

The Role of the Payments System Board

Address by Dr J.F. Laker, Assistant Governor (Financial System), Reserve Bank and Deputy Chair, Payments System Board, to the AIC Conference on 'Australian Payments System Evolution', Sydney, 16 June 1999.

Introduction

I am pleased to have the opportunity to address this conference on 'Australian Payments System Evolution' and to outline the work of the Payments System Board over the first year of its existence.

'Evolution' is perhaps not the right term to describe the changes in the regulatory framework for the Australian payments system which came into effect on 1 July last year. 'Watershed' is more the term which comes to mind. The establishment of the Payments System Board within the Reserve Bank, with the backing of strong regulatory powers, was part of wide-ranging reforms to the structure of financial regulation in Australia, which the Government undertook in response to the recommendations of the Financial System Inquiry (the Wallis Committee). The reforms also included the establishment of the Australian Prudential Regulation Authority as an integrated prudential regulator, and a revamped Australian Securities and

Investments Commission to deal, among other things, with market integrity and consumer protection issues across the financial system.

The goal of these reforms – enshrined in the mandate of the Payments System Board – is a more competitive, efficient and flexible financial system in Australia.

In my talk today, I want to briefly revisit the judgments of the Financial System Inquiry about the Australian payments system – and its organisation – which provided the *raison d'être* of the Payments System Board. Next, I would like to summarise the Board's preliminary stocktake of how the payments system currently performs and the soundness of its infrastructure. This stocktake has been essential in setting the Board's early priorities. How it has gone about meeting these priorities is the final section of my talk.

The Origins of the Payments System Board

The Payments System Board had its origins in the Financial System Inquiry's conclusion that there was considerable scope to increase efficiency in the Australian payments system, without compromising its safety. In reaching this conclusion, the Inquiry zeroed in on Australia's heavy dependence on cheques,

which left total payments system costs relatively high. Of course, this also meant that there was potential for substantial gains in efficiency, especially from substituting electronic forms of payment for cheques.

In other words, the Inquiry judged that Australia:

- had the wrong mixture of payment types; which
- made total costs higher than necessary; and thus
- was not at international best practice – on the contrary, Australia was seen as being only in the middle of the field as far as efficiency was concerned.

The amounts at stake are substantial. Although comprehensive data are not readily available – the Inquiry itself had to rely on unattributed interviews and industry estimates – overseas evidence would suggest that financial institutions probably spend between half to one per cent of GDP providing the nation's non-cash payments services. If the costs to consumers and firms are included, as much as three per cent of GDP might be absorbed in making non-cash payments. On these figures, an 'efficiency dividend' of only 10 per cent would generate savings in resources of over \$1^{1/2} billion a year.

Having identified the problem, the Inquiry also reviewed the self-regulatory arrangements which then governed the Australian payments system. While they had their strengths in technical matters, the Inquiry was unconvinced that co-operative arrangements could be sufficiently responsive to the goals of public policy – particularly the goal of improving overall efficiency.

In brief, the *status quo* was found wanting.

The Inquiry recommended that a 'separate and stronger structure' should be created within the Reserve Bank to give greater emphasis to efficiency and competition in the payments system. This 'structure' was a Payments System Board. The Government accepted the Inquiry's recommendations and formally established the Board on 1 July last year. It met for the first time the following month and has met regularly since.

The Board's Responsibilities and Powers

The Payments System Board has responsibility for determining the Reserve Bank's payments system policy. In terms of the *Reserve Bank Act 1959*, it must exercise this responsibility in a way that will best contribute to:

- controlling risks in the financial system;
- promoting the efficiency of the payments system; and
- promoting competition in the market for payment services, consistent with the overall stability of the financial system.

The Reserve Bank itself has been given comprehensive powers in the payments system, set out in the *Payment Systems (Regulation) Act 1998*. At its discretion, the Reserve Bank may *determine rules for participation* in payment systems, including rules on access for new participants. The Reserve Bank now has the ultimate say on questions of access, since access is inextricably linked to the mandate to promote efficiency and competition. In dealing with access matters, the Reserve Bank will work closely with the Australian Competition and Consumer Commission (ACCC), with which a Memorandum of Understanding was signed last September.

The Reserve Bank may *set standards* for safety and efficiency of a payment system. These may deal with issues such as technical requirements, procedures, performance benchmarks and pricing. In addition, the Reserve Bank may *arbitrate on disputes* over matters relating to access, financial safety, competitiveness and systemic risk, if the parties concerned wish.

The Act also gives the Reserve Bank extensive powers to *gather information* from a payments system or from individual participants.

These are substantial responsibilities and very strong powers, not to be taken or used lightly. No other central bank or supervisory

authority, to our knowledge, has legislative responsibility for efficiency of the payments system nor the same raft of powers. At the same time, the Government has indicated that it favours a so-called 'co-regulatory approach' and it has balanced the Reserve Bank's powers with safeguards for the private sector. Transparency, full consultation and a recognition of the interests of all potentially affected must be – and they will be – the hallmarks of any exercise of our powers.

The Performance of the Australian Payments System

The Payments System Board has not seen the need, to date, to invoke any of these powers. Given the strength and challenge of its mandate, the Board has seen its first task as being to undertake a careful stocktake or 'benchmarking' of the Australian payments system, addressing both its efficiency and its safety. Because of data limitations, this work has not been easy and the Board is still peeling away some of the layers. However, I would like to share with you some of the preliminary findings, which are the basis of the Board's early priorities and work program. Let me turn first to issues of efficiency and competition.

Efficiency and competition

Any tour of the Australian payments system landscape must start with the acknowledgment that *cash* remains an important payments instrument. Notwithstanding the inexorable flow of technological change – real and promised – there is no sign of any downward trend in the ratio of currency to GDP; if anything, the trend over the 1990s has been slightly upwards.

On average, non-cash payments to the value of around \$150 billion – equivalent to about 30 per cent of GDP – are undertaken every day in Australia. More than 90 per cent of this total is accounted for by a small number of high-value payments, which are now cleared and settled through Australia's real-time gross

settlement (RTGS) system. It is, however, in the many millions of low-value transactions each day that the largest potential gains in efficiency lie.

The main types of non-cash payment instruments in Australia, by number rather than value, are shown in Table 1.

Table 1: Number of Non-cash Payments
Per cent of total, 1998

Cheques	36
EFTPOS	22
Credit cards	17
Direct entry credit	19
Direct entry debit	6
Total	100

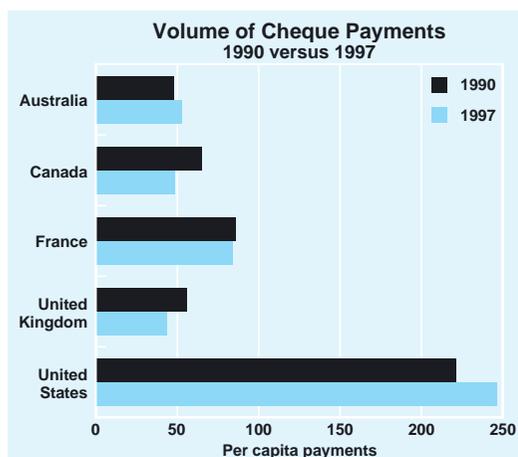
The points which stand out are that:

- cheques are the single most important non-cash payment instrument; but
- payment cards together are now more important than cheques; and
- direct debits are the least used of payment instruments.

Australian consumers have traditionally been keen users of *cheques* for non-cash payments. The number of cheques written annually has steadied at around one billion in recent years. As a share of non-cash payments, however, cheques have declined substantially in the face of the growing popularity of other means of payment.

The industrial countries divide roughly into two categories as far as payment instruments are concerned – those that use cheques extensively and those that use credit transfers. Australia falls into the first category, along with the United States, the United Kingdom, Canada and France. Most of the European countries and Japan are in the second. In all the high cheque use countries, the share of payments by cheque has declined and in some – namely France, the United Kingdom and Canada – the number of cheque payments per head has also declined (Graph 1). The explanation appears to lie in the ready

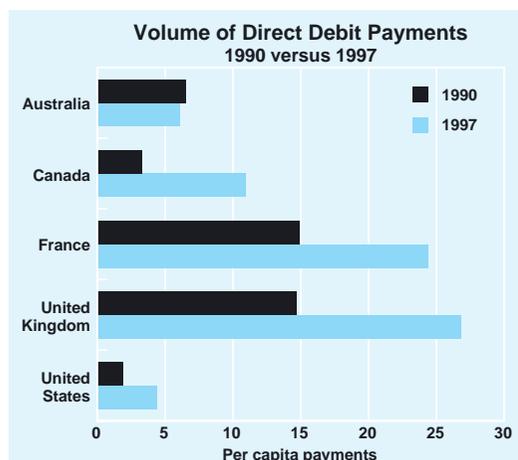
Graph 1



availability of more efficient, appealing and cheaper forms of payment. In contrast, the number of cheque payments per head in Australia and the United States has been on the rise.

Direct debits have always been a relatively little-used payment instrument in Australia. Though a convenient and relatively low-cost way of meeting recurring bills, the number of direct debit transactions per capita has actually fallen in Australia over the past decade. This is in sharp contrast to comparable countries (Graph 2) and, in fact, to every G10 country. Overseas, the benefits of direct debits are clearly recognised and their take-up is actively

Graph 2

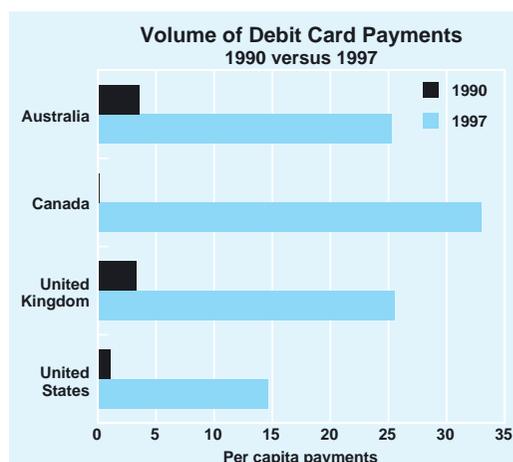


encouraged. Australia, alas, is lagging well behind. I will return to this issue later.

In contrast to our reluctance on direct debits, Australians have taken to *card payments* with enthusiasm. At the beginning of the 1990s, EFTPOS and credit cards together accounted for around 15 per cent of non-cash payments but that figure has now risen to almost 40 per cent.

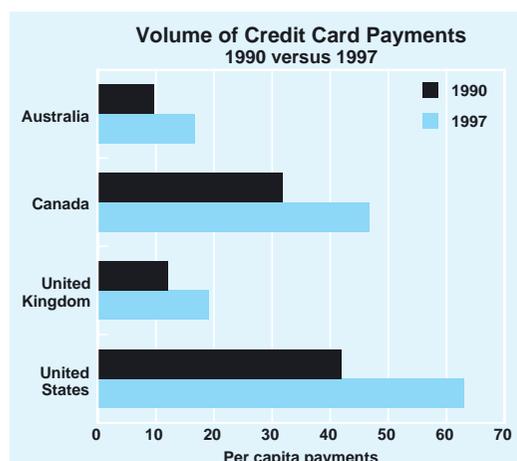
The growing popularity of debit cards for EFTPOS transactions has not been unique to Australia. The same pattern is evident in most industrial countries, as cards are increasingly substituted for cheques and cash at point-of-sale. This common experience is illustrated in Graph 3; most of the variation shown reflects the fact that debit cards were widely introduced in Australia and the United Kingdom before the United States and Canada.

Graph 3

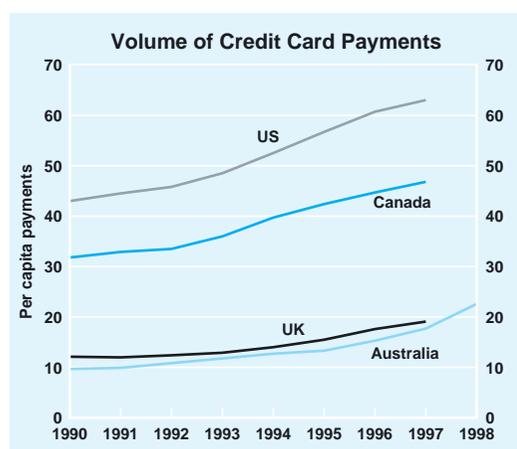


The story with credit cards is somewhat more intriguing. Credit cards have been around in Australia for about 25 years and even longer in the United States, the United Kingdom and Canada. They were a reasonably mature product by the close of the 1980s. Even so, their usage grew quite rapidly during the 1990s alongside that of debit cards (Graph 4). Further light is shed on this in Graph 5. In all four countries, credit card usage per capita, after a period of relative

Graph 4



Graph 5



stability in the early 1990s, has gathered pace in recent years, and is now between 60 and 100 per cent above 1990 levels.

Why would a relatively mature product suddenly get a new lease of life? The use of credit cards might have been restrained by the difficult economic conditions of the early 1990s, but the subsequent surge in their popularity seems too large to be attributed to macroeconomic developments. The more likely explanation is that credit cards are being used for new classes of payments, including remote payments – theatre tickets, mail order and, increasingly, utility bills. The Internet

could provide another boost to popularity before too long.

Underlying this shift in payment patterns seems to be the spread of loyalty and other reward programs. These schemes have the effect of making the marginal cost of each transaction to the customer actually negative. Of course, the cost of the transaction to the banks and the card companies is positive and merchants bear those costs directly. Mixed up in all of this is the interchange fee paid by credit card acquirers to issuers, which seems, on the surface at least, to be an important source of revenue funding loyalty schemes. It is an interesting mixture of pricing and incentives to say the least, but it is probably a clue to the poor take-up of direct debits in Australia. Basic economic analysis tells us that services that are priced below cost will be over-used and those priced above cost will be under-used.

Safety and stability

The other broad responsibility of the Payments System Board is the safety and stability of the Australian payments system.

The international central banking community has been doing a good deal of work lately to codify the desirable features of payments systems which are of systemic importance. A set of guiding principles and practices is being developed, which it is hoped will acquire similar status to the *Core Principles for Effective Banking Supervision*, published by the Basle Committee on Banking Supervision in 1997. The Reserve Bank has been fully involved in this exercise. The work is not yet finished, but I would like to draw on five main themes that are emerging from it to discuss our performance on safety and stability. These themes are legal underpinnings, risk control, timely settlement, access and oversight. These are echoes of the main elements of the so-called Lamfalussy Report.

As in most other countries, Australia’s payments system arrangements grew up largely as a matter of convenience and convention. But as the industry and the Reserve Bank began to look more carefully at

the *legal underpinnings* of these arrangements, a number of gaps and uncertainties were identified. The main concerns were that:

- transactions might be declared void under a so-called ‘zero hour’ ruling;
- payments netting arrangements might not be enforceable; and
- banks might have to pay out on cheques deposited with them, even if the bank on which they were drawn might be unable to settle for them.

After many years’ work, two key pieces of legislation which came into force last year – *The Payment Systems and Netting Act 1998* and amendments to the *Cheques Act 1998* – provide the basis for dealing with these concerns. I will mention these legislative changes again shortly. A year ago, the Payments System Board would have been entitled to feel uncomfortable about the legal underpinnings of the Australian payments system, but not so now.

Prior to the implementation of Australia’s RTGS system, the payments system was subject to unacceptably high levels of *settlement risk*. Most institutions could not even measure the risk accurately, let alone control it. The RTGS system has changed all that. Around 92 per cent of the value of domestic interbank payments are now settled on an RTGS basis, eliminating settlement risk for those payments. The Reserve Bank is also working with the payments industry to strengthen settlement arrangements in those clearing streams which continue to settle on a deferred net basis.

Settlement of high-value transactions now takes place on a more *timely basis*, continuously throughout each business day rather than at 9.00 am the day after they were

undertaken. This has moved Australia from being well behind world’s best practice to being unambiguously at best practice. Survey data to be released shortly show that our RTGS system has also made an important contribution to reducing the foreign exchange settlement risk for the Australian dollar leg of foreign exchange transactions.

Before the RTGS system, the *access* of many banks to the high-value payments system was through agency arrangements. These had the effect of concentrating risks in a limited number of banks and making smaller banks dependent on their commercial relationships with their larger rivals. All banks now have direct access to the various systems which operate on an RTGS basis. In this respect certainly, the playing field is level.

Finally, *oversight* of the Australian payments system has been clarified and strengthened through the introduction of the new regulatory framework, with the Payments System Board at its centre. There is no doubt about the Board’s authority or its ability to initiate change where this is deemed necessary.

Overall, the safety and stability of the Australian payments system scores highly against these broad principles. It would not have done so, however, a year or so ago.

That does not mean that the work program in this area is complete. On the contrary, there are currently two issues fully engaging the Reserve Bank and being closely followed by the Payments System Board. The first is the concerted effort being made by participants at all levels to ensure that the Australian payments system is ready for the Year 2000. The second are the preparations for inclusion

Table 2: Safety of Australia’s Payments System

	Before June 1998	Now
Legal underpinnings	Significant gaps	Identified gaps closed
Settlement risk	High and uncontrolled	Reduced by over 90 per cent
Timely settlement	Next day	Continuously
Access	Through agents	Direct
Oversight	Informal	Statutory

of the Australian dollar in the Continuous Linked Settlement (CLS) Bank, an issue to which I will refer later.

Let me conclude this brief tour of the payments system landscape by returning to the Financial System Inquiry's rationale for a Payments System Board. There was no hint in the Inquiry's report that this Board was needed to reinforce safety and stability. Though the Board takes this part of its mandate very seriously, it acknowledges that much of the hard work in this area was completed before it held its first meeting. On the other hand, the Inquiry made plain the need for a spur to efficiency and competitiveness. The Board's preliminary stocktake only confirms the Inquiry's concerns. Usage of the most expensive payments instrument – the cheque – has not fallen, the most efficient instrument for paying regular bills – direct debits – is vastly under-used and inconsistencies seem to affect the pricing of some payment services. Not surprisingly, then, the Board has put efficiency issues high on its initial work agenda.

What Has the Board Been Doing?

It might be helpful to summarise the Board's work in its first year under three broad headings – what it has done in its own right, what it has done in partnership with industry participants, and the role it is playing as a catalyst for change. The issues do not always fall neatly into these distinctions but they may provide some insights into how the Board is approaching its mandate.

In its own right

An important priority for the Board has been to determine eligibility requirements for Exchange Settlement (ES) Accounts at the Reserve Bank.

In its submission to the Financial System Inquiry, the Reserve Bank had noted that the introduction of Australia's RTGS system would provide scope to widen access to

ES Accounts. The Inquiry recommended wider access, and the Government agreed that eligibility should be liberalised on the basis of clear and open guidelines to be determined by the Payments System Board.

The Board announced a more liberalised access regime in March this year. In brief, all providers of third-party payments services are now eligible for an ES Account. However, applicants must have a need to settle clearing obligations with other providers and the liquidity to meet these obligations under routine, seasonal peak and stress conditions. Collateral requirements apply in certain cases.

Some commentators have seen the Board's decision as a significant step towards breaking-down barriers to access to the payments system. The Board takes a more modest view, since it is easy to overstate the importance of ES Accounts. The liberalisation should contribute to competition and efficiency, but probably at the margin.

On a more arcane level, though still fundamental, one of the Board's first jobs was to declare the Reserve Bank Information and Transfer System (RITS) and the Austraclear System (FINTRACS) as 'approved RTGS systems' in terms of the *Payments Systems and Netting Act 1998*. The approvals protect transactions in these two systems from the possibility of being declared void from a 'zero hour' ruling by a court. They provide a legal underpinning for the elimination of settlement risk in Australia's RTGS system. The Board is anticipating applications for other protections available under this legislation and also under the *Cheques Act 1998*.

As a partner for change

The Board is strongly committed to reducing foreign exchange settlement risk for banks in Australia. Currently, this risk is a large one because of the tyranny of the time zone and the heavy reliance by Australian banks on correspondent banks. A Reserve Bank survey in 1997 confirmed that exposures lasting in excess of 24 hours were the norm and, in some cases, the period of exposure was more than three business days. Results of a follow-up survey will be released shortly.

The most ambitious global initiative to reduce foreign exchange settlement risk is the Continuous Linked Settlement (CLS) Bank, which is being developed by a group of major international banks. We have from the outset wanted to see the Australian dollar in the CLS project. Earlier this year the Governor, as Chairman of the Board, wrote to the Chairman of CLS Services expressing our concerns about apparent delays in including the Australian dollar in the initial 'wave' of currencies to be settled by the CLS Bank. The letter drew out the importance of the Australian dollar in global turnover and its particular exposure to settlement risk because of the time zone. A revised timetable for the establishment of the CLS Bank is expected to be announced shortly.

In the meantime, the Reserve Bank has been working productively with the major Australian banks, all of which are shareholders in CLS Services, on the prudential and operational issues associated with the inclusion of the Australian dollar. We are reviewing, for example, the impact of the CLS arrangements on liquidity management and the required changes to the opening hours of the Australian payments system to overlap with the CLS operating day.

As a catalyst for change

To fulfil its mandate to promote efficiency and competition, the Board must turn a strong spotlight on current payments system arrangements, and work for sensible change. The *status quo*, as we know, has been judged not good enough. Two particular issues are in the Board's immediate focus.

Cheque clearing times

The Board has shared the community's longstanding frustrations at the delays many depositors of cheques have faced in gaining access to their funds. It has been supportive of the Australian Payments Clearing Association's (APCA) project to introduce electronic presentment and dishonour of cheques as a means of speeding cheque clearing times. Late last year, responding to

concerns that the momentum for this project might be flagging, the Chairman of the Board wrote to the chief executives of banks and other financial institutions seeking their assurance that they would provide the staffing and other resources needed to meet APCA's timetable. The Board is pleased that they did so and that APCA's project was implemented on schedule on 30 April.

Under the new electronic arrangements, there is no reason why institutions which accept cheque deposits cannot make funds available, in the normal course, on a 'three-day' cycle – that is, if a cheque is deposited on Monday the funds would be available on Wednesday. The only things which now prevent institutions from achieving this result are their own internal systems and procedures.

The Board wishes to see the three-day clearing cycle become standard in Australia. Despite the progress so far, the final hurdle has not yet been cleared by all banks. Accordingly, the Chairman of the Board has again written to chief executives seeking details of when their institution now makes funds available to its retail and small business customers, and of its plans for moving to 'best practice'.

The Board would be most disappointed if the replies do not indicate a rapid movement to a three-day cycle. More to the point, the community will find it increasingly hard to accept that, in this electronic era, institutions which accept a cheque deposit on a Monday and learn of the cheque's fate on the Tuesday evening, are unable or unprepared to provide funds to their customer until Thursday.

Direct debits

A second area requiring obvious attention is the usage of direct debits. Our research confirms that direct debits are the most economical way of paying routine bills for all three parties concerned – billers, customers and the financial institutions which process the transactions. This is especially so when time and internal processing are carefully costed.

While all major countries are embracing this means of payment more and more, Australia is going backwards. Australian consumers appear reluctant to utilise direct debits because they fear a lack of control over the payment, or because they may face large penalties on deposit accounts for a dishonour due to lack of funds. Other countries have found imaginative ways of enhancing the attractiveness of direct debits and are actively promoting the instrument. Australia could do much better.

APCA has been working on changes to the direct debit system for some years. The scope of this work has tended to concentrate on the supply side. Changes to procedures have been developed which are intended to reduce costs to both billers and financial institutions, in the hope that lower costs will reflect in prices and encourage greater take-up.

Useful though this work is, it is essential not to lose sight of the demand side. The Board believes that there are a number of important initiatives that could increase acceptance of direct debits, which have not been adequately explored in Australia. These include the offer of discounts, more personalised assistance with setting up arrangements, guaranteed refunds if errors or disputes arise and flexible debit dates. The overseas evidence is that these initiatives can work and have a positive pay-off. Against the background, the Board has written directly to major billers seeking their views on ways of promoting this instrument. Billers are keen for progress and we are now considering how best to take this exercise forward. There are substantial benefits to gain, and the Board looks forward to working closely with all those concerned – billers, customers and financial institutions – to bring Australia up to best practice in this area.

Summing Up

In principle, the twin goals of the Payments System Board – safety and stability on the one hand and efficiency and competition on the other – will require judicious balancing. The pursuit of greater safety, for example, through caution or excessive regulatory zeal may harden the very arteries of the payments system in the process. In practice, the balancing act has not been a difficult one to date. This owes much to the general soundness of the payments system which the Board inherited, particularly following the successful implementation of Australia's RTGS system.

For these reasons, the Board has directed its initial efforts to questions of efficiency and competition. Unfortunately, the term 'efficiency' in the payments system context does not lend itself to easy definition or measurement. As the preliminary stocktake identified, the potential for improvement in some areas – such as cheque clearing times or the usage of direct debits – is obvious. In other areas, however, where quality data are not readily available, a good deal of pioneering work is needed to gather the facts, digest them and develop rigorous benchmarks on costs and performance, so that the payments system can be assessed against international best practice. This work is underway; it is complex and painstaking; but it is work that must be done well.

Those who expected – or feared – that the Board would begin to swing lustily as soon as it reached the crease can be reassured that it is more interested in building a long and carefully constructed innings. Payments system evolution is that sort of match! ↗