

# Innovation, Stability and the Role of the Payments System Board

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Address to the Australian Payments Clearing Association 20th Anniversary Symposium  
Sydney, 28 May 2012

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I have not spoken publicly on payments system matters for some time, but it would be hard to find a better moment and a more appropriate event to take up the issue once more. This symposium of course marks 20 years of the Australian Payments Clearing Association (APCA), which was set up as a vehicle to coordinate decision-making in relation to clearing and settlement following the recommendations of the Brady and Martin Reports in the years prior. It effectively replaced the Australian Clearing House Association, which was largely focused on cheques – the dominant payment system of the time.

Sharing the stage with APCA in the early days was the Australian Payments System Council, which had been established in the 1980s as an advisory body to the government aimed at promoting and influencing the development of payment systems. The Council was wound up when the Payments System Board was established in 1998, following the recommendations of the Wallis Inquiry.

APCA itself has evolved over the years. New clearing streams have been added and it has moved more into an industry representation role. Its make-up has also evolved; for instance I note that it was originally chaired by a representative of the Reserve Bank, an arrangement that ended in 1998.

All this change over an extended period is a sure sign that there has long been recognition of how critical governance arrangements are to payments systems.

The same debates that have occurred in Australia on these issues are repeated around the world. In fact, while the institutional arrangements for payments vary enormously from one country to another, it is remarkable how similar the debates are in each of those countries. I will be dealing with some of those issues today.

The other reason that it is a good time to be speaking about payments is that, as I am sure many of you are aware, the conclusions of the Reserve Bank's Strategic Review of Innovation are due to be released very soon. In fact, they will be out within the next couple of weeks. I cannot pre-empt the detailed findings, but I will share with you some of the major themes. Naturally, most people will focus on the implications for the payments industry. But the conclusions will also have implications for the way that the Payments System Board goes about its business in relation to retail payments issues. That is as it should be. The Board is not a static entity either and its role evolves over time.

My focus today, then, will be both innovation and the role of the Payments System Board. But with regard to the latter, I will talk not just about challenges in the retail payments sphere, but also about the other role of the Board that is probably less known to most of the people in this room – that is, the regulation of financial market infrastructure in order to preserve financial stability. This takes up a sizeable and increasing part of the Board's time.

## Payments Innovation: Why is it Important?

Why all the focus on payments innovation? It might, on its face, seem strange for the Reserve Bank to have devoted a considerable amount of time and effort to reviewing innovation in the payments system.

For one thing, Australia has received great dividends from allowing, in most cases, commercial imperatives to drive the process of delivering new products, including payment products. We of course take a more cautious approach when it comes to matters of risk in the financial sector and we have seen how important those considerations are over the past few years. But in general, the notion that a regulator should be involved in matters of innovation might be seen as inconsistent with the regulatory philosophy in Australia. Certainly the Payments System Board has been reluctant to ‘pick winners’.

The other reason that it may seem slightly anomalous for the Reserve Bank to be preoccupied with payments innovation is that we see a great deal of it around us and every sign that there is significantly more around the corner. If we think about the rapid rise of PayPal, the spread of chip and now contactless card payments, and the enormous amount of energy that is being focused on mobile payments at the moment, there is clearly no shortage of innovation in payments.

There is, however, a problem, and one about which the various players in the payments space themselves have become increasingly concerned. It is that the innovation in the customer-facing technology is moving at a pace much greater than the underlying infrastructure. This is a problem because innovation in a network industry is not like innovation in other industries. No matter how much time, effort and money a financial institution puts into its own systems and the ways in which customers interface with those systems, the payments service it can provide is only as good as the arrangements that allow payments to pass between institutions. These arrangements are in the cooperative space; not even

the most innovative payments provider has the capacity to control these on its own.

It is easy to see how this could act as a constraint on innovation. Cooperative decision-making between competitors is notoriously difficult. The implications of different business mixes, strategies and investment cycles can easily derail cooperation, not to mention the constraints of committee-based decision-making. These are classic coordination issues, where some external impetus may be required to initiate change.

Even if coordination problems could be overcome for an innovation that is in the public interest, institutions collectively might find it difficult to make a business case to invest. Once again, this largely seems to be a quirk of the payments industry. Payment systems are ‘two-sided markets’. In other words, the market must satisfy two distinct sets of customers; for instance, a point of sale payment system can be successful only if it is adopted by both consumers and merchants. In two-sided markets the price faced by each set of end users may be altered so that the party with the greatest decision-making power faces a low price. This is most evident in the credit card market, where consumers typically face a low or negative price while merchants face a relatively high price. The flow of interbank fees to support this has traditionally made issuing cards profitable for financial institutions. Because payment systems often do not simply operate on a user-pays model, establishing a business case can be more difficult than in other industries, even where there is a clear demand from end users.

This means there is a case for some kind of mechanism to overcome coordination problems and to ensure that any disconnect between the public interest and the business case is properly managed. But any intervention by a regulator like the Payments System Board of the Reserve Bank must of course be carefully considered.

The Payments System Board will be addressing the issue from two different perspectives. First, it will be expressing some views about the governance

arrangements within the industry, with the aim of giving those the best possible prospects of successful collective decision-making and appropriate consideration of the public interest. More details on that will be included in the conclusions of the Review.

Second, the Board believes that in order to overcome coordination problems, it will need to take a stronger role in setting some general goals for the payments system, so as to help provide an appropriate focus for the innovation efforts of the various players. There will need, in the Board's view, to be greater interaction between the Board and the industry to establish and work towards shared goals. Our assessment of experience both in Australia and overseas is that superior industry outcomes have been achieved when there has been a policy influence promoting public interest goals. Examples range from reform of the ATM system in Australia to the establishment of the Faster Payments Service – for real-time retail payments – in the United Kingdom. Therefore, you can expect the conclusions of the Review to have more to say about a more constructive engagement between the Board and the industry in relation to payments innovation.

The Board will not be picking winners, nor generally will it dictate the technical details of systems. The Payments System Board is a policymaking body. It would not seek to impose the technical details of solutions, unless it was aware of a very clear public policy basis for preferring one approach over another. In most cases, it is for the Board to provide guidance as to what outcomes it believes are required in the public interest, but not specific solutions. The latter are clearly the domain of industry experts, with their knowledge of the technical and business constraints. But it is important that they be informed by the Board's broader policy goals.

The Board's thinking about those goals has been informed by two considerations.

First, early in the Strategic Review of Innovation, the Board identified a number of attributes that

were valued by end users, as well as some that are important in payments system design. These included such things as: the timeliness of payments; accessibility; ease of use; ease of integration into other processes (such as business systems); and safety and reliability. Examining the services the payments system offers in terms of these attributes strongly suggests the areas where greater innovation in the payments system is needed, and where the underlying infrastructure might be imposing constraints on innovation.

Second, the Board has considered developments in retail payment systems around the world. An understanding of what is available elsewhere and whether those things are valued and adopted by the users of payment systems is a very important commonsense test when considering what our own system ought to look like. This effort has in part been aided by interactions with many parties over the course of the Strategic Review, along with the work of the Committee on Payment and Settlement Systems of the Bank for International Settlements, which has conducted an examination of innovation in retail payment systems.

On the basis of this information, the Board sees the need to focus on the infrastructure capabilities of retail payment systems, rather than the specific products that are offered. Appropriate infrastructure can only be delivered cooperatively, but success in that delivery will allow payments providers to compete vigorously over the products and services they offer to customers. That should be true, not just for deposit-taking institutions, but for other innovative players that have something to offer in the provision of retail payments. I talked before about customer-facing innovation outpacing innovation in core infrastructure. What the Board is interested in is lifting the constraints imposed by that infrastructure.

As to the specific areas on which the Board is focused, to those who have followed this process, and the documents that have been produced along the way, it will be no secret that one area on which the Board has focused is the timing of payments. It is very clear

that both individuals and businesses are demanding greater immediacy and greater accessibility in all facets of their day-to-day activities. This includes payments. People expect to be able to book an airline ticket and choose their seat at any time of the day or night. They expect to be able to download music or a book while they are sitting on the bus. Our payments system supports these transactions by allowing the payment to be initiated, and goods or services exchanged, even though the funds will not be available to the merchant until some time later. This delivers the immediacy to the transaction itself, as people have come to expect.

On the other hand, if a business or an individual wishes to *receive* funds into an account at a financial institution, that same immediacy is not available. For instance, if a business wishes to make timely use of the proceeds from a large shipment, or an individual is in need of emergency assistance from a government agency, options are very limited. This is because the infrastructure that underpins retail payments assumes that making funds available the next business day is sufficient. This has served acceptably well to date, but, with systems for real-time transfers available in countries ranging from the United Kingdom to Mexico, Australia's approach is starting to look a bit dated. It is our belief that availability of real-time transfers would fill some important existing gaps, but would also open up enormous potential for innovation on top of that system. This would contrast with the current situation, where a significant amount of effort is being put into finding workarounds for the current constraints of our systems.

Another element of the timeliness of payments is the availability of the payments system out of standard banking hours. Some systems, such as card payment systems, give the impression of operating 24 by 7, but in reality no funds move between financial institutions out of hours, constraining the services that can be offered to end users of the payments system. Some would argue that anything more is unnecessary and that consumers

and businesses are not unduly inconvenienced by this. But we receive enough complaints about this to suggest that expectations are changing. It is not that long ago that it was accepted that if a person wanted to ensure that they had enough cash to see them through the weekend, they had to make sure that they visited their bank branch by closing time on Friday. But we would all see that as completely unacceptable these days and I think we have reason to hold the rest of our payments system to the same standards.

One question that we have come back to during the Strategic Review is what sort of payments system architecture would best allow us to deliver the features that we think are going to be demanded by payments system users in the years to come, including improved timeliness. Australia has had a long-running practice of operating payment systems that are based on both bilateral business agreements between participants and the bilateral exchange of payments between those participants. This model presents a number of problems, not least the complexity and cost of adding a new entrant, which must establish similar arrangements with each existing participant.

Some of the significant changes we have seen in the payments system over the past few years have represented partial moves away from those bilateral arrangements. This includes the move to the industry community of interest network for clearing payments and the creation of eftpos Payments Australia Limited to centralise governance of the eftpos system. These changes denote recognition of the constraints of bilateral payment systems. While the Reserve Bank does not advocate walking away from some of the well-established and low-cost bilateral systems we have, we can see a strong case for any new architecture that is established to meet emerging needs to be based on centralised architecture; that is, a hub and spokes, rather than bilateral, model.

So these are some of the things that will gain attention in the conclusions of the Strategic Review

of Innovation when they are released in the next couple of weeks. I do not mean to suggest that the issues identified by the Review will be solved quickly, but I think we – the industry and the regulator – owe it to the users we serve to embark now on the process that will get us on to the right path. As a first step, in the months following the release of the conclusions of the Review, I expect there to be a healthy dialogue with the industry on the sorts of goals that the Payments System Board has in mind for the payments system, along with more focused discussions on some specific solutions.

## Other Work of the Payments System Board

I have been talking about the innovation review and the way it will alter, in some respects, the role played by the Payments System Board in the future. But it is also worthwhile to talk briefly about other developments that also have an impact on the direction of the Board more generally.

The reality is that the Board's mandate of promoting stability, efficiency and competition requires it to play quite different roles in respect of two quite different sets of players in the financial system. Most people in this room would think of the Payments System Board as the body that capped credit card interchange fees and worked with the industry to achieve reforms in the ATM system. There is another set of players out there who think of the Payments System Board as the body that seeks to ensure the stability of key financial market infrastructure, or 'FMI's, such as securities settlement systems and, increasingly importantly, central counterparties – which stand between financial market participants in order to better manage risk. Much of this role came to the Board later than its initial payments mandate, when the *Corporations Act 2001* adopted licensing arrangements for all clearing and settlement facilities in 2001. As important as the Board's work on payments system efficiency is, the stable operation of FMIs has a direct bearing on financial market and financial system stability. Oversight of FMIs therefore

demands a significant proportion of the Board's time. It is also this work that is expanding most rapidly.

In fulfilling its responsibility for the stability of financial market infrastructure, the Board has historically focused on the high-value payments system – the Reserve Bank Information and Transfer System – with which people in this room are more than familiar, along with the debt and equities settlement systems operated by the ASX and the equities and derivatives central counterparties also operated by the ASX. In addition, the Reserve Bank has for some years been part of an international cooperative oversight arrangement for the global foreign exchange settlement system, Continuous Linked Settlement (CLS).

Two developments mean that the Bank's and the Board's workload in this area is increasing. First, while most financial market infrastructures serving Australian markets are currently operated by one entity, cross-border competition is increasing, particularly for central counterparty clearing services. It is likely that the Bank's oversight responsibilities will increase and become more complex as it has to deal with new entities offering services in the Australian market.

The other development affecting the Board's role is the global push to strengthen financial regulation in the wake of the global financial crisis. That includes the push for OTC derivatives to be cleared through central counterparties and reported to trade repositories, as embodied in the G-20 commitments from Pittsburgh in 2009. All this means financial market activity that is important to Australia will be increasingly reliant on centralised financial market infrastructure.

The logic of this reform is that it will reduce and simplify bilateral exposures between counterparties. But it will also increase the systemic importance of the financial infrastructure, because we will in effect be creating a small number of 'single points of failure'. Hence the resilience of that infrastructure will be critical, and the obligation of the official sector

to provide proper oversight to ensure that resilience will correspondingly increase.

These trends have been recognised in a number of areas that will affect the Payments System Board's work in the period ahead.

- The international standards used by central banks and securities regulators around the world as the cornerstone for oversight of FMIs have been comprehensively rewritten to reflect the lessons of the crisis and the increased importance of central counterparties and trade repositories. The revised standards were released just last month and it will be a substantial task for the Bank to reflect those changes in its own regulatory framework.
- The Council of Financial Regulators has made a number of recommendations regarding the framework for regulation of FMIs in Australia, including that the Reserve Bank – along with the Australian Securities and Investment Commission – be given the power to, *in extremis*, 'step in' and operate an FMI in the event that it suffers financial or persistent operational problems. The Bank has long had this capacity in regard to Austraclear, because of the systemically important nature of that system for the operation of the domestic money market. Domestic work in this area is occurring in parallel with international efforts to develop principles for the recovery and resolution of FMIs. Over the coming year, the Board will need to devote increasing attention to establishing how step-in and other recovery and resolution tools for FMIs would operate in Australia.
- Following further work by the Council of Financial Regulators, the Treasury is consulting on a legislative framework to support mandating of central clearing, exchange trading or reporting of OTC derivatives transactions, should this be warranted. Initially, however, the Council intends to rely on existing market and regulatory incentives to promote central clearing. The Payments System Board is likely to have a central role in the new regime, such as overseeing new

central counterparties entering the market to clear these products, as well as input into decisions about when mandates for central clearing might be appropriate.

- It is inevitable that the Bank will become increasingly involved with cooperative oversight arrangements for financial market infrastructure that operates on a global basis.

The upshot of all this is that the financial stability element of the Payments System Board's role is only going to increase. This is a continuation of a trend that has been under way for some time, and to which we have already responded with a significant boost in the resources we devote to these issues within the Bank. The work of the Payments System Board on the regulatory framework complements the Bank's broader focus on financial stability, which is of course overseen by the Reserve Bank Board.

## Conclusion

There is a clear sense within the Payments System Board that our work over the next few years will in some respects take us into some different activities. The work for which the Board has mostly been known has focused on addressing problems or distortions in individual systems, albeit with knowledge that these distortions had significant effects on other parts of the system. The solutions have tended to be focused on the rules of those systems. Payments innovation requires something quite different because it is more clearly about solving coordination problems, which by their nature are likely to be ongoing and do not necessarily occur within the confines of an existing system. Addressing this issue will require a change in the nature of the conversation between the Board and the industry. That conversation began with the innovation roundtable earlier this year, and will continue in the period ahead, stimulated, hopefully, by the release of the conclusions from the innovation review. At the same time, the Board's mandate in relation to financial stability remains a key focus, and the global response to the financial

crisis dictates that we take on a greater, and probably more complex, role as the global focus shifts to centralised financial market infrastructure.

This doesn't mean that the Board will be paying less attention to the payments system efficiency matters for which it is perhaps best known. Much as we might want to live in a world where that type of regulation is not necessary, unfortunately the issues do not become any fewer or any less complex, and the Board is committed to continuing to meet its legislated responsibilities in this area. In fact, one challenge from innovation is that old tensions about competition might emerge in new ways. The Board will need to remain just as vigilant in these areas in the years to come. ✎

