derogation from the rules by the regulators in case of future dispute.*
- An interim bank would need to accede to the legal agreements of whichever system(s) it wished to use for payments (presumably Bacs, CHAPS and FPS if not C&CCC). This would take some time since signing up to the rules and agreements of each system binds the acceding bank to legal and operational responsibilities and obligations to the systems, and it and the existing members to each other.
- In practical terms it would be impossible to transfer relevant account information for cheques quickly, given that new cheque books would need to be ordered, printed and delivered.
- Unless an interim bank took over existing account identities seamlessly there would need to be a break between old bank and new bank operating in a payments system. There is a possible short window in which this could happen in Bacs so that payments due to or from the old bank could be returned and re-issued in favour of the new. Because FPS is a 24/7 system the ability to do this does not realistically exist, so that potentially a large volume of payments would need to be redirected while the system is operating fully. The potential for operational disruption is high.
- Many customers have more than one type of account, often linked. For example, a current account can be linked to a mortgage or savings account. And small business owners have business accounts and personal accounts that may be linked by a guarantee or something similar. So it would be difficult to transfer accounts on anything but an all or nothing basis.
- The transfer of account details depends on the information available at the stricken bank. It is possible that, given the circumstances, the stricken bank's systems may contain significant inaccuracies or omissions. *The arrangements made under the SRR will have to make provision for the correction of these errors as it would be unreasonable for any liability to be assumed solely by the bank opening the new account. Indeed, this would act as a severe deterrent to a bank offering such a service.*

Bridge Banks

We consider that care must be exercised when considering the use of a bridge bank. We have the impression that, in the US, bridge banks are used to resolve insolvencies whereas the UK authorities contemplate their use here pre-insolvency. We are not convinced that a US model, developed in a market where there are much smaller banks offering a small number of product lines could be easily translated to a UK market where

there are fewer but larger financial institutions offering multiple products often in both wholesale and retail markets.

We can understand that there may be circumstances where it is attractive to transfer part of a stricken bank's business to a separate entity; but care must be taken to avoid triggering a default event.

If the bank provides different services to a customer, it must be clear to the customer what the impact of the transfer is. There may also be an adverse impact on markets: for example, offsetting or netting two positions with the same counter-party may no longer be possible if the positions are now with unrelated entities.

4. *is also seeking views on whether….the Authorities should have the power to appoint a suitable person or "restructuring officer" to carry out the resolution.*
   It seems clear that such a person would be needed, as a clear point of contact and to take overall control. But

   - It must be clear that this officer is distinct from an administrator, liquidator, receiver etc to avoid causing an event of default under the payments systems' current settlement agreements.
   - It must be clear to all, but especially to the payments systems, whether this officer has the power to block payments into or out of accounts at the stricken bank and how this power is to be put into effect.
   - The officer must understand that payments systems assume that instructions to them are valid, subject only to institution-level checks; this means that any instructions to the payments systems to vary their normal terms of business with the stricken bank must apply to the whole bank as it is identified in the system.
   - The officer must have the powers to give, and must give, explicit protection to the payment schemes if they are required to vary their normal terms of business.

5. *would welcome views as to whether the tools above achieve sufficient control of a failing bank or whether legislation to allow the Authorities to take a bank into temporary public sector ownership….should be introduced.*
   No comment except that a stricken bank cannot pass through a stage, however temporary, of being in administration, receivership or insolvent without being in default of the rules of any of the payments systems.

6. *proposes legislation…….to introduce a "bank insolvency procedure" to facilitate fast and orderly payment of depositors' claims under FSCS.*
   This is admitting that the special regime has failed and that the stricken bank is now insolvent (see above). The Authorities suggest that at this point FSCS payment to qualifying depositors will be activated as soon as possible (7 days is the expected pay-out period). Considerable practical problems can be foreseen:

- Where does the FSCS get liquid funds from? Possibilities are: a call on pre-agreed liquidity commitments; borrowing against funds on deposit at the stricken bank or from the Bank of England. If the sums of money are large there is a risk of disruption in the normal liquidity markets which may affect the payments systems, particularly CHAPS. In common with the rest of the banking industry, we are opposed to the idea of a pre-funded scheme.
- How reliable is the failed bank's information on qualifying deposits?
- How does FSCS make the payments? On insolvency, accounts are frozen. If the failed bank is a settlement Member in a system it will be suspended. Possibly it has had its settlement account closed at the Bank of England and its banking licence revoked. The FSCS will be facing putting considerable volumes of payments through the systems of its own bankers.
- The implication is that FSCS payments would be made direct to qualifying payees for them to decide how best to deal with them. Individual payees who have an alternative account in place can transfer normal banking instructions (SOs, DDs, standing credits etc) in their own time. Those that do not have an alternative account will have to set one up as soon as they can in order to receive their payments. As already noted, in the circumstances this is unlikely to be quick even for the simplest form of account. It seems clear that demand for duplicate accounts will grow.
- The quicker FSCS payments are made the greater is the potential for mistakes or fraud. Payments systems must be protected from any harmful consequences.

7. *would welcome views on how best to control a bank's entry into insolvency proceedings.*
   It appeared from the workshops that there could be advantages in reducing insolvency notice periods significantly from the current 14 days. If so it must be clear during any notice period whether or not the stricken bank is still operating as a going concern, that it is still capable of settling its payment obligations and that it does not threaten the integrity of the systems. Most importantly, the payment systems must be clear that they are still operating under the protection of the restructuring officer.

8. *is consulting on whether all the tools …should be available to building societies as well as banks.*
   To the extent that a building society is capable of carrying on substantial payments business, and therefore has the same economic effect as a payments bank, they should. But they will differ to the extent that a bank is constituted differently from a building society. Building societies can, of course, be full members of the payment systems. The Government should also note that, in time, it might well be possible for other types of payment service provider to be formed and to offer a variety of payment services. Such institutions will be outside the present regime but their insolvency could - in time and depending on the development of the market – cause problems for those wishing to access funds and make payments.

Stricken Payment Processors

We would like to flag one issue which is not covered in the document. We note the emphasis in the proposals on maintaining access to banking services, including the ability to make payments. We note that, at the present time, there are certain payment processors whose continued operation is equally essential for access to this service to be maintained. Yet these processors are commercial companies whose ownership may in the near future include external shareholders which are not part of the payment system; were they to pass into administration, the effect on the ability of consumers to access their funds would be seriously affected.

We recommend that the Government consider whether it is appropriate to provide for a special regime for certain processors of core payments, to deal with such circumstances.

Agency Banks

We note that the FSA is to work with banks to ensure that indirect members of the payment schemes have contingency arrangements, should their sponsor bank fail. The schemes would, of course, collaborate whole-heartedly to ensure that there was minimal disruption to the flow of payments business in such an event. We believe that there is no need to make any statutory provision on the subject.

Collateral Arrangements

We would suggest that this area requires very careful scrutiny as any error could have severe unintended consequences if it disrupted collateral arrangements anywhere else in the system (including the payment system).

Strengthening the Bank of England

The payment system has, as noted above, for a long time looked to the Bank of England for its oversight; this is an important component in its role of ensuring financial stability. We would have no argument with the codification of that role in statute, as this seems consistent with practice in other statutes dealing with other public bodies.

We have no comment on the size or role of the Court of the Bank of England as this appears a subject on which the views of those involved with its governance at first hand should take precedence.

---oooOooo---