

# FORUM II – ACCESS AND INNOVATION

## Introductory Speakers

### 1. Geoff Bebbington<sup>1</sup>

The National Australia Bank (NAB) welcomes the opportunity to prepare a short paper to act as a discussion starter on ‘Access and Innovation’ in respect of the Reserve Bank of Australia’s (RBA’s) regulatory reforms for the Payments System Review Conference.

After analysing stakeholder submissions to the RBA’s Review, NAB believes that there should be more emphasis on discussing innovation, and in particular the role that interchange plays, as it will have a more significant longer term public policy impact.

That is not to say that access is not important. It is. However, the access reforms to date have not generated a significant amount of comment from stakeholders with respect to the RBA’s paper *Reform of Australia’s Payments System: Issues for the 2007/08 Review*, henceforth referred to as Reserve Bank of Australia (2007).

Before moving on to innovation, NAB would like to begin with access.

### Access

#### General

At the outset of the reform process, access was a major focus of the RBA’s and the Australian Competition and Consumer Commission’s (ACCC’s) October 2000 report on *Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access* (the Joint Study).

Based on the conclusions of the Joint Study, the RBA’s main concern about access was that restricting access lessens competition, resulting in less pressure on margins and interchange fees.

In particular, the Joint Study states for credit cards (p. 55):

... the provision of credit card services in Australia generates revenues well above average costs, particularly for financial institutions which are both significant card issuers and acquirers. In a competitive market, it would be expected that competition from new entrants would put downward pressure on these margins and on interchange fees.

With EFTPOS the Joint Study states (p. 70):

... the need to negotiate bilateral agreements for access, may provide established players with market power and make entry more expensive. For example, if a small issuer is unable to negotiate a bilateral arrangement with every acquirer it will need to use more expensive gateway arrangements to provide its customers with a debit card which has universal acceptance. This can give large acquirers power to charge interchange fees above cost and can raise the cost of access for new entrants. The large acquirers are also issuers and in competition with those institutions seeking to establish interchange arrangements.

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<sup>1</sup> *Head of Payments, Policy & Support, National Australia Bank.*

In this section NAB will:

- summarise the access reforms to date and the RBA's rationale for imposing them;
- summarise the submissions received by the RBA for the current review; and
- discuss the issues raised.

## Summary of access reforms to date and their rationale

The table below is an extract from Reserve Bank of Australia (2007).

### Summary of Access Reforms

Reform Area	Description
Credit cards and scheme debit	Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit-taking institutions (ADIs). A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or <i>vice-versa</i> . Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.
EFTPOS	The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently \$78 000 (ex GST). An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).
EFTPOS Access Code	Under the EFTPOS Access Code developed by the Australian Payments Clearing Association (APCA), new and existing EFTPOS participants have specific rights to establish direct connections with other participants within a set time frame.

With the introduction of the Credit Card Access Regime, the RBA stated in its impact statement *Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement* (August 2002)<sup>2</sup> that, in conjunction with its other reforms at the time, the Access Regime would improve overall system efficiency by putting downward pressure on interchange fees, margins on acquiring services, interest margins on credit card borrowings and annual fees.

In the above document the RBA also stated that for EFTPOS the introduction of the Access Regime in conjunction with the Access Code would significantly improve access to Australia's EFTPOS System.

<sup>2</sup> Reserve Bank of Australia (2002).

It is important to note that since the RBA's incursion into credit card access reform, the industry has shown willingness for voluntary reform with EFTPOS and ATMs.

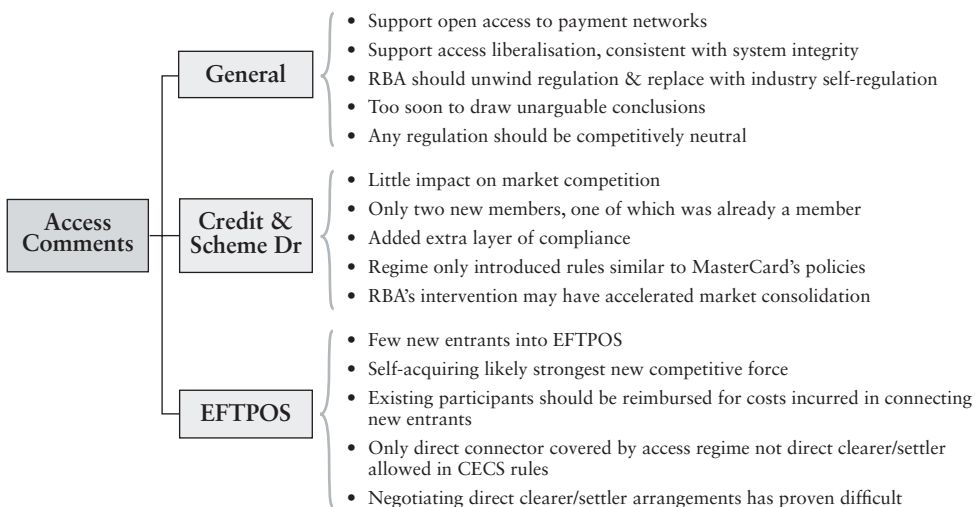
## Summary of submissions received

In the current review discussion paper the RBA asked three questions about access:

- What has been the effect of changes to access arrangements?
- What is the effectiveness of existing arrangements?
- If the current regulatory approach is retained, what changes, if any, should be made to access regimes?

Only 9 out of 25 submissions received made substantial comment about access. The key access issues are summarised below.

### Access Submission High Level Comment Summary



## Discussion of access issues raised

Based on the comments received, NAB believes the two key themes that warrant further consideration are:

- replacing the existing access arrangement with an entirely voluntary self-regulatory regime; and
- extending the EFTPOS access mechanism beyond direct connectors to cover direct clearer and settler relationships.

### Access self-regulation

As stated above, EFTPOS access is already subject to voluntary industry self-regulation, in that EFTPOS participants already have specific rights to establish direct connections with other

participants within a set time frame. The RBA, with agreement from the industry, used its powers as a practical way to set caps for direct connection cost reimbursement and interchange fees.

It is conceivable that either through the creation of a scheme for EFTPOS which is currently being explored by the industry, or by utilising some other means, the RBA's Access Regime could be withdrawn and replaced with another entirely self-regulatory mechanism that could achieve desirable outcomes.

Credit and scheme debit card access could also be examined to see whether the RBA's Access Regime could be withdrawn and replaced with voluntary self-regulation. In fact, as MasterCard stated in its response, 'MasterCard's rules, before the introduction of the Access Regime, had permitted regulated and supervised financial institutions to participate in the MasterCard system'.<sup>3</sup>

To achieve the unwinding of the RBA's Access Regimes as described above NAB endorses the approach proposed by APCA in its submission. Its approach is for the industry and the RBA to engage in 'a co-regulatory process (self-regulation with active appropriate public policy oversight) that will give the RBA confidence to unwind its existing direct regulation (Access Regimes and Standards) within a reasonable transitional time frame'.<sup>4</sup>

### **Merit of extending EFTPOS access mechanism to direct clearer/settlers**

The concept of a direct clearer/settler was not envisaged in the industry's creation of the existing EFTPOS access mechanisms. NAB believes that consideration should be given to the public policy merits of extending the EFTPOS access mechanism to cover direct clearer/settlers, as part of the overall approach to developing a co-regulatory environment as proposed by APCA in its submission.

## **Innovation**

### **General**

In Reserve Bank of Australia (2007), the RBA sought comment in two key areas of innovation.

The first, under the general heading of 'The effect of interchange fee reforms on financial institutions', was 'the effect of the reforms on product innovation'. The second, under the general heading 'The effect of the reforms on the competitive position of different payment systems', was 'any effects of the reforms on product innovation'.

In this section NAB will:

- summarise the submissions on the questions above received by the RBA for the current review;
- discuss the issues that arise; and
- discuss how interchange regulation is inhibiting innovation of 'new' types of payment methods and how it should be rectified.

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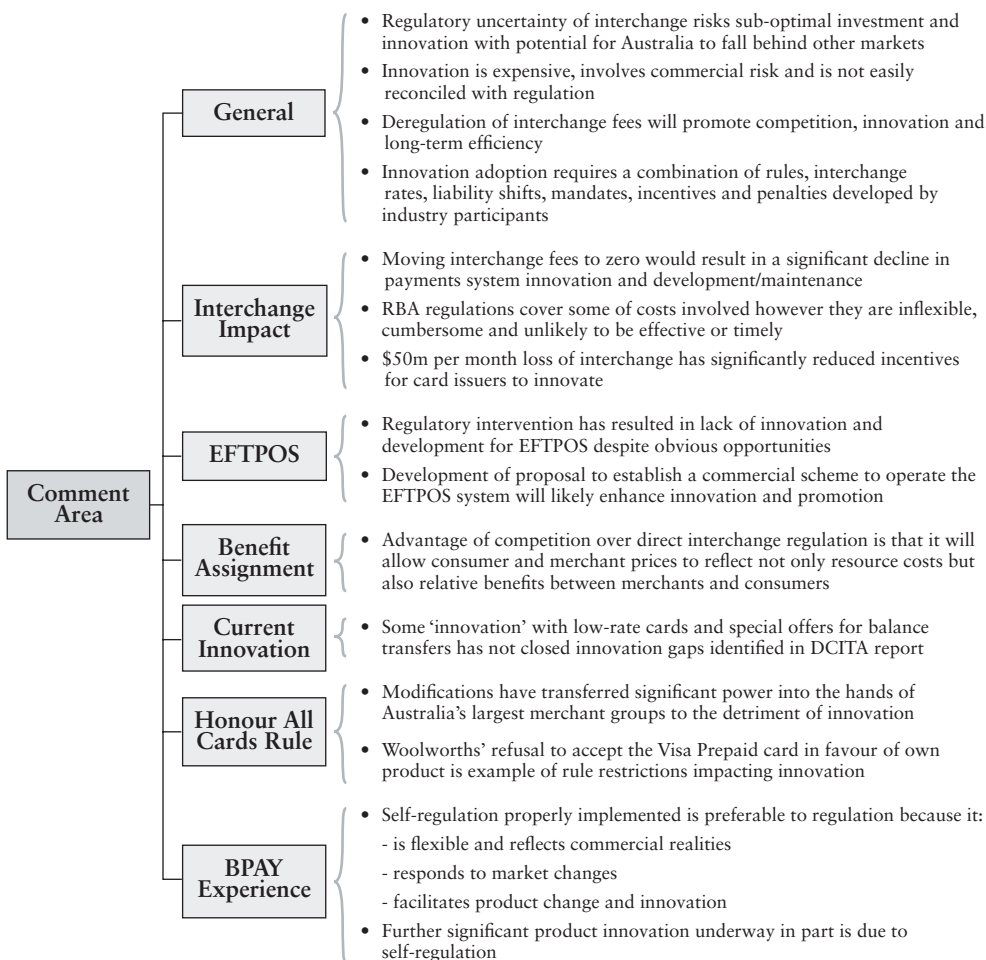
<sup>3</sup> MasterCard (2007), pp. 30-31.

<sup>4</sup> APCA (2007), p. 16.

## Summary of submissions received

There were a significant number of submissions to the RBA around the problems that the RBA's intervention has caused for innovation. NAB has summarised them below.

### Summary of Innovation Comments Made



## Discussion of innovation issues raised

From the above summary it is clear that industry participants believe that the RBA's interventions have indeed put innovation at risk, and that deregulation, particularly of interchange, will go a long way to resolving the situation.

ACIL Tasman's submission on behalf of American Express supports the above views and contends, based on Productivity Commission statements, that regulators are likely to set prices sub-optimally for innovation. They say:

One concern expressed regarding price regulation is the difficulty of collecting information to undertake the task of setting an efficient price in a non-competitive market. According to the Productivity Commission:

‘... this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment’.<sup>5</sup>

As with access, NAB contends that the co-regulatory process outlined by APCA would be the mechanism by which an approach could be developed for the RBA to withdraw from its existing interchange regulation.

### **Interchange regulation inhibiting innovation of ‘new’ types of payment methods**

Some industry participants have expressed a view that Australia runs the risk of falling behind the rest of the world because of its lack of innovation.

The RBA has also expressed its concerns as to whether Australia is failing to keep up with overseas developments. In a speech entitled *Presentation to Australian Bankers’ Association and Australian Payments Clearing Association Forum on Payment Systems Evolution*, Philip Lowe – the RBA’s Assistant Governor (Financial System) – posed the issue as to:

... whether the development of payment products in Australia has been keeping pace with that abroad.<sup>6</sup>

In this speech he also talked about developments in business products:

There have been a number of recent developments overseas which appear to have improved the efficiency of electronic payments for business customers, particularly by upgrading the interface between the payments system and business accounting systems and facilitating better opportunities for straight-through processing for business-to-business (B2B) payments.

He went on to speak about ‘online debit’ being available in 13 countries but not in Australia.

NAB believes that the RBA interchange regulation not only has an impact on innovation in existing and derivative payment types/channels as per the submissions summarised above, but also affects innovation for substantially ‘new’ methods of payment as well.

Large financial institutions need to choose from two broad approaches when it comes to developing ‘new’ payment methods. Because of the nature of payment products they usually need to opt for either an industry based or ‘on-us’ approach.

An example of an industry solution is BPAY View, whereas examples of an on-us option are any number of payables or receivables products sold to large corporates.

More often than not, this is a difficult and complex decision to make, with many factors needing to be taken into account.

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<sup>5</sup> *ACIL Tasman (2007)*, pp. 26-27.

<sup>6</sup> *Lowe (2006)*, p. 1.

Some of these factors are:

- potential customer demand;
- existing and potential market share;
- pricing level versus customer benefit;
- competitive advantage;
- potential competitor response;
- value of first mover advantage; and
- level of potential interchange.

Innovation by its very nature is risky and can often result in poor commercial outcomes which fail to meet shareholder financial return objectives. To achieve these return objectives it is essential that the end-user pricing be such that the potential rewards offset the level of risk associated with the innovation.

In the past, decisions have resulted in both approaches being selected. However, since the RBA's cost-based approach to interchange setting has been introduced, there is an industry concern that the level of reward required will not offset the risk involved, as pricing will tend to commoditise too quickly.

On the other hand, there is a view that on-us solutions provide first movers with a competitive advantage resulting in a greater level of control over pricing and the associated risk reward balance. The downside of this from a total industry perspective is that these types of models are not in the best interests of long-term efficiency of the payments system.

Interchange set by the industry itself has worked spectacularly well in the past, properly matching the benefits, revenues and costs amongst the participants during start-up. The initial credit card and EFTPOS networks are testament to this fact.

Even the RBA believes there are respectable arguments for interchange in new and developing networks. Dr Lowe stated before the *House Of Representatives Standing Committee on Economics, Finance and Public Administration* that:

I think the issue here is whether an interchange fee is in the public interest. There are respectable arguments for why such a fee is in the public interest and promotes efficiency in the system. It helps develop the network.<sup>7</sup>

If interchange is set too high with 'new' payment methods, take-up would decrease because either merchants or consumers would not use them. Only market forces are best able to determine the correct balance between the benefits and costs used to establish the level of interchange.

NAB believes that it is in the best interests of the long-term efficiency of the payments system that interchange for 'new' payment instruments should be competitively set and not regulated. The RBA could endorse this approach immediately, and APCA's co-regulatory process could be used to agree a self-regulatory basis that the industry could use to review the interchange fees when 'new' payment methods had matured.

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<sup>7</sup> *House of Representatives (2006), p. 46.*

## Issues for Discussion

Based on this overview of the issues raised on access and innovation, the following key questions arise:

1. Has the right level of access already been achieved by the Reserve Bank's regulatory intervention?
2. Can industry now take a greater self-regulatory role in ensuring access going forward?
3. How important is interchange in ensuring investment in innovation, particularly for 'new' payment methods?

## References

ACCC and RBA (2000), 'Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access', October.

ACIL Tasman (2007), 'Submission to the Reserve Bank of Australia: 2007/08 Review of the Reform of Australia's Payments System', August.

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Lowe, P (2006), 'Payment Systems Developments and Architecture: Some Background', speech to the Australian Bankers' Association and APCA Forum on 'Payment Systems Evolution: Where to From Here?', 27 September.

MasterCard (2007), 'Payments System Regulation: Response by MasterCard Worldwide to the Issues for the 2007/08 Review', 31 August.

Reserve Bank of Australia (2002), 'Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement', August.

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## 2. Manuel Garcia<sup>8</sup>

Thank you, Ian, for the opportunity to speak today on the subjects of access and innovation in the Australian payments system. These are both subjects that are of significant importance to our organisation and where more work is still needed, particularly if we aim to have a payments system that allows new entrants and promotes an environment that is progressive and open to change.

To put my comments into context, let me briefly explain who Indue is. We are an authorised deposit-taking institution (ADI) which specialises in providing 'own labelled' and co-branded

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<sup>8</sup> *Chief Executive Officer, Indue Limited.*



payment solutions to smaller organisations who wish to provide payment functionality to their customers. Two important differentiators for us are flexibility and agility. These are also important competitive advantages for us and allow us to customise our solutions so that they integrate efficiently and seamlessly with our customer's own environment. This empowers them to develop the type of customer experience they believe is important to them. For our organisation, we compromise flexibility and agility when we allow complexity to creep into our solution. So at Indue keeping things simple is top of mind.

Equally, our customers want solutions fast. While we have made much improvement in this area over the last few years, there is still more work to be done. Going beyond the customer, agility for us is more than just getting a product into the market quickly. It is also about the cost associated with delivering that product and the resource drain that product places on us. Clearly, the less agile we are as an organisation, the greater the cost of bringing a product to market.

I believe there are some parallels between what is our experience in providing our customers with payment functionality and the ease with which one can gain access to the payments system; and once in it, how creative and innovative one can practically be.

I am conscious that I only have a limited amount of time available today and will restrict my comments to three specific areas, namely: physical access to the payments system; connectivity within the payments system; and creating an environment that is conducive to encouraging organisations to be creative and innovative.

Improving access to the payments system has been a feature of the Reserve Bank's (RBA's) reforms since the beginning. In the first instance the RBA considered how to improve access to the Visa and MasterCard schemes. This led to the creation of a special class of institution called Specialist Credit Card Institutions. Next we considered access within the EFTPOS system and as a result we now have the Access Code and the Access Regime which together have created a greater level of certainty for those seeking to become a direct connector, both in terms of the process and the cost. Now we have the Australian Payments Clearing Association (APCA) looking at the issue of access to the ATM system and an ATM-specific Access Code is expected by August 2008. By and large I believe the work undertaken on access through the reform process has moved us forward as an industry and, therefore, been successful.

However, there is more work to be done in the area of access and we must widen our focus and consider access on a whole of system basis; particularly in the EFTPOS payment system. In the EFTPOS system, our bid to improve access has focused our attention on only one aspect of access, namely that of securing a direct connection. While this is important, particularly for a new entrant looking to enter the market as an acquirer, establishing a connection is not the only piece of the puzzle required to have effective access to the system. While a direct connection will certainly enable them to exchange messages – and, where they introduce new technology, realise the benefits of this – they also need to be able to exchange value with the issuers of cards whose transactions they acquire. In this case, securing access to direct settlement and clearing arrangements requires the same level of certainty as currently exists for direct connection. At present this is not the case.

Of course this is not just an issue for acquirers but is also an issue for issuers who may wish to re-engineer their settlement and clearing arrangements in a bid to unlock important cost savings. In our organisation, re-engineering our remaining indirect settlement and clearing arrangements will unlock up to 66 per cent of the cost of performing this function indirectly.

The need to allow a market participant to re-engineer their settlement and clearing arrangements was foreseen by APCA during the development of the Access Code. As a consequence, changes were made at that time to the Consumer Electronic Clearing Stream (CECS) rules which allowed a market participant with at least 0.5 per cent of the national throughput to request direct settlement and clearing arrangements with an existing direct settler and clearer. It also gave some certainty with respect to the change windows when such changes can be scheduled to occur. While these changes are welcomed, they are not enough in removing the barriers to entry for a market participant who wishes to enter the payments system as a direct settler and clearer.

Unlike the position for a direct connection where certainty exists with respect to the level of costs to be incurred by an access seeker, the same certainty does not exist for a seeker wishing to establish direct settlement and clearing arrangements. Instead the access provider gets to set their own price and, in our experience, the disparity between the price demanded by the various access providers varies significantly. In one encounter we have been quoted a price that is more than double that set in the Access Regime, namely \$78 000, for a direct connection – and the work involved in establishing a direct connection is far more extensive and complex. While I can accept that some organisations may suffer from inefficient legacy systems, why should the access seeker have to pay for this inefficiency and lack of investment?

Furthermore, the split interchange rate for EFTPOS transactions, specifically the unregulated fee, also has the potential to frustrate access, as there is no obligation on the access provider to negotiate fairly.

These all combine to restrict the level of access that I believe was in the spirit of what was intended to be achieved when access was first raised as an issue in the payments system. We need to also understand that unless we correct this in the current review, then any restrictions that remain and favour the existing access providers will only hurt the system as a whole. Particularly, the more innovative organisations, who typically will be smaller organisations like Indue, will be handicapped in their endeavours to secure reasonable passage into the payments system, specifically when it comes to direct settling and clearing.

Being restricted in the level of access one can gain to the whole of the payments system will limit the degree of innovation one can reasonably expect to see within the payments system. Equally, where a system, because of its inherent structure, accommodates complexity, innovation will also suffer. I said earlier that for our organisation simplicity in how we develop our systems is paramount in giving us flexibility and enhancing our agility. Both of these combine to help us develop ‘out of the box’ solutions for our customers which often are creative, if not innovative, because of how we have adapted to meet the needs of our customers. It is no different in the payments system.

Complexity is usually an arch enemy of innovation and often we tend to innovate to remove the complexity that time allows to creep into the system. The inherent structure of our EFTPOS payment system at present has all 8 direct connectors bilaterally connected to each other. By its very nature in its current form, with every new connector that is added, the level of complexity in the system will increase. However, given the uncertainty that previously existed in the process for securing a direct connection, the potential for complexity, understandably, has not been a major concern. However, with the greater degree of certainty introduced by the Access Code and the Access Regime, the potential for new direct connectors increases and, as such, we face the real risk that our web of 8 connectors may become potentially a far more complicated web.

But complexity is not just limited to the technical infrastructure that supports our current bilateral web of connections. Certainly as more organisations seek to become direct connectors, the number of connections required will increase. While we have capped these costs at \$78 000, we must not forget that with every new connection added, the cost for a new entrant increases by a multiple of \$78 000 each time. In a short space of time it is not difficult to see that, if the number of connectors increases, then notwithstanding the cap imposed in the Access Regime it may still prove to be price prohibitive, and in effect become a barrier to access and innovation.

So how can we remove this potential for complexity from our current access arrangements? Well, one way would be to remove the need for future new entrants to have to seek direct bilateral connections with every organisation they wish to establish a direct link with. This could be achieved by re-engineering the underlying communication infrastructure of bilateral links to achieve a central hub. This would mean that our potentially increasing web of connections would by and large remain relatively simple. Consequently, connection costs could be kept as low as just \$78 000 for any new entrant.

While moving to such an environment no doubt threatens the very fabric of what we hold dear today, let me ask you to think about why we remain locked into the current web of connections. Is it because we feel that the act of switching transaction messages between institutions gives us some form of competitive advantage – and hence, to relinquish control makes us less competitive? It is hard to think that there could be any competitive advantage in sending and receiving a standard message format. At this level of switching, I would argue that it is a commodity and, as such, the issue is all to do with the cost of switching these messages. I would expect that all of us at this level would want this done as cheaply as possible. While I can accept that perhaps some may feel some cost advantages may exist in the actual processing of these messages, this would still remain a function of each institution's host environment, and hence any competitive advantage an institution may have in this area would be unaffected.

Some work I acknowledge has been done on exploring this idea of a central hub by APCA through its CECS Interchange Communications Facility Project. While I believe this project made good progress in its efforts to try and simplify access and create the means for innovation and creativity to be allowed to flourish, I find it disappointing that this work did not receive funding in APCA's 2007-08 project plan – and, by implication, did not receive priority. If as a community of financial organisations we believe ourselves to be progressive, how can we not see this work as important?

Lastly, let me explore briefly some of the things we should consider if we are to create an environment within the payments system that will facilitate access and promote and foster innovation and creativity. In this sense, the challenge I believe is how to facilitate an effective governance structure that will work towards these goals.

At present in the payments system we have three ways of creating change. We have the RBA, which under the *Payment Systems (Regulation) Act 1998* has the powers to designate a particular payment system which, among other things, they believe to be inefficient and where change to that system would be in the public interest. Next we have APCA which is an administering body and by and large oversees the efficient operation of the various payment streams in terms of their policy, standards and procedures; and then we have self-regulation or voluntary reform from within the industry.

Over the last 5 years we have seen all three methods of change in action. The least intrusive method, namely self-regulation, we have applied to ATM reforms. This process commenced in 2002 with the formation of the ATM Industry Steering Group and only in the last 12 months, after 5 years of discussions, do we have an agreed way forward. An important turning point in this process was when the RBA intervened in March 2007 by holding a series of meetings for industry participants. At the first of these meetings the RBA stated clearly that unless the industry could agree to a position, the RBA would exercise its powers and designate the ATM system. This single action crystallised years of debate.

APCA developed for us the Access Code for EFTPOS and generally this was a successful process. However, I think it is important for us to acknowledge that access to the EFTPOS system was flagged by the RBA in June 2004 and so we, the industry, knew that access was an important issue for the RBA and therefore, we would frustrate APCA in its work to our detriment. History will say that the Access Code was developed and accepted by the Industry and pretty much delivered an important element of the RBA's planned reforms for the EFTPOS payment system. However, I ask you the question: had the RBA not made access an important public issue, would APCA have been successful in driving the development of the Access Code?

The RBA, over the last 5 years has invoked its powers under the *Payment Systems (Regulation) Act* to designate a number of payment systems to drive reform. Clearly, in invoking these powers it must have reached the view that the path of self-regulation, while ongoing, was not going to achieve a satisfactory outcome within a reasonable time frame. Now whether you agree with all that the RBA has done or not, one thing is certain: by its action it has brought focus to the payments system in totality and driven change. I think it would be hard to deny that the RBA's intervention has improved access, particularly with regards to direct connection. Certainly, for our organisation we are all the better for the work of the RBA on access and have realised real benefits because of it.

However, the RBA's work has been intrusive and intensive and most likely I think we would all agree (including the RBA) that we would prefer to find a better way for future reforms of the payments system.

I believe from watching the proceedings of the last 5 years, one of the reasons we have found self-regulation difficult to enact has been because we can only move forward once we have by and large a unanimous view. Even then, the four major banks must agree to the change before

the rest of the industry can then be convinced of the benefits of change. This is fine if the change is good for the major banks and is something they want to do, or if the regulator is making its intended desire painfully clear. But what if the change is not so welcome by the majors?

Under this scenario can APCA play a role in reconciling the views? Well yes it can, but let us not lose sight of the fact that the majors have 43 per cent of the voting rights at APCA and, hence, have a strong position of influence. To be perfectly clear, I am not suggesting that the majors behave badly. Like the rest of us, they are commercial businesses and, in practical terms, need to run their businesses in a manner that best suits them. Change for them, and us, is always best at a time when we are ready to receive it.

While it may sound as if I am about to make a strong case for leaving all future reforms to the RBA, as our experience of the last 5 years shows that they have been the most effective means of driving change, in fact I am advocating quite the opposite. In order for change to be sustainable, change itself must be driven from within. When change is created from within the industry, there is normally a greater commitment to it and a stronger sense of urgency towards its implementation. But this does not mean that all want the change. Often not all want change for a variety of reasons, and this is where good leadership and good stewardship need to exist. In instances where doubt exists over change, the industry must be able to turn to an independent arbitrator who can exercise leadership and make a decision, after due consideration of all pertinent facts, that is in the best interests of all. This is true of an organisation, and I see no reason why this would not also be true of our payments system.

In summary, let me recap on the three points I have made. With respect to access, I believe we must create the same level of certainty in the payments system for those looking to become direct settlers and clearers as we have created for those wishing to become direct connectors. Secondly, if we want to foster an environment within our payments system that will promote innovation and creativity, we must look towards ensuring that our communication infrastructure remains simple and adaptable. We must support APCA's work in exploring how to streamline the current web of bilateral connections to avoid the growth of these connections becoming an effective barrier to entry for smaller and more innovative organisations. Lastly, we have tried the path of self-regulation over the last 5 years and, if we are honest with ourselves, we have failed to self-regulate. While this should not be a reason to rule out self-regulation in the future, the lessons from the last 5 years suggest that where we have failed is in our pursuit to secure unanimous consent to change. Therefore, we need help in breaking this pursuit for unanimous consent by putting in place strong leadership that will help us, as an industry, govern ourselves by making decisions that will, in the long term, be for the good of the whole payments system.

# Discussion

Most of the discussion in this session focused on whether innovation in the Australian payments system has fallen behind that overseas and, if so, why this might have occurred. There were also some comments about access and the potential for further reforms in this area.

Concern was expressed that the Australian payments system is lagging behind international best practice. A number of innovations were cited as having occurred overseas but not in Australia, including: online PIN debit; electronic invoicing for business-to-business payments; mobile phone payments; contactless payments; PIN on credit cards; the introduction of chip technology; and more flexibility in the information that can be included with direct entry payments.

Although there was some disagreement about the significance of these various innovations, two views emerged on the reasons for the apparent lag. The first was that payments system regulation, particularly interchange regulation, has impeded innovation. There were two main reasons given for this. First, interchange fee regulation was said to have limited the pool of funds available to issuers for investment and, due to the compliance burden, resulted in a drain on resources that might otherwise be directed towards innovation. Secondly, the reforms were argued to have created uncertainty about returns on investment. Since investment in payment systems is a long-term proposition, it was suggested that a climate of regulatory uncertainty has made institutions less likely to invest.

The second view, however, dismissed the relationship between regulation and innovation. It was pointed out, for example, that interchange fees in the United States average around 1.8 per cent, far higher than in Australia, yet PIN authorisation for credit cards and chip technology have not been introduced in the United States. It was also noted that there needs to be a business case for investment to take place. Some participants argued, for example, that the introduction of chip functionality in Australia has been delayed, not because of regulation, but because fraud rates have not been high enough to generate a business case for its introduction.

Those who supported this second view typically argued that the lack of recent innovation in Australia's payments system is more likely due to a lack of suitable governance arrangements. It was argued that payment systems with central governing bodies appear to be more successful at innovation than those without such bodies. It was, therefore, suggested that the industry should focus on creating an appropriate self-governance structure to promote innovation. It was argued, for example, that the EFTPOS system requires structural improvements to remain competitive, but this is unlikely to occur unless a more appropriate governance structure is put in place. It was broadly acknowledged that there are challenges in advancing any innovation which requires industry-wide agreement, and that an appropriate governance structure could help overcome such impediments.

Finally, there was some discussion about access. It was suggested that access reforms have benefited competition and that new entrants, although few in number, have encouraged innovation. The continuing difficulties with access to Australia's bilateral payment systems were highlighted – and it was argued by some that the Reserve Bank should go further in its access

reforms. In this context, the question of the architecture of Australia's EFTPOS system was again raised: specifically, whether EFTPOS should move from a bilateral to a centralised system. It was noted, however, that it could be costly and time-consuming to restructure the existing EFTPOS system, and that significant investment in the current system should not be overlooked.