Overview of Pay.UK Decision:

A proposal by seven Participants to introduce a Faster Payments Service (FPS) rule requiring the payment of a Contingent Reimbursement Model (CRM) Fee

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Contents

Introduction

On 26 July, Pay.UK received a change request from UK Finance on behalf of seven Faster Payments Service ("FPS") Direct Participants: Barclays; HSBC; Lloyds Banking Group; Metro Bank; Nationwide; RBS; and Santander (this is referred to as "the Change Request"). The Change Request proposes introducing a requirement into the FPS Rules for Participants to pay a Contingent Reimbursement Model (CRM) Fee. The monies raised through the CRM Fee would be used to fund the reimbursement of all customers who fall within the category of "no-blame" as per the assessments outlined within the Contingent Reimbursement Model Code for Authorised Push Payment Scams ("the Code").

This overview explains the key reasons why Pay.UK is unable to progress the proposal and the next steps that we think should be considered on this issue.

Pay.UK, as operator of the FPS, and in its broader role as an independent, impartial financial market infrastructure positioned at the heart of the UK retail payments ecosystem, wants to work with the payments industry and regulators to do all it can to ensure consumers are protected and don't fall victim to fraud.

The Call for Information (CfI)

Changes to FPS rules can be proposed by any FPS Participant. Our governance, regulatory and supervisory requirements as FPS Operator ensure we consider the views of relevant service users when considering any proposal and, to support this, we sought views, insights and information from those stakeholders that would be affected by the change through a Call for Information (CfI). The CfI was published on 27 August and closed on 1 October.

The CfI was the first public consultation on the detail of providing a specific mechanism to fund "no-blame" cases. It has identified new information and views on this topic.

We received 41 responses to the CfI from a range of different types of Payment Service Providers (PSPs), as well as some businesses and charities. The responses were split in terms of support for the rule change – with 12 respondents in favour of the proposal, 24 opposed to it and five stating no firm view. As part of the CfI we also asked PSPs whether they would be willing to pay the CRM Fee – around a third of PSPs reported that they would be willing to pay the Fee, with two-thirds saying that they would not be prepared to pay it. **However, we found the vast majority of PSPs were supportive of providing reimbursement to customers in the "no-blame" scenario.**

The parties that support the rule change argue that the rule will ensure consistent outcomes for customers who are victims of APP scams, could create shared incentives to reduce fraud and should support more widespread adoption of the Code. Some of this group also consider that the rule change could enable other sectors to share in the burden of the cost of reimbursement (for example, firms that have caused data breaches). The PSPs have explained that the obligation created by this rule would help improve the quality of data on APP scams, which would help in pushing other parties to help prevent APP scams and contribute to the cost of reimbursement.

Those who oppose the proposal identify a number of specific issues with the rule change that impact on their individual business models. Many are concerned that the rule change would introduce unjustifiable cross-subsidies and may, in fact, have a negative impact on incentives to reduce fraud/fraud costs. There is a good deal of concern in this group about the lack of consideration of other solutions to the question of funding the "no-blame" scenario. A significant number of this group consider that better incentives for fraud control would be created by a so called "self-funding model" – whereby the cost of customer reimbursement for "no-blame" would be provided by the customer's own PSP, with that PSP then in the best position to manage the risk of APP fraud to its own business and customers.

Our Conclusions

The CfI explored a range of questions we identified relating to how the proposal fits against our core purpose and strategic objectives as FPS Operator. We have used the evidence collected in response to these questions to support our analysis and evaluation of the Change Request. We have set out our conclusions on each of five areas included in our CfI at Annex A and included a summary of our key conclusions in this section.

We support the work that has been done on the APP CRM Code and think that it is positive that a significant proportion of customers are already able to rely on the protections offered by the Code. In coming to a conclusion on this Change Request, we have been careful to keep in mind that we are not assessing the merits of customers receiving reimbursement in cases of APP scams – which we are strongly supportive of and which has already been considered through a broader programme of public policy work. The decision as to whether victims of "no blame" fraud are reimbursed is not for Pay.UK; this is, and has always been, a decision for PSPs. Through our work we have assessed the feasibility and impact of one possible approach to the collection of monies to cover the cost of "no-blame" reimbursements.

We understand the drivers behind the Change Request. There has been significant work by a group of PSPs to develop and commit to the Voluntary Code and stakeholders are looking for PSPs to make the same commitment – or to go further than the standards provided in the Code. In the absence of regulatory or legislative action, it is understandable that the proposers have looked to the FPS rules as an alternative route to mandate these arrangements.

However, evidence collected through the CfI and our policy, operational and legal analysis demonstrates a number of significant and unresolvable issues with what has been proposed, including:

- Given the lack of PSP consensus – and the nature of the arrangements proposed which don't relate to systemic or other risk management at the Payment System Operator (PSO) level – we don't consider that the proposal could be implemented or enforced in practice. This goes to the heart of the effectiveness of the proposal as a mechanism to require all parties to be required to pay the CRM Fee.

- We don't think it is right from a policy perspective for our rules to be used to make a separate and voluntary initiative, mandatory.

- The approach of creating a socialised, shared fund may dampen individual incentives to invest in fraud controls.

- It appears that requiring all parties to manage their fraud risk in the same way, regardless of their business model and systems and controls, may result in various cross-subsidies and an increase in cost for some Participants and, therefore, potentially a number of undesirable competition effects on the ability of and/or incentive for PSPs to compete, enter or expand in the market.

We have considered whether the issues identified could be mitigated through amendments to the Change Request. However, we found there is a fundamental misalignment between the problems that the Change Request is seeking to overcome and our ability to address these issues in our PSO role. As such we have decided that we cannot progress the proposal further.

Our Recommendations

Pay.UK - in its broader role as an independent, impartial financial market infrastructure positioned at the heart of the UK retail payments industry - wants to work with the payments industry to ensure consumers are better protected from APP scams. The open and transparent CfI that we have run has given interested parties the opportunity to provide us with their perspectives and so given us broad insight on this challenge.

From this, it is clear to us that there needs to be a concerted effort to reach consensus on the funding of "no-blame". As such we are proposing the steps that we think should be taken next on this issue:

- PSPs continue to have the ability to reimburse victims of APP scams. The APP CRM Code is a significant industry achievement and the regulator has observed that it is working well. **We hope that Code signatories maximise the benefit of the good work they've done in developing the Code by continuing their commitment to meet these standards.**

- In parallel to our consideration of the Change Request, UK Finance has been coordinating work with PSPs to look at other "no-blame" funding arrangements – which we understand could be included in the Code. From our CfI, we understand there is significant support for one particular model that has been considered through this work - a so called 'self-funding' arrangement – particularly among those not in favour of the Change Request. PSPs that supported this arrangement have pointed to self-funding as the simplest and easiest model to implement. We note that this type of arrangement could be developed so as to allow *flexibility for firms* to enter voluntarily into socialised arrangements such as the one proposed in the Change Request. Providing a flexible arrangement may be key to gaining consensus on how to fund "no-blame". **It is positive that the industry has carried out this work and in light of this evidence, we invite UK Finance to confirm whether it will be recommending this approach for inclusion in the Code.**

- Responses to our CfI indicate that the inclusion of a self-funding model in the Code – as well as some modification to the Code for different PSP business models - would open up the opportunity for more PSPs to want to join the Code. Evidence suggests that many parties that are not currently signatories support the self-funding approach. In light of this we expect more parties will be able **to commit to joining the Code under these circumstances**.

While recognising the Code is voluntary, we hope that the industry will come together and take these steps to move towards more consistent outcomes for customer protection. Further to this we consider there may be actions that other parties could take in the medium term:

- The Lending Standards Board (LSB), which administers the Code, has committed to review the effectiveness of these arrangements from July 2020. In light of the evidence from the CfI, we consider that this review could usefully include: (1) Ensuring that the Code is fit for purpose for a full range of PSP business models; and (2) Testing the overall effectiveness of the arrangements for customers. **We would be happy to share our insights with the LSB to support this review.**

- Pay.UK proposes to, with the support and resources of PSPs and regulators, coordinate work on the feasibility of developing a Guarantee (similar to the Direct Debit Guarantee). The aim of this would be for FPS Participants to commit to protecting their customers in the event of an APP scam and to formalise this commitment on an enduring basis. In order for this work to be successful there would need to be clear consensus among FPS Participants, and this may require regulatory support. It could be that this arrangement also prescribes data-gathering requirements for PSPs that would support the fight against APP scams. **Importantly, this solution could be flexible for those that prefer self-funding or those who prefer other socialised arrangements. We have today written to our Participants seeking their support for this project.**

- We hope that the industry is able to work together on these actions. However, APP scams are a crime committed across multiple payment channels. A Guarantee would only protect customers from scams (for which they were not at fault) perpetrated through a Faster Payment. To deliver a consistent solution for consumers across all payment systems would require regulatory and/or legislative action. We note that a legislative provision could not only resolve many of the issues we've identified through the CfI but also across other payment channels. **We welcome the Treasury Committee's report into Economic Crime which recommends the introduction of legislation to underpin the Code and protect the interests of victims of fraud. We are keen to see Government and regulators deliver on this recommendation.**

ANNEX A - Our analysis and evaluation

We have undertaken a thorough evaluation of the Change Request informed by the evidence we received through the CfI. In this section we present a summary of that work, on an issue by issue basis, as well as our overall observations on the proposal.

The use of the FPS rules to support a voluntary industry initiative

The Change Request proposed that Pay.UK, as the operator of the Faster Payments system, introduce a mandatory rule requiring that the FPS Direct Participants fund a voluntary endeavour – namely the monies for the APP scams "no-blame" fund. By introducing the requested rule, Pay.UK would be compelling FPS Direct Participants to play a mandatory role in this voluntary initiative. We think **this creates a significant issue** for the following reasons:

- There is a fundamental disconnect between a Code envisaged as a voluntary arrangement among a group of PSPs and the CRM Fee imposing the mandatory cost of the "no-blame" fund on a wider set of PSPs through an FPS Rule.
- There is a lack of control for Pay.UK over the arrangement. Changes to the effects of the proposed CRM Fee rule would lie with Code governance which is not subject to the same regulatory requirements and oversight as Pay.UK, in its capacity as FPS Operator. The proposed governance arrangements bring a lack of ability and control for Pay.UK to manage future risk and decisions which affect the attractiveness of using FPS. Many PSPs, particularly Indirect PSPs, have expressed concern that they would be unable to influence decisions on the scope of the CRM Fee

Consumer benefit

Consistency of operation and outcome for end-users is the key justification made by the seven PSPs that proposed the rule change. We have assessed the benefit that could be derived from the proposal for customers:

- **Code PSPs' consumers**: Benefits for Code PSP consumers arise from the Code not the FPS Rule. The FPS Rule is not the only way to ensure Code PSPs abide by the Code.
- **Non Code PSPs' consumers:** Non-Code consumers would gain from being reimbursed because of the FPS Rule (assuming their PSP would not otherwise have reimbursed them). However, non-Code consumers face a more complex claims process than Code consumers reducing their likelihood of claiming and indicating a lack of consistency in consumer protection[1]. Further, in the absence of the CRM Fee proposal, more PSPs may be prompted to join the Code which would bring a consistent approach to more consumers. (i.e. more PSPs may be willing to sign up to the Code under a self-funding arrangement).

[1] Non-Code consumers are required to complain to the Financial Ombudsman Service (FoS) in order to gain reimbursement from the "no-blame" fund.

- **Non-consumer customers:** Not all end-users of FPS would benefit from the Code since non-consumer customers (referred to as "business customers") are excluded from the scope of the Code. Business customers do not benefit from the CRM Fee; indeed they are likely to cross-subsidise consumers.

Incentives to reduce fraud

There are potentially **mixed incentives** with respect to reducing and preventing fraud and, therefore, investment in fraud control measures that arise because of the CRM Fee. These are explained below.

- **Improved incentives for fraud control**. If the CRM Fee causes some PSPs to join the Code that would not previously have joined the Code, and if the fraud control standards of the Code are higher than the fraud control standards of those PSPs, then this could improve fraud control. This is the position argued by the proposers of the rule change.

- **Reduced incentives for fraud control**. In contrast to the views of those proposing PSPs, the majority of other respondents were strongly of the view that the Change Request would reduce incentives for fraud control. They highlighted that this would result in the situation where PSPs that had higher and more effective standards of fraud control would subsidise those with lesser standards and, as a result, that PSPs would be less incentivised to maintain higher standards of fraud control.

Our view is that having a shared "no-blame" fund reduces incentives for PSPs to control and prevent fraud because they no longer face the full consequence of fraud committed against their consumers. It also raises the risk that PSPs will be incentivised to claim that they, or their customers, are not at fault in order to draw from the "no-blame" fund. Strong incentive arrangements would, however, be attached to PSPs being required to reimburse customers of APP scams in a PSP blame and "no-blame" scenario and being exposed to the full cost of those reimbursements.

Competition effects

We considered a range of issues relating to the potential impact of the proposed CRM Fee on PSPs' ability and/or incentive to compete, enter into or expand in the market. These are summarised below.

- **CHAPS and on-us transactions:** The definition in the Code of APP scams covers transfers of funds executed across "Faster Payments, CHAPS, or an internal book transfer" (i.e. where the sending PSP is the same as the receiving PSP, also referred to as "on-us" transactions). The Change Request therefore relates to some transactions that are executed across different payment channels. It is not appropriate for an FPS Rule to create such a requirement.

- **Introduction of cross-subsidies:** Using a centralised no blame fund introduces a range of cross-subsidies between different PSPs. This is because all PSPs would pay the same per transaction CRM Fee, subject to certain exemptions, irrespective of the extent of "no-blame" APP Fraud that their customers were faced with.

These various cross-subsidies reflect the fact that the extent of fraud faced by different PSPs and their customers will depend on a variety of different issues including the effectiveness of fraud controls, customer base, how customers use payments and different business models. Responses we received to the CfI suggest that the CRM Fee will introduce non-trivial cross-subsidies between PSPs, and that the exemptions proposed (as discussed below) would not necessarily be adequate to counteract any such cross-subsidisation. PSPs with a lower proportion of qualifying fraud (because of better fraud controls, more frequent low-value transactions, low-risk business models, and/or more business customers) will therefore subsidise other PSPs. Such PSPs would not be able to pass on the benefit of their lower fraud risk and costs to their customers, which may, in turn, cause a reduction in competition arising from reduced incentives to lessen and prevent APP fraud.

- **The provision of insurance**: The "no-blame" fund would mean that individual PSPs would be insured against facing the consequences of very large value "no-blame" APP scams. However, small PSPs have said in their CfI responses they do not value the insurance element of a centralised fund.

- **Increase in and commonality of a significant part of FPS marginal cost:** The CRM Fee will cause a non-trivial increase in the marginal cost of using FPS, which at least indicates a real possibility of an impact on the ability and/or incentive of PSPs to compete. Since all FPS Direct Participants will face the same increase in fees for qualifying transactions it is likely that this will be passed on to their customers including Indirect Participants. By contrast, if each PSP faced *different* marginal costs arising from APP scam fraud (which would be the case under a self-funding model), it would be more difficult for them to pass on any increased cost to customers because this would remain an element on which PSP costs would differ and therefore compete.

- **Incentives for innovation:** Higher costs and the uncertainty surrounding future changes to the CRM Fee could reduce innovation and, as a result, have a detrimental impact on the use of FPS over the longer term.

Proportionality

The proposed exemptions

The method of calculating contributions to the "no-blame" fund is proposed to be based on the number of each PSP's FPS transactions. However, various exemptions to the relevant number of FPS transactions have also been proposed. These have been proposed by UK Finance in order to address specific issues raised where a mandatory fee might be considered "unfair, an impediment to competition or otherwise compromise the attractiveness of FPS as a payment channel".

The exemptions are partly aimed at reducing the extent of the cross-subsidies, inherent in the centralised fund, so as to limit the extent to which they may give rise to a distortion of competition. However, the exemptions will not fully eliminate the cross-subsidies described in the previous section and, indeed, in some cases they are the root cause of the cross-subsidies. The exemptions also introduce monitoring and administrative costs over time.

It is worth noting that under self-funding arrangements none of these cross–subsidies would arise (with the possible exception of subsidies between sending and receiving PSPs depending on the precise self-funding arrangements).

Payback of interim funding

The PSPs that provided interim funding for the voluntary "no-blame" fund have stated that they provided this funding on the understanding that it would be recouped from others once a longer-term solution was agreed. Our view is that it would not be appropriate for PSPs that were not able to access the interim "no-blame" fund to be required to pay for it.

Operational assessment

We have considered the operational implications of the proposal:

- **Operational implications for Pay.UK**: Overall, the ongoing operational implications for Pay.UK as FPS Operator would be expected to be minimal.

- **Operational implications for FPS Participants**: There would be some operational costs for FPS Participants particularly in relation to changing internal processes to check and integrate the CRM Fee into their systems. Uncertainty surrounding future decisions related to the CRM Fee would also give rise to some costs. Overall the costs are not thought to be significant compared to other issues.

- **Administrative costs for the fund administrator**: Administrative costs of operating the "no-blame" fund will be incurred but these do not appear to be significant compared to other issues.

- **Enforcement:** For the overall arrangement to work effectively, all CRM Fees would need to be collected. Some PSPs have chosen not to join the Code and some PSPs have said that they would be unwilling to pay the CRM fee. As such there would need to be an appropriate mechanism in place to deal with situations where the CRM Fee is not paid by individual PSPs. Given the sanctions available to us, as FPS Operator, there may be challenges surrounding enforcement of non-payment of the CRM Fee. (N.B. This brings into question whether the rule change would actually deliver the policy intent behind the proposal).

Implementation assessment

Given the divergence of views on the proposal, we have also undertaken further work to understand the likelihood of our being able to implement and enforce the rule change in the case that the proposal were taken forward. We think there would be significant difficulties in the rule being implemented because it would require both the amendment of the FPS Rules and the participant agreements. FPS Participants can refuse amendments to the participation agreement. As such an individual FPS Participant that does not support the CRM Fee rule could effectively block its implementation.

The reason for this is that the FPS participation agreement is a single, multilateral contract (one contract with each of the FPS Participants being a contracting party to that one agreement), therefore, we have an 'all or nothing' situation in that:

- If we were to effect an amendment to the participation agreement we would require **all** FPS Participants to agree and sign the same amendment;

- The way the contractual framework for FPS is designed, and the potential impact of the regulatory and supervisory requirements as to access, means that we cannot negotiate unilateral amendments/side letters with just any one or group of participants (i.e. all FPS Participants must agree all the same contractual amendments); and

- In some cases we have tools to help encourage Participants to accept amendments to their participation agreements. Where a change is to deliver 'an appropriate risk management tool' to manage systemic or other material risks created by, or in connection with, the operation of FPS, we can suspend or revoke participation for those who do not accept the proposed contractual amendments or refuse to sign the amended agreement. However, because the **purpose** of the CRM Fee does not fall clearly within Pay.UK's risk management functions as Payment System Operator of FPS[2], we would be unable to follow this approach in this case.

This creates a similar enforcement issue as identified above and goes to the heart of the effectiveness of the proposal as a mechanism to require all parties to be required to pay the CRM Fee.

Bringing this together – our observations

As can be seen from the above, our findings are that there are significant issues with the proposal. We have considered these issues in relation to Pay.UK's strategic objectives and legal and regulatory/supervisory obligations. We found that the most significant issues are:

(a) The use of an FPS rule to mandate the support of a voluntary initiative.

(b) The lack of control Pay.UK would have over the setting and use of the CRM Fee.

(c) The potential dampening of incentives for individual PSPs to tackle APP fraud.

(d) The use of monies raised on the basis of FPS transaction volumes to fund the reimbursement of frauds committed via other payment channels.

(e) The level and design of the CRM Fee, potentially creating an impact on the ability and/or incentive of PSPs to compete, including as a result of undesirable competition effects including various cross-subsidies and a notable increase in cost for some Participants in comparison to their managing "no-blame" reimbursement on a self-funded basis.

(f) The proposal that the PSPs that have provided funding for the interim "no-blame" fund during 2019 receive this funding back from all PSPs (despite other PSPs' customers not having benefited from the interim "no-blame" fund).

(g) Concerns over our ability to effectively enforce the rule were it to be put in place.

[2] To introduce measures to monitor, manage and mitigate risks that have a direct impact upon Pay.UK/ upon participation in FPS/ or otherwise upon the safe and efficient operation of FPS.

(h) **Concerns over our ability to effectively implement the rule given the number of FPS Direct Participants that oppose its introduction, and given the nature of the arrangements proposed (i.e. which don’t relate to systemic or other risk management at PSO level).**

We have considered whether the issues identified could be mitigated through amendments to the Change Request. However, we found there is a fundamental misalignment between the problems that the Change Request is seeking to overcome and our ability to address these issues in our PSO role. As such we have decided that we cannot progress the proposal further.

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