



Australian Payments
Clearing Association

Submission to the Reserve Bank of Australia

Strategic Review of Innovation in the Payments System: Systemic Governance Issues

About this document

This is the submission of the Australian Payments Clearing Association to the Reserve Bank of Australia's *Strategic Review of Innovation in the Payments System: Issues for Consultation* document, issued in June 2011.

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Overview

Successful ongoing payments system innovation requires a framework for ensuring that system development priorities evolve over time and continue to:

- meet public policy priorities;
- address the changing needs of end users; and
- enjoy the support and engagement of system participants.

As RBA Governor Glenn Stevens has noted, the interplay of public policy, participant cooperation and participant competition is critical for good system governance. While the coordination challenge is never straightforward, Australia's payments system has historically addressed it better than most. However, we now have a much more diverse, complex and competitive payments environment than was envisaged in 1997, when the Wallis Committee last undertook a comprehensive review.

It is timely and necessary to conduct a holistic review of the governance of the payments system, covering the role and responsibilities of the public regulator, the way in which the industry self-regulates (currently largely through APCA) and the relationship between public and private bodies, governed by the Payment Systems (Regulation) Act 1998 (PSRA).

Effective system governance requires consideration of the following four elements:

Goals	- What is payment system governance trying to achieve?
Responsibilities	- Who does what? - What powers do industry and public bodies have?
Representation	- Who participates in system governance? - What rights do they have? - What obligations do they have, including funding?
Decision-making and Commitment	- How do we ensure decisions are timely, comprehensive and high-quality? - How do we ensure industry decision-making will be widely supported and, where necessary, complied with?

A single, comprehensive industry self-governance body should be established to work with the public regulator. The self-governance body should have clearly defined self-regulatory authority, supported by changes to the PSRA to develop, implement and ensure compliance with industry self-regulation, under well-defined RBA oversight. APCA submits that it is best placed to take up this role, subject to reform of its own governance.

APCA intends to continue the work it has already commenced in relation to reform of its own governance arrangements, with a view to presenting a comprehensive model of industry governance for public and regulator scrutiny in early 2012.

Detailed recommendations appear on p16.

Governance of the Australian Payments System Needs Reform

The “how” of payments system innovation and why it matters

This submission focuses on the “how” of payments system innovation – how do we continuously decide on system development priorities, ensure the right voices are heard, drive towards a widely-supported solution and allocate responsibilities to deliver the result. In its capacity as the self-regulatory body for Australian payments, this is a matter close to APCA’s heart. This submission responds to questions 10 to 25 of the Reserve Bank of Australia’s *Strategic Review of Innovation in the Payments System: Issues for Consultation* (the Consultation Paper).¹

In a companion submission, APCA addresses the “what” of payments system innovation - from what we know now, what “beneficial change” do we need systemically in the next 5 to 10 years? The companion submission responds to questions 1 to 9 and 26 to 51 in the Consultation Paper.

As the companion submission notes, APCA applauds RBA’s highly consultative approach to public policy review. This gives the best chance of articulating public policy priorities that clearly give effect to the RBA payments mandate of controlling risk, promoting efficiency and promoting competition consistent with financial stability. Clear public policy priorities would be an excellent outcome of the review.

But this submission is based on a conviction that successful ongoing payments system innovation needs more than this. It requires a framework for ensuring that system development priorities evolve over time and continue to:

- meet public policy priorities;
- address the changing needs of end users; and
- enjoy the support and engagement of system participants.

These are outcomes of good system governance. It must balance competing priorities on a continuous basis as the system evolves, rather than simply establish an agenda at a given point in time. So APCA’s view is that system governance needs separate attention beyond the scope of the Innovation Review.

Balancing public policy, industry cooperation and competition

In 2009, Governor Glenn Stevens described the interplay of public policy, participant cooperation and participant competition that is critical for good system governance:

The economics of networks are complex, and the role of public policy is a delicate one. The aim is to ensure, as far as we can, that the correct balance is struck between the need for co-operation and the benefits of competition. Co-operation is required in order to ensure that the benefits of an extensive, and reasonably standardised, network can be enjoyed by the public, raising economic welfare. Competition is vital in the long run to make sure that costs are minimised and the incentive to respond to changing consumer preferences maximised. Policy has to recognise and fulfil its role

¹ RBA, (2011) *Strategic Review of Innovation in the Payments System: Issues for Consultation*.

in dealing with the externalities inherent in the set of decisions made by private market participants, while also respecting and maintaining the competitive dynamic.²

The Governor acknowledged the mutually interdependent roles of industry participants and the regulator. In our market economy, successful systemic innovation must meet public policy priorities and reflect the interests of end users, but it cannot occur unless participants invest in, develop and use the proposed innovations.

Payments systems the world over are substantially industry-driven and self-regulated, albeit with support from and oversight by the regulator.³ As a network service, a high degree of coordination amongst participants is unavoidable in payment systems.⁴ For example, regulation of the cards system in different jurisdictions involves varying degrees of self-regulation and legislative support.

As Governor Stevens notes, self-regulation raises the risk that those with the best expertise and culture to develop and implement system requirements (i.e. industry participants) may be prey to (or be seen to be prey to) externalities relating to their own commercial interests. The structure of system governance, and in particular the role of the public regulator, is crucial to resolving this.

Both Governor Stevens' speech and the RBA's Consultation Paper highlight that the core problem is participant coordination to deliver systemic innovation that would not be delivered by the competitive marketplace. There are various descriptions of the coordination problem in the consultation document, including academic treatments and recent practical examples. What they all boil down to is the continuous challenge of aligning public priorities and diverse business interests across many different kinds of participants for long enough to undertake significant system changes for the ultimate benefit of end users.

Direct public regulation is very much a "last resort" answer and carries its own very substantial risks. The Governor puts this well:

In most cases, a graduated approach to regulation ... is pursued, reflecting a reluctance to assume that a regulatory solution is necessarily superior, or that the government would necessarily be able to choose the best standard, particularly in a highly technical or rapidly changing field. The typical approach of network regulators is to prefer a co-operative industry approach to standard setting, to provide some suasion where this process is unsuccessful, but ultimately to set standards if necessary. ...

The Payments System Board is content to confine itself to encouraging industry solutions and being the occasional catalyst for agreement among the parties, where that achieves the goals the Board has been given. But it is and must be also prepared, if needed, to use regulatory powers more forcefully.⁵

The Need for Governance Reform

In his 2009 speech, Governor Stevens delivered a harsh assessment of governance in the Australian Payments System, based particularly on the long history of ATM direct charging reform:

The result is that, in the underlying architecture of the Australian payments system, very little has changed over the past 20 or 30 years, even though technology has evolved in the quarter of a century since the technology underlying the ATM and EFTPOS systems was first established. So while the payments system infrastructure has served Australia well, pressures for change are

² Stevens (2009) Third Ian Little Memorial Lecture, "Conclusion", published at www.rba.gov.au/speeches/2009/sp-gov-250309.html

³ Manning, M, E. Nier and J. Schanz (2009) *The economics of large value payments and settlement: Theory and policy issues for central banks*, Oxford University Press, Oxford, in particular chapter 9.

⁴ Shy, O. (2001) *The Economics of Network Industries*, Cambridge University Press, Cambridge UK.

⁵ Id. Note 1, "What role for public policy?"

building. The network structure needs to be updated and services to customers are starting to fall behind those available in other countries. In the past, the Reserve Bank has identified real-time internet payments, business-to-business payments and online payment mechanisms as examples where progress has been made overseas but not, to date, in Australia.⁶

APCA would submit that at least as at 2011, this significantly understates progress. Amongst many other developments, it ignores:

- the advent of BPAY, a global leader in bill and online payments;
- the conversion of the bulk of Australia's card system to EMV chip;
- the seamless adaptation of the direct entry system to online payments, resulting in the substantial replacement of cheques with electronic alternatives;⁷
- the conversion of nearly all Australia's infrastructure to triple DES encryption;
- the commercialisation of the EFTPOS network and the very healthy level of competition amongst card schemes,
- the entry of PayPal and other new competitors into the marketplace, and
- the establishment of the IP-based Common Payments Network comprising an industry Community of Interest Network, the RBA's Clearing Interconnector and SWIFT.

Clearly, systemic innovation can occur and is occurring. APCA's submission is that while the coordination challenge is never straightforward, Australia has historically addressed it better than most, as suggested by the list above. A key reason for this has been the use of utility-style clearing systems to which a relatively homogenous community of market participants all have access. They have often formed the vehicle for the participant cooperation referred to by the Governor.

However, more recently, technology, globalisation and changes in market structure mean that competition is more prevalent at multiple levels in the payments system. We now have a much more diverse, complex and competitive payments environment than was envisaged in 1997, when the Wallis Committee last undertook a comprehensive review. New providers have entered the market and competition is emerging in new areas. Universal clearing systems are giving way to payment system operators who compete and innovate in a commercial marketplace to serve diversifying and evolving needs of consumers and businesses.⁸

This is great for product innovation and improved service to end users, but it means we need to rethink the coordination side of network economics in the Australian Payments System. Not only do we need a new way to coordinate in order to make major system changes that are not incentivised by the competitive landscape, we also now need to ensure that the rules of the competitive marketplace are fair and effective.⁹

It is therefore timely and necessary to review the governance of the payments system. This review must be holistic, and include the role and responsibilities of the public regulator, the way in which the industry self-regulates (currently largely through APCA) and the relationship between public and private bodies, governed by the PSRA.

⁶ Id. Note 1, "A recent Australian example".

⁷ An adaptation that has still not occurred in many other developed economies including USA and Canada.

⁸ This landscape is described in more detail in APCA (2008) *Low Value Payments: An Australian Roadmap*, Sydney. APCA has committed to reviewing the LVP Roadmap in 2012.

⁹ As APCA's submission was being finalised, it was reported that BPAY had decided not to proceed with a new service, MAMBO. It is not yet clear what implications this might have for system governance, if any. APCA would make the general observation that new consumer payment services must of necessity be developed as commercial services facing an increasingly competitive marketplace. They therefore involve considerable project risk. That a service does not come to market may be no more than evidence of an efficient, competitive marketplace where risks are high and returns tight.

Elements of Effective System Governance

The RBA's Consultation Paper focuses on representation in the current industry governance arrangements. It suggests that a focus on innovation may be constrained by the business case of incumbents and points to a perception that the needs of end-users are not considered sufficiently, with some industry players not able to appropriately input into industry decision-making.¹⁰

While APCA regards appropriate representation as a vital part of good governance, simply involving more diverse representation in decision making will not provide better outcomes. In fact, just adding more voices increases coordination problems. It makes the process more cumbersome, and decisions more difficult to achieve. The answer is not to take away rights of influence from active participants in favour of other stakeholders. This is likely to entrench their opposition to a development.

But there is a better way. APCA believes that good system governance requires a holistic approach — of which representation is only one important element. This requires consideration of the following four elements, and we urge the RBA to consider these elements in any future discussions about system governance:

Goals	- What is payment system governance trying to achieve?
Responsibilities	- Who does what? - What powers do industry and public bodies have?
Representation	- Who participates in system governance? - What rights do they have? - What obligations do they have, including funding?
Decision-making and Commitment	- How do we ensure decisions are timely, comprehensive and high-quality? - How do we ensure industry decision-making will be widely supported and, where necessary, complied with?

A useful test of this approach is to consider the current work of the Canadian Task Force for the Payments System review, which has just published its own consultation document.¹¹ The Canadian approach starts with a principles-based approach and then proposes a new governance framework that explicitly addresses all four elements above in a structure that includes legislation, a public oversight body and a self-governing organisation recognised and supported by legislation. Although the operational structure of the Canadian system is materially different, the holistic approach based on future scenarios and guiding principles is, APCA submits, a good model.

Each element is discussed further below.

¹⁰ RBA consultation document, Section 5.2.

¹¹ *The Way We Pay Transforming the Canadian Payments System, Task Force for the Payments System Review*, (2011) Canada, page 8.

Goals

System governance must support agreed system goals, including but not restricted to the promotion of innovation.

In determining what is “good system governance”, an important first step is to define what the governance framework should deliver.

In the Consultation Paper, the RBA sets out a non-exhaustive list of objectives for the Australian payments system including:

- Timeliness
- Accessibility
- Ease of use
- Safety and reliability
- Low and transparent prices

APCA’s companion submission suggests that “business potential” for participants is also an important factor.¹²

Overseas policy development initiatives have similarly sought to define the goals of the wider payment system. In 2011, after wide consultation, the Canadian Payments System Task Force identified a set of 12 principles it believes are “fundamental to the sound stewardship of payments”¹³. The first six principles relate to both the values and needs of the system users, including competition and innovation, user access and efficiency, transparency and choice, and fairness and accountability. An additional six principles relate to the oversight and administration of the payments system, including consistent standards, minimal regulation, neutrality by function, proportionality, independent and inclusive, and framework adaptability.

The UK National Payments Plan, published by the UK Payments Council in 2008, outlined the Payments Council’s objectives as promoting the efficiency and effectiveness of UK payment systems, fostering the development of new payment systems and other innovations, and safeguarding and enhancing the integrity of UK payment systems.

The goals or objectives are and should be subject to debate. However, there needs to be broad agreement amongst key stakeholders on payments system goals to enable the construction of a governance framework that supports them.

It is likely that there will be tension between identified goals. For example, a system that seeks to aggressively promote innovation may compromise security and efficiency. A balance needs to be struck. Good system governance can optimise the balance. Promoting competition amongst payment system operators maximises efficiency and innovation. At the same time, widely supported, universal platform requirements can underpin payment system competition to promote wide access, security and reliability.

In this sense, it is important to leave as much as possible to market-driven development. The approaches of both the UK Payments Council and the Canadian Payments System Task Force suggest that it is *not* the job of system governance to innovate directly, but rather to support a payments system that *promotes* innovation.

APCA agrees with this approach. The primary role of the industry body should be to work towards the agreed goals, in particular promoting competition, minimising barriers to entry and otherwise creating the conditions for innovation to flourish in the marketplace.

¹² APCA (2011), Submission to RBA Innovation Review at p. 8.

¹³ *id.* Note 10, page 20

Responsibilities

Good system governance achieves its objectives by establishing clear roles, authority and relationships amongst public and private governance organisations.

The RBA's Consultation Paper cites industry coordination problems as an inhibitor to payments system innovation in Australia.¹⁴ This reflects a challenge for all network industries. APCA's contention is that while coordination problems will arise in any network, the problem is exacerbated in the Australian Payments System by the absence of a widely-recognised, authoritative self-governance organisation to provide the vehicle for industry coordination. As mentioned above, this is not a job that the public regulator usually finds itself able to do; on the other hand APCA's origins as an administrator of particular clearing systems with a narrow scope and consensus-driven approach has inhibited its ability to fill the role.

The long history of the ATM direct charging reforms is an example of this problem.¹⁵ Because of a perception that APCA could not provide a venue for industry coordination on matters of pricing, there was no easy starting place for industry coordination on this issue. The industry made a number of attempts at ad hoc coordination, ultimately requiring significant inducements from the regulator to reach agreement. However, once agreement in principle was reached, the industry was able to use APCA to manage operational design and delivery of the reform in a short timeframe. Even then, the solution required regulatory support to manage perceptions of competition policy risk.

On the other hand, a number of major systemic innovations of recent years have not required formal regulatory intervention. Examples of these are the introduction of 3D Secure, the roll-out of chip cards, the introduction of PIN use for credit and scheme debit card transactions in stores, the adoption of an industry-wide Retail Run Code of Practice, the development and migration of transactions to the COIN, the formation of a new scheme for eftpos transactions and recent account switching reforms. In each case, APCA or another industry grouping was able to provide the vehicle for engagement of relevant participants (even in some cases outside of APCA's membership) to bring about outcomes that met the public policy objectives. In some of these cases, the regulator also applied informal pressure to secure outcomes.

In APCA's view, where coordination problems have existed, these have been made worse by lack of clarity around industry authority and public/private responsibilities. Where the public policy objectives have been clear and where industry has been able to develop a framework and assume the necessary authority to respond to these, self-governance has worked.

Historically, APCA has had limited industry self-regulatory authority to bring about system change outside of its traditional clearing system mandate.¹⁶ Other quasi self-regulators, such as Visa and MasterCard, have now commercialised. In addition participants have observed RBA's willingness to intervene using extensive powers under the PSRA.

In deeply contentious matters, and in the absence of a clear and authoritative self-governance framework, the natural response of industry participants has been to focus

¹⁴ RBA Consultation document pp13-14.

¹⁵ This example is analysed in Governor Stevens' speech, id note 1.

¹⁶ APCA contends that since the adoption of its broader core purpose of improving the payments system in 2006, perceptions of its scope and role have gradually changed, providing incremental opportunity for it to do more industry coordination where it is needed.

their efforts on encouraging the RBA to make their preferred decision. This has been preferable to trying to fashion an ad hoc industry process of uncertain scope and authority, and for which any outcomes are highly conditional and subject to “appeal” to RBA anyway.

The recent history of card scheme competition policy is the primary case in point. Concerns about card scheme competition and the dynamics of two-sided markets have dominated payments policy debate for 14 years.¹⁷ Yet important aspects of the applicable policy are still hotly debated today. Without detailing the long history of this area, regulatory and policy work aimed primarily at providing a better framework for card scheme competition has encompassed the following topics:

- Interchange fees;
- Honour-all-cards rules and the right of merchants to decline acceptance;
- Merchant surcharging;
- The rules applying to multi-function cards;
- Access regimes and codes;
- Transaction activity statistical reporting and publishing.

In each and every case, policy debate has been harder to resolve because of system governance problems, in particular:

- how and by whom the policy objectives should be set, and
- how and by whom solutions should be implemented.

In APCA’s view, the underlying problem was the absence of an industry body able to coordinate self-governance effort across the card payments system and to work effectively with the public regulator. On other issues, the relevant system operator (APCA, Visa, MasterCard or BPAY) has been able to do this, but not when the subject matter is competition amongst commercialised system operators. RBA’s preferred approach of “encouraging industry solutions and being the occasional catalyst for agreement among the parties”¹⁸ does not work very well if the industry, duly encouraged, has no widely supported framework for addressing the issue.

The result has been repeated regulatory intervention, which in itself reduces the likelihood of future attempts at self-governance. It doesn’t need to be this way. An overarching industry self-regulator could work with the public regulator to resolve coordination problems. APCA has successfully done so in some areas such as account switching, Retail Run and the common payments network, and is attempting to do so in others.

In APCA’s view, there are three requirements for addressing this situation, within the scope of industry governance reform:

- establishment of new, more authoritative self-governance arrangements;
- reform of the PSRA to support authoritative self-governance subject to clear public policy oversight; and
- reform of the interaction between the RBA and industry self-governance to provide clarity, certainty and credibility to industry decision-making.

¹⁷ The Wallis Report in 1997 included a specific recommendation relating to interchange fees.

¹⁸ Governor Stevens, id note 2.

Authoritative Self Governance

APCA's Board recognises the need to reform APCA. It has been considering submissions on law reform, and has been consulting members on ways to reform APCA's internal governance to allow it to fully take up a broader self-governance role. We set out our detailed views on these issues below.

The Consultation Paper asks whether another body may need to be formed to take up a self-governance role. This would involve much more risk and cost than seeking to reform APCA. APCA's submission is that APCA is best placed to take up this challenge, recognising that APCA's work needs to be undertaken subject to debate and scrutiny from regulators and the broader community.

If the broader debate yielded the conclusion that a new body is in fact required, APCA would of course work within that framework, taking a role in the new arrangements as appropriate. Whatever vehicle is chosen, the critical issue is to get system governance right in terms of the four elements on page 8.

APCA will continue with its already well-developed review process, now informed by RBA and community views expressed in the consultation process. APCA hopes to use the forthcoming Australian Payments Forum on 10 October as a venue for debating issues with a broader stakeholder community, following which it will conclude its current governance review by bringing forward a new governance model for public and regulator scrutiny in early 2012.

PSRA Reform

In light of APCA's identification of the need for a broader industry self-governance role, APCA proposes reform of the PSRA. This would give greater clarity and certainty to the respective roles of the regulator and the industry self-governance body.

Currently the PSRA gives the RBA the power to designate certain payment systems and to impose standards and access regimes. As recognised by the RBA in its Consultation Paper, although conceived as a jurisdiction of last resort, the RBA has had to apply its powers under the PSRA more frequently than was originally intended in order to address regulatory uncertainty around industry solutions i.e. the applicability of the competition legislation. In several cases, absent competition law concerns, an industry self-regulatory solution may have presented a better outcome to the designation of a payments system and imposition of standards or an access regime.

RBA intervention has also been necessary in circumstances where industry has been unable to achieve a collaborative outcome, because no one industry body has had the requisite authority to deliver a 'whole of industry' outcome. ATM direct charging serves as an example of both situations.

APCA is providing Treasury with a submission seeking reform of the PSRA. The proposal in that submission seeks to do two things:

- to give an additional and alternative power to the RBA under the PSRA to support industry self-regulatory outcomes - by approving an industry-developed 'Code' (subject to its continuing oversight by the RBA) that would have regulatory force once approved; and
- to remove the threat of application of the competition legislation where the RBA has intervened, to provide greater certainty to industry.

APCA believes that this legislative change would provide industry-developed regulation with the necessary authority and certainty to make the self-governance framework work more effectively.

APCA is proposed as the cross-industry body best able to develop, implement and promote compliance with self-regulation that supports a more efficient payments system. This is not to suggest that this opportunity resides only with APCA. What is important is the credibility of the organising body, such that outcomes are transparently arrived at, subject to public policy oversight, broadly accepted and widely complied with.

Both the South African and proposed Canadian frameworks reflect this. By contrast, this level of public accountability appeared to be lacking in relation to the way in which the UK Payments Council was structured, leading to the public policy concerns now being expressed in the UK Treasury Committee report.¹⁹

Reform of Interaction between RBA and Industry

The proposed PSRA amendments outlined above go a long way towards establishing a better framework for the respective roles of the public regulator and industry represented through an appropriate body such as APCA.

However, law reform takes time. Moreover, if and when the additional power is available, RBA and the industry will need to work out a liaison process for deciding:

- what issues will be addressed by an industry coordination process, having regard to clear public policy priorities and criteria set by RBA; and
- how an industry code, service, system or other coordination arrangement will be developed, consulted on, approved by RBA and implemented;

Accordingly, even as we explore law reform, APCA believes that greater clarity could be achieved by reform of RBA/APCA liaison arrangements to establish processes for undertaking these tasks. These will need to detail the respective roles of public and self-regulatory structures.

Under a new governance framework, APCA proposes that revised RBA/industry liaison arrangements be established that clearly demarcate the respective roles and responsibilities of the public regulator and the industry governance body, as well as ensure appropriate communication and reporting. APCA proposes to provide greater detail on this when it brings forward a governance proposal in 2012.

Representation

Good system governance maximises buy-in from all stakeholders by effectively balancing their different interests.

APCA welcomes the public debate on better representation of stakeholder interests in industry governance.

A balance must be achieved between larger participants with the greatest level of investment in the payments system and smaller, new or non-traditional participants and other stakeholders who have a legitimate interest in how the payment system operates, and often generate competitive tension that drives innovation in products and services. Any such representation arrangements must be (and be seen to be) fair, such that all stakeholders "buy in" to the outcomes of the governance framework. These arrangements must also be capable of engaging new stakeholders as these emerge.

The RBA understandably focuses on the voice and participation of non-traditional stakeholders – non-ADI service providers, payments system users and new/potential entrants. The Consultation Paper notes APCA's efforts of recent years to promote

¹⁹ House of Commons Treasury Committee 'The future of cheques', Eighteenth Report of Session 2010-12.

participation from this broader community. APCA has done a lot to encourage broader participation, through initiatives such as the Stakeholder Forum and Australian Payments Forum, but more can be done.

APCA recognises the importance of ensuring broader stakeholder involvement. It promotes more informed decision-making, and gives credibility to outcomes. For example, the way in which APCA has managed consultation in relation to the decline in cheque usage has been markedly different to the more industry-centric approach adopted by the UK Payments Council.

At the same time, it is important to ensure that the governance structure is capable of making decisions effectively and that these decisions are adopted and adhered to by all those whose engagement is needed to make the system operate effectively. The wider the interests taken into account, the harder it is to find broad engagement and support

There are a number of ways of addressing the need for balance in both debate (input) and decision-making (outcomes). This can be achieved through a combination of change to representation and participation in decision-making, as well as a broader opportunity for engagement and influence through consultation with stakeholders across the community.

In addition to existing forums for more inclusive debate referred to above, APCA is looking at ways of ensuring that broader community concerns can be captured in decision-making without losing the 'buy-in' of incumbent risk-takers and investors:

- APCA's Constitution already provides for groups of smaller participants to collectively exercise decision-making power and there may be broader and more logical groupings that could be adopted;
- Membership criteria could be extended beyond the traditional clearing system participant base;
- Decision-making rights could be linked to relative levels of participation across the payment system as a whole ie removing the link between decision-making rights and clearing system volumes;
- Independent directors could be introduced to add balance; and
- The way in which RBA participates within the industry governance framework could be more clearly defined.

As indicated above, APCA intends to bring forward proposals for governance reform for public debate in early 2012.

Decision-making and Commitment

Good system governance establishes a decision-making process that promotes high-quality, timely system decisions that will "stick".

Agreed system goals, clear responsibilities and fair representation are all key elements for good system governance. A fourth element is a process for timely industry decision-making that enjoys the confidence of regulators, participants and system users.

In 2007 and 2008, APCA, both on its own and through the International Council of Payment Association Chief Executives (ICPACE), undertook significant work on system self-governance.²⁰

²⁰ ICPACE (2007) *Principles of Payments Industry Self-Governance*; APCA (2008) *Reinventing Co-regulation: Improving system governance in Australian payment cards*.

This work distils the criteria of a good process to include:

- Certainty — Clarity of objectives, processes, powers and rules.
- Transparency — Objectives and processes should be publicly visible.
- Legitimacy — Supported by stakeholders and regulators.
- Flexibility — Responsive to new developments.
- Efficiency — Minimise cost and risk associated with exercising its powers.

Though any given system decision will have supporters and detractors, certainty and legitimacy will be critical for all. At a minimum, all participants will need to respect the process, accept the outcome and, in the end, conscientiously comply. This may require mechanisms for monitoring, sanctioning and conflict resolution.²¹

A clear decision-making process ensures that participants will understand consultation processes, the part they play in developing options, and the responsibility they have. For example where decisions require funding, the responsibility for this amongst participants should be clear.

Furthermore APCA proposes a publicly-documented industry case process for major industry decisions, so that all stakeholders have access to the decision-making process and decision criteria and transparency is maintained.

Ideally the process should be supported by the regulator. The decisions of APCA (or another industry body) that follow the recognised process should be clearly backed by the RBA. Under proposed amendment to the PSRA, discussed above, self-regulatory 'Codes' developed by industry through such a process would have the benefit of regulator approval and legislative support.

Once properly made, self-regulatory decisions must enjoy a strong and widespread expectation of compliance. In large part this can be achieved by getting incentives right. That is, making sure the risk/return proposition for the great bulk of participant groups aligns well with public policy priorities. In addition, there needs to be an element of enforceability, even though enforcement action should be the exception rather than the norm. The existence of compliance and enforcement options has two impacts on decision-making quality:

- It increases the likelihood that new requirements are carefully and minimally drafted so as to affect behaviour only to the extent strictly necessary to achieve industry-agreed goals;²² and
- It promotes the likelihood that participants organise their own affairs on a mutual assumption of engagement, making them more likely to make needed investments and meet industry timetables because they can be assured others will do so.

Good decision processes are an underrated but critical part of solving coordination problems. No matter how "encouraged" a community is to coordinate action, if they do not have confidence in a coordinated decision process, they will struggle to act.

²¹ As noted by Lenox (2007), "absent explicit mechanisms for penalizing malfeasance, self-regulatory programs are likely subject to adverse selection and moral hazard". See Lenox, M. (2007) "The Prospect for Industry Self Regulation of Environmental Externalities" in D. Brown & N. Woods (eds.), *Making Global Self-Regulation Effective in Developing Countries*, Oxford University Press, Oxford. See also Ostrom, E. (1990) *Governing the Commons: The Evolution of Institutions for Collective Action*, Cambridge University Press, Cambridge, p. 90 for the design principles illustrated by long-enduring self-regulatory institutions.

²² This is a key aspect of the "efficiency" requirement in the ICPACE work.

APCA's Recommendations

1. The overall governance of the Australian Payments System should be reformed to recognise a more complex, competitive and diverse environment. Reforms need to cover **goals, responsibilities, representation, decision-making and commitment**.
2. A single, comprehensive industry self-governance body should be established to work with the public regulator. The body should have clearly defined self-regulatory authority, supported by changes to the PSRA to develop, implement and ensure compliance with industry self-regulation, under well-defined RBA oversight. APCA is best placed to take up this role, subject to reform of its own governance.
3. APCA should, with PSB endorsement, publicly determine comprehensive payment system goals that emphasise competitive markets for services and payment instruments as the best way to promote innovation in the long term.
4. The PSRA should be amended to establish a clear division of responsibilities between the PSB and APCA: the regulator establishes the public policy priorities to be met through industry collaboration, and APCA takes up the broader self-governance responsibility to ensure industry coordination responds to public policy priorities, with RBA retaining ultimate oversight power.
5. Greater clarity and certainty be established in payments system governance through revised liaison arrangements that recognise the distinct roles and responsibilities of the public regulator and APCA as the industry self-governance body.
6. In combination with changes recommended above, APCA's Constitution should be reformed to enable it to take up the broader self-governance role. We believe that doing the following will enable APCA to provide transparent and fair self-governance for the payments system. APCA proposes to:
 - a. Establish/confirm organisation objectives that relate to continuous improvement of the overall payments system, through self-governance;
 - b. Reform existing governance arrangements to ensure a voice and balance of interests amongst incumbents and new, smaller and alternative participants in the overall payments system (potentially through changes to representation, voting and funding rights);
 - c. Establish/confirm best practice stakeholder consultation that ensures the views of system users and the broader community are properly taken into account;
 - d. Develop and publish best practice decision-making standards (industry case formation) for system-wide decision-making;
 - e. Establish self-regulatory rule frameworks with clear compliance arrangements that enjoy widespread confidence and the support of the RBA.
7. APCA intends to continue the work it has already commenced in relation to the amendment of its own governance arrangements, with a view to presenting a comprehensive model of industry governance for public and regulator scrutiny in early 2012.

Response to the RBA's Questions

We briefly respond below to questions raised by RBA in the Consultation Paper, drawing on the main body of the submission as relevant.

Q10: Do current governance arrangements adequately promote payments system innovation?

Current arrangements have certainly promoted both systemic and product innovation – see p7. However, coordination problems which arise in any network industry are exacerbated in the Australian Payments System by the absence of an authoritative, recognised vehicle for coordination across payments issues. APCA's recommendations seek to address this – see p16.

Q11: Are the needs of payment systems users and non-ADI payment service providers adequately considered in decisions about the direction of the payments system?

APCA recognises the importance of broader stakeholder engagement and has undertaken initiatives such as the Stakeholder Forum and Australian Payments Forum to help with this. It can do more. Representation is about balance of competing and sometimes conflicting interests. It is important to promote participation by newer, smaller and alternative participants, but it is also important to ensure decisions are adhered to by those whose engagement is needed to make innovations work - see pp13-14.

The broader the engagement, the greater are the co-ordination issues. Adding more voices without other reforms will actually reduce systemic innovation – see p8.

Q12: Are there ways of altering current governance structures to make innovation easier?

Yes, but innovation is only one objective. The governance structure must also provide the framework for a secure, reliable and accessible system – see p9. APCA's recommendations suggest a way forward.

Q13: Are there ways of altering current governance structures to take more account of the views of end-users?

Yes, as indicated above. Broader representation and engagement can be promoted subject to balancing this with the interests of those with greatest investment and risk - see p13-14.

Q14: Could a new decision-making body with broad representation of payments system participants, service providers and end-users provide a better strategic focus for the payments system, taking adequate account of costs and the public interest?

Conceivably, yes, but in addition to changes in representation arrangements, the new body would need to comprehensively address goals, responsibilities (in particular the respective roles of public and industry bodies and the authority of the new body), decision-making and commitment arrangements – see p8. Without attention to these matters, broader representation would not deliver any improvement. In fact it could increase coordination problems.

APCA' proposal is to work towards reform of APCA to fulfil this role: see p 12.

Q15: How could such a body have the capacity to reach decisions across a diverse group of members?

This is a key concern of effective governance. The answer lies in a comprehensive approach to system governance:

- clear goals,
- clear allocation of responsibility and appropriate authority,
- fair and balanced representation,
- timely and transparent decision-making and effective participant commitment.

APCA's Recommendations suggest a way forward – see p16.

Q16: Could such a group make binding decisions and how could they be enforced?

Yes, if the comprehensive approach suggested by APCA is adopted. See p16. Enforcement mechanisms should be rule-based and contractual in the first instance, but with public regulatory recognition as proposed in our submission – see p12.

Q17: Could formalization of a broader mandate for APCA, coupled with broader representation, provide better industry-wide outcomes?

Yes, provided that the roles and responsibilities of APCA and RBA, including RBA support for self-regulatory outcomes subject to public oversight, are spelled out through law reform and changes to liaison arrangements – see pp10-13. Another key requirement is for improved decision processes – see pp14-15.

Q18: What role should the Reserve bank and PSB play in setting the reform agenda for the industry?

RBA and PSB must set the public policy priorities and provide oversight of industry self-governance to ensure it is delivering against them. The public policy “success criteria” should be focused on desired outcomes, leaving the industry to develop the mechanics through the appropriate mix of competition and coordination. Law reform and revised liaison arrangements need to clarify respective roles and authority - see p13.

Q19: Have concerns about the CCA prevented the industry from achieving greater co-operative innovation? What approaches are suggested to deal with this in a way that does not undermine the intent of the CCA? What are the advantages and disadvantages of each?

There have been examples of attempts by industry to self-regulate, which have required regulatory support through designation and standards to avoid the operation of the CCA (then TPA) notwithstanding widespread support for an industry solution. APCA proposes amendment to the PSRA to give an additional and alternative power to the RBA to approve an industry ‘Code’. Such a power would support greater self-regulation, enable industry to more effectively enforce self-regulation and remove the uncertainty around the application of the CCA in respect of approved Codes.

Q20. Does the current structure of clearing and settlement adequately allow for the introduction of new payment products? How could this be improved?

Under the current structure, Australia has seen substantial innovation in products and systems: see p7. However, the Payments System is evolving away from universal clearing systems towards commercialised, competitive network services – see p7 and

APCA's Low Value Payments Roadmap, 2008. In response, the structure of clearing and settlement rule books has changed, and is continuing to change.

This has important implications for innovation. Effective competition amongst system operators and schemes will drive network and product innovation. The role of industry governance is to promote innovation through establishing a fair and effective framework for competition, and establish the minimum platform requirements (for example settlement arrangements, connectivity networks and messaging standards) to promote wide access, security and reliability.

Q 21. Is the current structure of rules applied to payment systems, including the five APCA clearing streams, the most appropriate?

Whether or not the current structure is the most "appropriate", market forces are driving change – see Q20 above. Marketisation of payment systems means that new systems will tend to develop as commercial and competitive services, and the role of traditional clearing systems will tend to reduce over time. This can already be seen in the evolution of the APCS and CECS systems.

Good system governance will assist this evolution by providing a venue for debate on the interplay of public policy, competition and coordination – see p5-6. Issues of consistency of treatment and future evolution of different rules sets are one aspect of this. A new governance model can promote innovation by establishing industry coordination arrangements to support a competitive marketplace. See p8 and the recommendations on p16.

Q22. How should clearing and settlement rules change to take best advantage of upcoming functionality in RITS for same-day settlement of bilateral bulk payment files (and existing functionality for same-day batch settlement). Could rules be established for individual 'settlement streams', including for instance on the timing of availability of funds and the individual transaction values eligible for that stream?

APCA believes this needs addressing on an instrument by instrument basis. Implications of the improvements to RITS functionality for BECS are addressed in APCA's companion submission under Timeliness of Payments.

In the longer term, more flexible settlement facilities should facilitate competitive development of new instruments and services.

Q23. Are there alternative models for clearing rules? For instance, could a set of generic (but narrowly focused) clearing standards cover multiple payment systems, with more detailed system rules applied at the individual system level? Should such clearing arrangements be mandatory for all payment systems, including those not currently party to APCA arrangements?

Much depends on what is meant by "clearing standards", and therefore what is being proposed as "mandatory". Common network elements like settlement, message standards and connectivity can support multiple payments systems.²³ In other areas, the public policy case for minimum standards across multiple payment systems would need to be carefully made given wide variations in users and user needs.

A new governance model could provide the venue to explore the need for such standards, and the framework for articulating and implementing such standards – see p16.

²³ APCA (2008) Low Value Payments Roadmap.

Q24. What other ways are there of allowing providers of new payment products or systems easy access to clearing and settlement arrangements. Is there a case for establishing a standard minimum payment message type that participants are obliged to accept from agreed counterparties?

Widely adopted message standards may assist, but only if they are globally recognised and widely used in practice – in the Australian marketplace, this would require significant market evolution. Refer APCA's companion submission under Standards.

An attempt to impose a new standard minimum payment message type on existing systems would be extremely costly, and hard to justify in terms of community benefit. Instead, there are prospects for progressive evolution to global standards – refer companion submission.

Q25. Do existing clearing arrangements allow sufficiently easy access for new participants? If not, what could be done to improve this?

APCA's BECS and CECS clearing systems have been modified extensively in recent years to accommodate new entry, notably to facilitate Tyro's activities in the Australian market. APCA is also experiencing an increase in new memberships, particularly in the paper system (APCS) and direct entry (BECS). In 2010-2011, four new members were admitted in APCS, four in BECS and one in the high value system (HVCS). Similar numbers appear likely in the current year.

Entry criteria are already calibrated to functional requirements: that is, the ability to operate safely and reliably in the clearing system dictates entry requirements, and system entry costs do not appear to be a barrier, based on levels of new entry in recent years. We are not aware of any evidence that those with an interest in joining clearing arrangements are unable to do so.