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PAYMENTS INDUSTRY TRENDS IN A HYPERCONNECTED WORLD

The payments industry is undergoing significant changes, driven by technological innovation, new regulations and the broader macro-economic environment. We identify some key trends that are emerging.

Summary

Digital and card payments are on the rise as use of cash declines. Recent years have also seen a proliferation of fintechs offering innovative payment services and solutions. At the same time, there has been a focus on the role of competition in payment services, with Open Banking initiatives requiring payment account providers to provide account and data access to new market players. Whilst the initial focus has been on retail payments, opportunities for similar innovation in other segments of the payments market, such as with SME and wholesale clients are rapidly emerging.

Whilst commerce is becoming more global and interconnected, the decline in correspondent banking continues, despite efforts to halt this trend. However, new technologies and models for faster and more efficient cross-border payments are gaining traction. Related to this, the van Steenis report on the Future of Finance recommends that the Bank of England should develop infrastructure to make cross-border payments more efficient and cheaper but also keep abreast of developments in relation to crypto-assets. Significantly, however, the report supports the Bank's decision not to develop a central bank digital currency at this stage.

Finally, there is a much greater focus on cyber and other operational risks that accompany these technological innovations from both firms and regulators, with a view to ensuring payment system security and resilience.

A roadmap for the future of cash and digital payments

Financial inclusion in a cash-light society

At the retail end of the market, the shift away from cash to electronic payments continues, raising questions about the sustainability of the current cash payment model. In 2017, the number of card payments overtook cash payments for the first time. Mobile payments are also on the rise, whereas the decline in ATM transactions has been accelerating and some (mostly independent) shops and cafes have stopped accepting cash altogether.

This shift in payment habits of individuals has significant implications for the viability of the current cash payment model over the medium term. There are also concerns to ensure that this move towards more digital payments does not lead to financial exclusion, particularly for less affluent, or elderly or rural communities, who may be unable to benefit from these technological advances and continue to rely on cash. Sweden's move to digital-only is posited as an example of technology adoption leaving some in society behind.

In response to these concerns, the LINK-sponsored UK Access to Cash Review published recommendations in February 2019 calling for the UK government and regulators take action to ensure continued access to cash over the next 10–15 years. HM Treasury and the Bank of England have already taken preliminary steps in this direction. In May 2019, HM Treasury announced that it would set up and chair a Joint Authorities Cash Strategy Group to facilitate further co-ordination and oversight of cash infrastructure (including steps to improve resilience and efficiency) and how best to ensure access to cash for those that need it. As part of its response to the van Steenis report on the Future of Finance, the Bank of England also indicated that it has "*convened relevant stakeholders to develop a new sustainable system for cash distribution*" and is launching a forum to explore the future of money in an increasingly digital economy.

Innovation, competition and Open Banking
At the same time, the UK government and regulators have been exploring how to support a broader transition towards digital payments and harness the benefit of other technological innovations in the payments space. The past few years have seen a proliferation of fintechs offering innovative payment services and solutions. According to McKinsey & Company[1], around 35% of all UK fintechs and financial innovations relate to payments and more than 10% of estimated card revenues for 2017 were captured by new firms entering the market within the last 10 years.

A key aim of the UK Open Banking project (and similar EU-wide requirements) was to support this innovation and encourage competition particularly in retail payments. The UK Open Banking initiative requires the 9 main UK retail banks to provide access to third party payment service providers via Application Programming Interfaces (**APIs**), with various other jurisdictions requiring or encouraging use of APIs for similar data sharing purposes.

These initiatives are ongoing but the take-up of account information and payment initiation services by consumers remains fairly limited, despite the significant investment made by banks in developing APIs to allow secure access to customers' accounts and data. The van Steenis report therefore recommends that HM Treasury should lead a review of lessons learned from the first 18 months of Open Banking and how to mitigate risks, make adjustments and galvanise opportunities, such as dovetailing with proposed smart data initiatives in other areas. Amongst other things, we expect that this work may seek to address the reluctance of many consumers to share their data (even with regulated third-party service providers), as identified in responses to the Payment Services Regulator's discussion paper on data in the payments industry.

1 New analysis provided for the van Steenis Future of Finance report (p27)

We expect to see a shift in consumer attitudes and greater adoption of Open Banking over time, but the more immediate opportunities may lie with applying Open Banking technology in other contexts, such as provision of payment services to SMEs. The van Steenis report highlights that 83% of SMEs use a mobile banking app. Therefore, SMEs are likely to have access to and familiarity with the technology to make good use of the benefits that Open Banking might bring, as well as a commercial incentive to find and adopt efficient payment solutions.

The van Steenis report also highlights potential opportunities for use of Open Banking technology outside the payments space, for example by opening up SMEs' access to their tax and credit data and enabling third parties to provide overlay services. The UK government's Smart Data consultation, published in June 2019, proposes extending Open Banking-style secure data sharing to financial services more broadly as well as to other industries. We therefore foresee payments leading the way as part of a broader trend towards secure data sharing and the emergence of platform-based ecosystems across a wider range of financial services.

The entry of Big Tech firms into payments and financial services is arguably even more significant at a global level than the proliferation of fintech start-ups that we have seen over the past few years. Indeed, Big Tech firms already have global footprints and customer bases and advantages of scale that fintechs do not. To date, we have not seen mass adoption of payments integrated with social media in the UK, in contrast to China and certain other jurisdictions. Nor does it seem likely that Libra will achieve this end, at least in its current iteration, despite Facebook's ambitions for Libra. However, the Libra announcement has focussed the attention of policy makers and supervisors on the myriad challenges posed by the potential mass adoption of a decentralised cryptocurrency and has accelerated discussions in this area. Big Tech firms are providing payment services and the evidence suggests a desire to increase their foothold. Banks beware.

Payments infrastructure and data

The Payment Services Regulator (**PSR**) is also exploring use of data in the payments industry and intends to look at the feasibility of opening access to scheme-wide datasets and building a data sharing capability into the New Payments Architecture. The PSR hopes that this will enable firms to develop so-called "overlay services", such as transaction monitoring for fraud and financial crime and more efficient processing and reconciliation of payments. In order to address concerns around data privacy and security, the PSR intends to look at the possibility of using "synthetic data" – i.e. a computer- generated, artificial dataset with characteristics similar to the real data – to allow firms to explore potential use cases for scheme-wide datasets without putting real transaction data at risk.

At the same time, Pay.UK and the Bank of England are also upgrading their payment systems infrastructure to use the ISO 20022 messaging standard, which will allow for inclusion of richer, enhanced data in payments messages. Migrating to ISO 20022 is likely to require substantial industry investment but may also bring benefits to the extent that this enhanced data can be utilised, for example in the provision of new overlay services. Indeed, data quality will be a key factor for firms assessing the viability of potential use cases for overlay services in the payments space. We therefore expect to see the migration to ISO 20022 going hand-in-hand with firms starting to explore opportunities and develop use cases for further unbundling of business models and provision of overlay services using payments data.

Access to payment systems

The Bank of England was the first G20 central bank to open up access to its RTGS service to non-bank payment service providers in 2018 but we expect other central banks to follow suit. The Bank of England has indicated that it intends to consult further during 2020 on how banks and other payment service providers should be able to access its payments infrastructure and balance sheet, including what safeguards are appropriate for different levels of access. Connected with this, the van Steenis report recommended examining the possibility of introducing "tiered" regulation of payment service providers, with the aim of ensuring that firms are regulated in a way that is commensurate with their activities and level of access to central payments infrastructure.

The Bank of England has, however, decided not to develop a central bank digital currency (**CBDC**) at least at this stage. This appears to be for a number of reasons, not least that creation of a CBDC has potential to effectively disintermediate the banking sector, as it would give end users of payment services direct access to central bank money (in digital form). The Bank of England has instead indicated that its priority is instead to enable private sector innovation in this space, with the aim of enabling development of next generation electronic payments that are both diverse in nature and resilient. For example, this could include the development of a Utility Settlement Coin (**USC**) to facilitate settlement of the payments leg of transactions in digital assets, as envisaged by the Fnality consortium of banks, as well as other similar initiatives.

Cross-border payments, correspondent banking and stablecoins

We expect that the volume of cross-border payment flows may continue to increase over the coming years. This is due to a number of factors, including the growth of e-commerce and the rise of China and other emerging economies in global markets. However, cross-border payments remain relatively slow and expensive, relying in many cases on correspondent banking networks. At the same time, correspondent banking has been in decline for a number of years. For example, in May 2019, Moody's indicated that there had been a cumulative decline in correspondent banking transactions of nearly 20% between 2011 and 2018.

This decline has been attributed in large part to concerns around AML and CTF compliance, as well as changes to banks' risk appetites, compliance costs and the low interest rate environment. However, it is a matter of concern internationally, with the Financial Stability Board and Financial Action Task Force both working to try to slow or halt this decline, for example by looking at ways to improve AML compliance in some "respondent bank" jurisdictions.

One implication of this is that there is a clear need for improvements to cross- border payments infrastructure. This work has already started, for example with the development of SWIFT's global payment innovation (gpi) and the Bank of England exploring proofs of concept for innovation in cross-border payments and settlement in partnership with fintechs and other central banks. We foresee this will continue to be a key area of focus going forward.

Another potential solution being explored and developed in the industry relates to the use of stablecoins to settle cross-border transactions. We expect to see continuing increased interest in stablecoins, both due to their potential to reduce friction in cross-border transactions but also because they could open up the possibility of settling transactions on a distributed ledger. The use of distributed ledger technology, however, raises important legal and regulatory questions and until some of these are answered with certainty, there may be pause before market-wide adoption.

Managing cyber and other risks
Regulators across the globe recognise that technological innovation comes with both opportunities and risks, including cyber and operational risks. As payments has become more reliant on technology, so too these risks have grown and evolved. We therefore expect to see a growing focus from regulators on how firms manage and mitigate these risks. New regulations such as the revised Payment Services Directive (PSD2) and GDPR have also introduced incident reporting requirements, which may increase regulatory and, in some cases, public visibility of the frequency and severity of operational incidents, cyberattacks and data breaches.

Alongside this, one of the Bank of England's current strategic priorities is to improve the financial sector's operational resilience, including by developing a cyber stress testing programme. This reflects a broader international trend as the Basel Committee has recently also established an Operational Resilience Working Group with a remit covering both cyber and operational resilience.

As recommended by the van Steenis report, the Bank of England may look at ways of enhancing data recovery capabilities across the financial system in the event of a major cyber-incident. For example, this could include mechanisms for firms to "step-in" for each other in the case of outages, in a similar way to the US Sheltered Harbor cyber-resilience initiative.

About Clifford Chance's Global Payment Services Group

An International, premier payment services team

Clifford Chance has a **market-leading international payments services group**, with an unrivalled depth and breadth of experience in transaction services, payments, technology, privacy and data protection. Ours was the first dedicated payments practice to be established among the other leading global law firms.

Our partners are recognised as the leading payments lawyers in Europe. We advise leading market participants on an immense range of payment matters from product development to dispute resolution, from regulatory change implementation to strategic partnerships and collaborations. **We advise actors throughout the ecosystem:** payment systems, corporate, retail, private and challenger banks, fintechs, governments and regulators.

Teams at the forefront of financial services regulation

Our practice group has **played a leading role in shaping new legislative and regulatory frameworks** across a broad range of markets. We have been deeply involved in developing legislative frameworks globally. We work closely with governmental and regulatory bodies and with industry associations, exchanges, and clearing, payment and settlement entities.

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The Clifford Chance team has **invested time in building relationships at all levels** with world financial services regulators (such as the Bank of England, PRA/FCA, Federal Reserve, BaFin, ECB, MAS and others), policy makers and industry associations. We have a sound understanding of the approach of these regulatory authorities.

Experience in handling complex, cross-border regulatory issues

Our geographical reach is unique, we are recognised as having strong advisory practices in the US, the UK, Continental Europe, the Middle East and Asia – a strength that is particularly important to global financial institutions who form our core client group. We have extensive experience of working on complex multi-jurisdictional regulatory matters

Dedicated public policy team closely connected with European-wide developments

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