

Payment Systems Regulator

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Mr Paul Horlock
Chief Executive Officer
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18 January 2018

Dear Paul,

I'm sure you'll agree that 2018 will be a crucial year in the development of retail payments in the UK. The New Payment System Operator (NPSO) will take over the operation of three key interbank retail payment systems – Bacs, Faster Payments and the new Image Clearing System for cheques. The NPSO is also responsible for designing and delivering several key strategic payments initiatives, which were developed by the Payments Strategy Forum (the Forum) and handed over to you in December 2017 for implementation.

We have strongly supported the consolidation of the operators of the three payment systems, as this should deliver a number of benefits which will support our statutory objectives. It should increase the capability and capacity of the existing schemes, and support our open access agenda by promoting more harmonisation of rules across all three.

The creation of the NPSO is also an important step towards a generational change in UK payments. It should help facilitate the safe and secure transition to, and management of, a New Payments Architecture (NPA) – the cornerstone of the Forum's vision. We believe the NPSO and the NPA have the potential to deliver more dynamic competition and innovation in payments. Consumers should benefit from new entrants coming into the market, offering new services and innovative products starting with request-to-pay and confirmation of payee.

I think we both recognise that this represents a historic opportunity for the UK payments community.

Implementation work and ensuring success

I know you and your colleagues at Thomas More Square are working hard to finalise the consolidation process (i.e. the transfer of operational responsibility of the retail schemes into the NPSO), and to do the necessary assurance work and preparation for the NPA's implementation.

The PSR recognises that the consolidation process is necessarily the initial priority. This must be completed smoothly and without undue delay, and we – together with the Bank of England – will continue to watch this process closely. But alongside this, and without detracting from that process, the NPSO also needs to think about its longer term target operating model (TOM) and the development and delivery of the NPA.

I understand that part of your work early this year will be to design your TOM, your stakeholder engagement approach and a procurement strategy for the NPA. This is the right time for the PSR to set out the priorities we want you to consider in this work. We think it is helpful to be clear about our expectations at an early stage – with the aim of minimising uncertainty and disruption down the road.

We will work with you to help ensure that consolidation and the NPA deliver the benefits to customers and other service users that the Forum intended. We consider that the following targets would need to be met for the NPA to be successful:

- We want to see **increased innovation in the payments industry**.
- There needs to be **effective competition** across all layers of the NPA, with low entry barriers for PSPs and other service providers.
- We want to see the NPA delivered in a timely manner, with **support and engagement from all stakeholders**.
- The NPA needs to be **technically robust and resilient**.

Through our own assurance work, we've identified some areas of focus – our initial 'priorities' – that we think will be important for the NPSO to act on, as you embark on this ambitious programme of work. We believe addressing these priorities effectively will help you meet the success measures above.

PSR priorities – establishing the NPSO and the NPA

I've set out our six priorities below and in the annex attached to this letter, for you to consider and respond to. We want to see the NPSO develop into an organisation that drives innovation and competition in retail payments, while maintaining their resilience, and that designs its approach to this around service-users' needs. I hope you'll see how our priorities support this aim. I appreciate that you may well already be considering many of them.

Below is a brief summary of the areas the priorities relate to.

Stakeholder engagement

Transparency and accountability are vital to the NPSO's success. Effective stakeholder engagement will facilitate this, enabling the NPSO to build broad, ongoing support for its strategic decisions and execution of its work. We want the NPSO to design a stakeholder engagement framework which can achieve these outcomes and build on the Forum's success.

Strategy setting and decision making

As the single body responsible for the management of key retail payment systems in the UK, it is essential that the NPSO's decision-making framework is transparent and stakeholders play a key role in its strategy setting process. Decision-making should be based on advancing the NPSO's strategic objectives, as developed by the Payment System Operator Delivery Group (PSODG).

Competitive procurement of the NPA's central infrastructure

Our infrastructure market review identified the need for competitive procurement of any central payment systems infrastructure. The specific directions we made provide the regulatory framework for engaging with us on this issue. In the annex, we set out some key issues we will want to understand as the procurement process is developed, so that we can be confident that it provides the maximum opportunity for competition and innovation across all layers of the NPA. We'd also expect that you would embark on a comprehensive migration planning exercise to help build confidence in the NPA.

Development and management of NPA rules and standards

The NPA rules must enable interoperability and low barriers to entry, which will facilitate competition and innovation. It is vital that the initial rules are developed through an effective consultation process to ensure that they are fit for purpose. In addition, we want to see a robust governance process for future modifications of the rules, developed with the broad support of stakeholders, and giving stakeholders a clear role in those processes.

Clarifying the NPSO's 'market catalyst' role

Where there is an identified user need that is not being met, the NPSO can act to 'catalyse' the market to encourage innovation. However, it is important that you find the right balance, and don't unintentionally stifle market-led competition and innovation by, for example, taking premature steps. We would like you to clarify how you will fulfil this role.

Risk management

The NPSO must ensure that the NPA is secure, resilient, and reliable. As part of the wider risk framework that you will develop, we expect you to adopt and enhance the NPA risk work developed by the Forum.

Other regulatory requirements

We already have a number of specific and general directions in place. You should note that where these obligations apply to the operator of a payment system for which you will become operator (for example, Bacs), you will become responsible for compliance. You may be interested to note that we are reviewing the directions we adopted in 2015 (General Directions 1 to 6 and Specific Direction 1). In the next few months we expect to consult on what changes to these directions, if any, are appropriate.

Next steps

I've written this letter to make sure you're aware of our expectations, so we can work together effectively to achieve the full range of benefits from the consolidation process and the NPA. While we have a range of powers which we could use to facilitate the successful development of the NPSO and delivery of the NPA, our preference is for you to manage these issues through the development of your TOM, your stakeholder engagement approach and your procurement strategy for the NPA.

I would appreciate it if you could send me your response to each of the issues in the annex to this letter, including the timeframes for each of the actions you plan to take. I recognise this will require you to consider carefully how these steps fit into your overall programme of work. I hope that you will be in a position to provide a response not later than 30 March, although an earlier response would be welcome. We plan to publish your response on our website.

I am fully committed to the success of the NPSO and the NPA. I look forward to continuing to work with you on these issues, and any others which may arise over 2018.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'H Nixon', written in a cursive style.

Hannah Nixon, Managing Director – Payment Systems Regulator

CC:

Melanie Johnson, Chair – New Payment System Operator

John Griffith-Jones, Chair – Payment Systems Regulator

Annex

The PSR's initial priorities for the New Payment System Operator

Issues we expect the NPSO to consider in its 2018 work

- 1.1** We have identified a number of priorities that we think are important for the New Payment System Operator (NPSO) to focus on. If it addresses these priorities effectively, the NPSO should be in a strong position to successfully implement consolidation and the New Payments Architecture (NPA). We describe below the outcomes we expect to see for each one, and the actions that the NPSO could potentially take. We have asked the NPSO to respond to us with its views and proposed actions.

Stakeholder engagement

Action: Ensure effective stakeholder engagement

- 1.2** We think the NPSO's approach to stakeholder engagement will be critical to its success as an organisation. The Payments Strategy Forum (the Forum) has shown how much can be achieved when stakeholders work together and market participants, from banks to end-users, have an equal voice and opportunity to engage.
- 1.3** Many of our priorities reflect the need for the NPSO to engage effectively with stakeholders to determine its work plan and strategy, and to involve them in the execution of that work.
- 1.4** Effective and ongoing stakeholder engagement will enable the NSPO to remain transparent and accountable. It also means it can remain fully informed of stakeholders' views, and ensure they are content with its approach to work which affects them. Considering how its decisions could affect users across the value chain will be crucial to the success of those decisions and help build broad support and legitimacy. This will be particularly important as the NPSO embarks on its ambitious programme of work to establish the NPA.
- 1.5** We want the NPSO to design an effective stakeholder engagement framework that can achieve these outcomes. We are interested in how the NPSO will use the two advisory councils recommended by the Payment System Operator Delivery Group (PSODG) as part of its formal governance framework, and how it will assess their effectiveness.
- 1.6** We also expect the NPSO to consider what additional structures have to be established with key industry stakeholders to take forward the design and delivery of the NPA.

Strategy-setting and decision making

Action: Embed the NPSO's strategic objectives into its governance processes

- 1.7 The PSODG developed the NPSO's purpose and strategic objectives to give the NPSO board a framework for decision-making. Importantly, this framework requires the NPSO board to base its decisions on the broad perspective of payment system needs – which are reflected in the strategic objectives. The framework also requires the board to contemplate and assess the trade-offs involved in specific decisions.
- 1.8 We fully support the use of the strategic objectives for NPSO decision-making. We agree with the PSODG's reasons for setting them, and think they will support transparency and accountability – as the NPSO uses them to justify its decisions.
- 1.9 Given the importance of the strategic objectives, we want to see how they will be embedded into the NPSO's governance arrangements. We want to know how the NPSO will deal with the following points:
- We think the strategic objectives should be written into legal documents, so that the board and other NPSO decision makers are required to consider them when evaluating options and making and justifying decisions.
 - We think the NPSO should develop a mechanism which it can use to ensure the rationales for decisions are recorded, so that if necessary these can be reviewed by the regulators.
 - We recognise that there may be a time when the NPSO needs to change or adapt its strategic objectives. We would expect the NPSO to first consult its regulators to get their support. As such, we want the NPSO to propose a process for changing its objectives which incorporates appropriate consultation with us.

Action: Publish an annual plan and report on its progress

- 1.10 As the body responsible for managing key payment systems in the UK, it is critically important that the NPSO's actions and decisions are transparent and accountable.
- 1.11 The PSODG envisaged that the board's guarantors could scrutinise it through an annual meeting. It also envisaged some form of public reporting on the NPSO's performance by its Advisory Councils. In addition to these measures, we think the NPSO should consider publishing an annual plan and annual report.
- 1.12 It could use an annual plan to communicate its work for the coming year in the context of its broader strategy. We expect that the NPSO will also identify key performance indicators (KPIs) to measure its own performance in delivering its work. The KPIs will form an integral part of the self-assessment exercise in the annual report, and inform the contents of each annual plan.

Competitive procurement of central infrastructure for the new payments architecture

1.13 The NPSO will be responsible for competitively procuring the NPA's central infrastructure and managing the resulting contract(s). It will need to structure, award and manage this contract effectively so it can deliver the NPA successfully without undue delay.

Action: Report on the competitive procurement of the NPA

1.14 Following our infrastructure market review (IMR), we introduced competitive procurement requirements that mean the NPSO must report to us every six months on the NPA procurement. The focus of that reporting is in part to enable us to understand how the NPSO is making the procurement as competitive as possible, through the design of the process and engagement with the market (for example, by testing the market to encourage credible bidders). We expect the NPSO to work with the existing payment system operators to seek any necessary extensions in accordance with our IMR remedy to enable the successful development and implementation of the NPA.

1.15 As part of undertaking procurement in compliance with the infrastructure market review remedy, it will be important for the NPSO to consider the following issues. We are keen to understand, from the NPSO's response to this letter, the NPSO's approach to the four points below.

- **Assurance of the Forum's blueprint:** We expect the NPSO to ensure the timely assessment and translation of the Forum's blueprint into detailed user/functional requirements, so that the procurement process can start without undue delay.
- **Securing user commitment:** The NPSO will need to develop an approach to ensuring that there is sufficient commitment from future users of the NPA to allow for efficient financing of the project.
- **Broader competitive dynamics:** The NPSO should assure that it has minimised the risk of the winning bidder using its unique position to affect competition in related markets (such as overlay services in the NPA).
- **Flexibility of technical design and contracts:** In the future, as new innovations are delivered through the NPA, there may be a need for adjustments to the central infrastructure. To maintain low barriers to entry and facilitate innovation, the infrastructure contract should allow for such changes at an efficient cost. We are interested in how the NPSO will achieve this through the design of its procurement process.

Action: Carry out a comprehensive migration planning exercise

1.16 We see that one of the first steps in the procurement process is a comprehensive and inclusive migration planning exercise. This exercise should enable the NPSO to engage and encourage potential NPA users (for example, payment service providers or third party providers) to plan their individual transition to the NPA. In addition, we think that such an exercise would be an important step in the process of securing user commitment for the NPA. Securing commitment from users is an important part of the procurement process, as it lowers infrastructure vendor risk, which in turn should help encourage an effective procurement competition, secure funding and minimise costs.

Annex: The PSR's initial priorities for the NPSO

- 1.17 We expect this migration planning exercise to start as soon as possible, to give all parties as much time as possible to prepare.

Development and management of rules and standards

- 1.18 The NPSO will be responsible for developing and administering the rules and standards for the NPA's central infrastructure and overlay services. It must ensure that the rules and standards are appropriate and that all NPA participants comply with them. We anticipate that from time to time the NPSO will need to change the rules in response to the evolution of the industry, or requests from stakeholders.

Action: Ensure interoperability and low barriers to entry

- 1.19 It is important that NPSO develops the NPA's standards openly, and that they are consistent with international developments. For example, it will be critical to take a joint approach and fully exploit the synergies with the Open Banking initiative. This will help to ensure consistency and end-to-end-interoperability, ultimately lowering barriers to entry for innovative solutions.

Action: Consult on initial NPA rules

- 1.20 The rules of the NPA must be fit for purpose, and have broad stakeholder support and legitimacy. 'Fit for purpose' includes enabling services to be delivered in a way that suits user needs, while facilitating interoperability and innovation. As such, we suggest that the NPSO formally consults with a full range of interested stakeholders to produce rules that meet these requirements.
- 1.21 To be transparent and accountable, it will be important for the NPSO to be able to demonstrate how its consultation process has informed the rules (for example, it should be able to explain why particular proposals have or have not been incorporated).

Action: Establish governance process for rule changes

- 1.22 There will be points in the future where the NPA rules may need to be changed – for example, to accommodate new innovation. It is important for the NPSO to establish a governance process for rule changes which is inclusive, transparent and credible, and includes a mechanism to evaluate the impact of the proposed rule changes on all stakeholders.
- 1.23 We consider that it is important that the rule change process enables a wide range of stakeholders to propose changes. This inclusivity should help to facilitate innovation. Furthermore, rule change proposals should be assessed against a clear framework that is based on the NPSO's strategic objectives.
- 1.24 Finally, the NPSO should be mindful of the costs to stakeholders of participating in the rule change process itself. This includes both the cost of initiating a change and the cost for others of responding to proposals.

Annex: The PSR's initial priorities for the NPSO

- 1.25** In designing this governance process, it may be useful for the NPSO to draw on 'best-practice' approaches seen in other industries. Other regulated sectors have governance arrangements that allow market rules to be changed at the request of users (or potential users). In order for changes to be made, appropriate tests have to be met. There is an agreed framework for assessing proposed changes and each application for change is assessed against that framework.
- 1.26** In addition to the above, we have specific regulatory powers relating to the rules of a designated payment system. As such, we expect to engage with the NPSO as it designs its governance process for rule changes, and to discuss our role relating to the NPSO's framework.

Market catalyst role

- 1.27** As described in the Forum's final blueprint, the NPSO could act as a catalyst for payments-related innovation where the competitive market is not meeting an identified need. While we support this idea in principle, we see that there is a need to more precisely define the role of a market catalyst. As it stands, there are risks that the NPSO may unintentionally over-act or under-act to stimulate innovation, potentially stifling competition-led innovation.

Action: Define the market catalyst role

- 1.28** The NPSO should publish the scope of its role as a market catalyst. This could include:
- Explaining the potential actions that it would or would not carry out in fulfilling this role. For example, it could choose to develop standards to enable innovation or provide test facilities – but not directly develop products itself.
 - Developing criteria for circumstances when it would (or would not) choose to carry out these actions.
 - Giving consideration to how it will ensure it does not stifle innovation and future competition (for example, by setting standards that are too restrictive or favour one solution over another).

Risk management

- 1.29** As the NPSO embarks on its ambitious programme of work, it will be imperative for it to have effective risk management. This will need to be consistent with existing requirements, such as those from the Bank of England. However, we do have one specific action in this area which we expect the NPSO to consider.

Action: Adopt and continue the Forum's risk management

- 1.30** In developing its blueprint for the NPSO, the Forum identified a comprehensive set of risks that the NPSO may face in the course of delivering the NPA. As part of an effective, best-practice approach to risk management, the NPSO must also ensure that the NPA is secure, resilient, and reliable. As part of the wider risk framework that the NPSO will develop, we expect it to adopt and enhance the Forum's NPA risk management work.