

Inside FCA Podcast: What are the challenges and opportunities for the payments sector?

OI: Hello and welcome to the Inside FCA podcast. I'm Ozge Ibrahim and today we're taking an in-depth look at the payment sector, a part of the financial system that has seen monumental change in the last five years. New technologies and products have fundamentally shaken up a part of everyday life. Much of this change has been driven by regulation with PSD2 which was introduced to prompt innovation and competition, and help make payments safer and more secure and open banking. So, what are the issues and how should the FCA as co-regulator of the sector respond to them? We have a range of perspectives from our panel of experts: Chairman of payments association P20, John Hutton, Director General of the Emerging Payments Association, Tony Craddock and from the FCA, Maha El Dimachki who is responsible for the supervision of all payments firms in her role as the founding Head of the FCA's Payments department. Welcome to you all.

I'd like to start off by asking what the top challenges are facing the payments sector? Maha, would you like to kick us off?

MED I'm not sure if I'll call it challenges but with opportunities actually come risks and that's where perhaps the challenges come into us. There's a lot of growth in this sector at the moment, there's tremendous growth, there's a lot of innovation that's going on in the sector, there's a lot of excitement around the sector but with that comes some of the risks that we as regulators want to make sure that we look out for. So when we are looking at new business models entering, when we are looking at different ways in which people interact with their money, their banks, non-bank payment firms and how they send and receive payments or how they send and receive funds, what are the regs that sit around that particularly as new emerging models come to life but also what are the unwritten rules that will dictate various outcomes and really the focus is on making sure that these outcomes are the right outcomes for the economy and specifically for consumers.

TC With a backdrop of regulation being a critical part of this, the challenge I think our industry is facing in payment is to do with the plethora of new and whether it's new regulations or new products or new technology or new distribution channels, new users, we are grappling with and trying to work out how to optimise how we service all these people in a way that really positively impacts all the various stakeholders, whether it's a user or the investor or the management or ultimately the economic beneficiaries behind this who will gain from a successful payments industry. It's getting alignment between these various new things and making sure they can be complementary rather than contradictory that I think is going to be the secret of success in the next one, two or three years.

JH So I think one of the main challenges especially in payments is that we have to wrestle with the convenience and instant type of culture that was being developed at the moment through, you know, social media and so forth where people aren't prepared to wait for things anymore and yet we have payments systems and services that are same day settlement, batch processing and so forth that means that people don't get their money at the time that they expect it – they want it now. The challenge with that is because they don't get it now, they move and use different payments types, they lose patience and banks and payments companies take quite a beating for that.

I actually see the opportunity in there is that there doesn't seem to be a huge amount of new payment types coming through, there's an awful lot of overlay services, an awful lot of companies who are being developed in order to provide value-add type services but they're all still sitting on the existing payments rails and what I think needs to happen better and more quickly is that the underlying infrastructure becomes real-time and that's real-time for every payment type so that people can get those, and use the payments and settle them instantly in the way that they expect.

MED That's really interesting isn't it because, I mean, there's a lot of conversation at the moment around friction, less friction, more immediacy, like you said, and the rate of fraud and whether we see that they're associated, whether the – you know, this concept of everything having to be real-time is actually potentially going to contribute to forward and we know that there are £208 million lost to APP fraud last year, I believe, and £237 million lost to card fraud, and so fraud is a real important topic for us and we're kind of looking at, you know, with this concept of immediacy and with this concept of less friction and real-time payments, what does that mean?

TC I think we've got a couple of things coming down the line, haven't we? We've got strong customer authentication, we've got confirmation of payee – these are going to be small little bumps in the road in terms of the consumer's experience which is good. So there are some particularly important payment types that you don't want to have in real-time, so you don't want to be able to buy a house by authenticating the transaction on your phone – you need to have some hurdles in the way to make sure that you really do want to buy the house. So, sometimes, for some transactions, frictions can be good. What I think we're going to see, we're going to see some of these things like confirmation of payee and strong customer authentication – they're going to start to move the fraud into softer areas. So, let's not forget fraud doesn't stop, we can't stop it, we won't stop it, what we have to do is to make sure it's going into areas which are more containable and in time that ultimately will improve or reduce the cost of fraud. I don't know whether you agree with that, John?

JH I do in part. I think a lot of this comes down to consumer choice. I think some people will want to buy their house using, for example, a real-time or faster payment. Confirmation of payee that you mentioned is a really interesting one. I mean, if you think how far BACS are behind lots of other basic validation techniques that you have when you look for address finders and so on, you know, simply having something in there that says, Is this the intended beneficiary? Can you check? Seems like we missed that many years ago and it's now coming through.

Now, these aren't catch-all type anti-fraud measures, they're not going to prevent romance scams, investment scams and other types of scams. They will prevent things like invoice scams where details will have been checked and so on and I don't think we have to pretend that we're going to, to your point, Tony, solve everything. On strong customer authentication, I think strong customer authentication's going to push payment traffic away from cards because I think yes, the intent is very good, you can receive a one-time passcode or whatever the model might be that a bank uses but unless that SMS comes through within a certain timeframe, people are going to move onto another card and it's going to get faster and so on and so on because, again, they're always going to go back to that level of convenience and trying to get it instantly, and I think it's going to be really interesting watching how that develops over the next couple of years.

OI And can I ask, I mean, going back to the question about choice and scams particularly, what are some of the challenges this poses for the regular, Maha?

MED Well I think, you know, let me actually qualify the figures that I just gave just in the first half of 2019 – I said, not from last year, but the first half of 2019. You know, fraud is one of our – the key harms, it's a really important priority for us to constantly monitor and assess. And we appreciate that it's not necessarily going to go down to zero, that would be great but realistically that's not the case. The initiatives that have come in like confirmation of payee and strong customer authentication actually contributing to the reduction of fraud. We'd also like to see, you know, what is the market thinking about in terms of where are the challenges around fraud and what can we innovate around this area where we're not necessarily competing on fraud, it is something that hopefully everybody comes around the table to reduce it because it is a cost and an impact to all businesses.

So we're hoping actually that whilst, you know, everyone understands that fraud is a priority for the regulator but also important for all the participants to contribute to the reduction of fraud and fighting fraud, what is the impact of innovation on getting that kind of – those ideas out there to reduce fraud?

TC This is where the elephant in the room sits, I think, and it's referred to as digital identity. It's the thing that, without a doubt, if we could crack that one in this country, as we have shown in many other countries, we can get to avoid all sorts of harms impacting on various stakeholders. There is some history here, there's some willingness around consumers to adopt digital identity and all of these things I think have mitigated against us really embracing this. I think we need a strong but a central government push from this, I think we need an edict from the Bank of England to say let's treat this seriously and I think we need to have some heads banged together to say how do we go about building a commonly accepted ubiquitously adopted digital identity system in the UK.

JH Which it would for 80% of the UK and the rest who are still dependent on cash and maybe don't have access to internet and so on – we have to still be very cognisant of financial inclusion, being able to cater for those who don't have smartphones and so on and one of the things I've seen in my previous role at Nationwide is that the real sort of – the member demographic of how that gets split across people that use digital payment types and then those who are still very much dependent on cheques and cash and making sure that we don't leave those behind.

We are very much moving to a digital payment economy but taking the Swedish example who have gone towards this very much cashless society but went too quickly and are now having to reinvest into the cash society because they understand that still 10-15% of the population are very much dependent on it and the digital KYC kind of system, as controversial as it might be in the UK, is a global phenomenon, you know, and the US as well – they're absolutely struggling with it.

OI And do you think there's a risk to consumers of that rapid pace of change that you've described from Sweden, for example?

JH Yes, I think so. I mean, I think having been part of the Access to Cash Panel a few months ago, some really stark numbers came out of that in the UK alone, still 20-25% of the UK are very much dependent on cash. We can't pretend that everybody is using digital payment types and in fact the use cases that are always projected which frustrate me slightly because they all seem to be very much more disadvantaged parts of the country to demonstrate the use of cash isn't always fair. But what has been seen through the research is that people who are struggling with bills, who are in debt, who have money issues, gambling issues and all sorts of different things, revert to cash as a way of being able to budget better and that's a really strong way of them being able to get back on track.

Now, we can't just stigmatise cash and say it's only those who want to get themselves back on track that are going to use it or those who are trying to commit some kind of money laundering scam are using it because that's kind of what's happening in different countries in the world – it's still very much a payment type that we have to make sure that people don't get left behind in this push towards digital payments.

TC So now I think our job is more about promoting adoption, promoting education, promoting engagement in these things so that my poor mum and dad who may not be natural digital equipment users are educated, informed and guided and helped. And so, I think we have some responsibility as an industry to help to educate and promote the adoption of these things because they're good and they help people, and it's not the same as cash, I'm not denying that cash is still important and preferred for a lot of people but at some point we have to remember that these are good things that we should be promoting and encouraging.

MED Certainly, the point on education is a really important one. I think education generally in terms of, you know, financial knowledge, you know, how to engage with your financial affairs – but generally actually as you rightly mentioned right at the beginning, things are becoming a lot more complex. We are trying to solve quite a lot of, you know, problems and we're coming up with great ideas and solutions but, you know, there are times where I find that consumers might be quite confused with all of this and trying to decipher what is good for them becomes very, very difficult.

So this idea of education and clarity of what outcome is the consumer actually signing up to rather than just the features and, you know, attributes of a product – what is the outcome that they're going to get from it and potentially what are the risks of them signing up to this product? Because, I mean, again, financial services carry risk – that's the premise on which financial services is set up. So, this idea of education and actually ensuring that there is clarity of message for consumers to make the right choice in a world where things are becoming quite confusing when – I know it sounds like a paradox – it's becoming confusing even though we're trying to solve problems and make life simple and getting that balance right is really important.

OI And what do you think firms can do, Tony, to help with that?

TC Well, we've just launched something called inclusion signpost which is a comparison site – it essentially allows you to go on there and say if I'm this sort of person with this sort of... – I think I use the word Avatar but it's not that...this sort of person in this sort of place, these are the products that are best suited for me as somebody who might want an account. Now, that's one of many financial services products, an account, but it's a very good product, it's going to be distributed through the Inclusion Foundation as I've mentioned, and that's an example very specifically shining, holding a mirror up to the industry, helping it to actually show people what the various products do.

JH We can't forget that we're talking about adults who have to be of a certain age to be able to open a current account, to have money coming into it, to being able to spend that and make conscious decisions around what they do. I think it goes back further. I mean, if I think of my children, they don't learn at school how to budget, they don't talk about getting an income and then an expenditure profile that says if you spend all your money every month, you're going to be in the red and you might have to take a loan and that's a cycle of doom and so on. I'm not saying that's for everybody but, you know, it could be.

And I think it goes back further – I think that the education has, to your point, Tony, there's some great tools out there that can really help. We should be pushing to get them incorporated into the overall general syllabus so that kids as they come through and they get into further education or first jobs or whatever it might be, already have an understanding of how to be able to manage their money, already can budget and so on because we're on the back foot now – we're looking at banks and we're looking at payments associations and saying, Well, it's our job to go and educate people how to spend money.

Well, I think we can help but people still have to be accountable for how they spend their money, they still have to be accountable for what they spend it on and when it comes to fraud, to your point, Maha, I mean, they click on those links, you know, they click on the things that say they're going to get their inheritance and that person that says they loved them in some far flung country that they never met before and then they send all their life savings over, they consciously make those decisions and we just have to find the balance of where do we fit in that because we can't be held accountable for people making those decisions.

OI Isn't there a challenge as well in trying to educate on such rapidly developing digital technology? How do you do that?

JH That's a good question. Maybe there's an opportunity for a slower payment rather than a faster payment, you know, somewhere that you can – I know that there are tools and companies out there that could park it so that there's kind of a way by which somebody who might not fully understand how to use the tools and the speed at how things work, that can park the payment for a day or two whilst they consider what they've done and so on.

TC It sounds like a cheque!

JH It sounds like a cheque, you know, which are now digital!

TC Yes, that's true.

JH You know, so it's really interesting how, again, it comes back down to consumer choice. You know, we have to give people a range of options how to pay and so on, and then they make their choice and if they don't want it to go fast, then they should get that opportunity. If they want to take some time to or a grace period before they pay for something, they should take that opportunity but they have to be responsible for what they're paying for.

MED You know, as we were talking, I was reflecting on how many payments firms we have, these are not the banks, we're not talking about the banks who have a banking license, we're talking about the non-bank payment institutions. We have 1,100 of them today and there's something like 200 that are looking to come through the gateway – so add 200 or so to that number if and when they get authorised. So, it seems like the – the interest in conducting some kind of payment activity is not waning at the moment and there's a lot of innovation around that. 30% of the first cohorts coming through our Sandbox are payments firms, were payments firms, and there's still some, you know, some numbers around that – perhaps the ideas aren't innovative so they don't necessarily make it to the Sandbox but they are coming up with innovative ideas.

OI Could you explain the Sandbox, sorry, for anybody who doesn't know what the Sandbox is?

MED The Project Innovate, so our FCA Regulatory Sandbox for new and novel ideas of firms who need to be regulated by the FCA but want to test their idea against the regulations so the general feedback we get is it's been quite useful for those firms.

So what I'm concerned about – I mean, there's the excitement of the growth and the innovation and the new ideas flooding into the market and open banking etc, but there's also the standards aren't where we want them to be so some of the key priorities for us after some eighteen months of working with these firms, you mentioned that the department is a newly created department and we've been working with these firms over the last eighteen months and we're seeing where some of the gaps are and it is around how do you safeguard customer funds, how do you make sure that your customer funds are protected? You know, are you safeguarding correctly, are you co-mingling, have you got the right records, are you reconciling the right way? So all of those questions are really, really important to get right.

The other is around just prudential soundness, understanding what is your path to profitability, what is your exit strategy, do you need a wind-down plan? Well, best practice is to have a wind-down plan in any case but do you have that and do you understand what that should look like, you know, should you need to wind up. And the other is we don't want these firms to be a vehicle for financial crime so your AML processes and procedures and all of that sits under the banner of governance and, you know, risk controls and making sure you've got the right systems that are going to actually protect the firm, therefore protecting its customers.

So I'd like to see that those standards – we're working very hard with the industry to make sure that those standards are lifted so when we are moving more and more into new business models and innovation and great ideas being deployed and more uptake from consumers in the market, that we're starting from a solid base rather than a shaky base. And that's kind of a key thing for us at the moment.

JH I mean, I agree with you, Maha, that the standards need to continue to improve. I do have some views with regards to, let's say a lot of these 1,100 and maybe 1,300 payment type companies that are coming through who really don't have an inkling of just exactly how much governance and regulation they're going to be hit with when they have an established customer base and what that could potentially mean. And that's why I think the tech giants are staying away from current accounts and those types of products because if you take the big e-com retailers, they could be the ones that actually push open banking by adopting it through their channels and saying actually move away from cards and use this faster payment real-time mechanism to be able to pay for things – if that happened, it would take off, right, and then we would get what we've been looking for which is a proliferation of open banking across lots of different e-com sites.

TC I think that's a good forecast. I think the other thing is, just to stress, that the industry is absolutely determined to lift the standards as well, as you just said. And we want to be working very much more closely with the Supervisory Department of the FCA to make sure we can understand what we need to do to raise the bar and to find a way of funding the sort of support that we think is needed from the FCA, we've got to be very creative. I don't know quite what that means just at the moment but we've got to find a way of making sure that you can support us. So we want – we want... we want some partnership rather than policing, so the ideal thing would be that there are no failing PIs and no failing EMIs and no failing credit institutions – that would be the great thing because you'd helped us to keep our standards at the highest level so that we didn't break the law.

OI Is there anything final points you'd like to make, Maha?

MED Payments is an eco-system, it serves the economy. I think, you know, I was explaining it to somebody I know the other day and they said it's a bit like kind of the blood supply to all the different parts of the body, it takes the oxygen to the different parts of the body and I think that's what the payments infrastructure does for our economy. And so it's an eco-system and the way the eco-system is going to work well is if all participants are actually collaborating and so it's a really important point around ensuring that everybody in the chain understands their role, understands what everybody else's role and they're collaborating to get the best outcomes.

OI Thank you, Maha.

TC So my concluding comment is I genuinely believe we're very good at this in the UK, got a unique partnership between the FCA as a regulator, and us as the industry. We have a chance to use payments as a source of competitive advantage on the global stage regardless of what happens with Brexit, whether we're in the EU or not, I think this is something we should be focusing on and becoming very proud of being able to enable the world to move money better.

OI John, last from you, please.

JH I've said this point before on a number of different panels and that is I think we have very progressive regulators in this country and I think because of that, we're able to try and push the standards in ways that we don't see across other different European and non-European countries. I think the payments industry absolutely wants to collaborate and I think it's an open door, absolutely, there to be able to bring together the different aspects of that eco-system so that we can get the best outcomes.

OI That's all we have time for today. I'd like to thank my guests, Tony, John and Maha for their time and expertise. I'm Ozge Ibrahim, join us again soon for the next Inside FCA Podcast.