Ranee Jayamaha: New opportunities in retail payments

Speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at the IBA-Finsight Payment Systems Summit 2008, Mumbai, 16 May 2008.

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1. Background and present status

1.1 The rapid advancement of innovative payment systems we experience today is a part of the financial system infrastructure in most countries. In both wholesale and retail areas, new technologies, participants and alliances have emerged, transforming the payment systems landscape. This transformation has blurred the distinction between large value and retail transactions, and also the payment instruments used for such transactions. Often, we find that large value payments are made through cheques, while electronic payments are used for small value retail transactions. Although banks have been in the forefront of promoting some payment instruments, such as credit cards and electronic payments, and the related infrastructure, by and large, the wider payment reforms have been initiated by central banks.

1.2 The retail payment mechanisms, some of which are also systemically important, have been evolving over the past few decades. However, the progress has been slow. Given the demand for integration of retail payments with high value payments, domestic as well as international, pressures are building up to reform the retail payment systems. Accordingly, the increased availability of convenient retail payment instruments at reasonable and competitive prices has changed the individual payments behaviour and patterns. Although the gradual move out of cash has made paper-based instruments such as money orders, postal orders, bank drafts etc., popular for several decades, their market sizes have continued to decline, largely due to inherited inefficiencies and cumbersome processes in effecting and settling payments. Some of these retail payment instruments and systems have now been replaced by electronic payment instruments and cards, and the tendency is to move towards electronic credit and debit transfers. According to the statistical reports of the Bank for International Settlements, some interesting movements in the use of retail payments in selected countries can be seen. In volume terms, France, Germany, Italy and the UK have reduced cheque use from a range of 3-38 percent of total non-cash payments, respectively, in 2000 to a range of 1-26 percent in 2006, while there are no cheques at all in the Netherlands. In Brazil too, cheques have decreased from 57 to 25 percent or less in the same period. Credit and debit transfers and cards, on the other hand, have risen significantly in these countries. This picture is different to that of India, where cheque use has reduced at a slow pace from 84% in 2004 to 73% in 2007 and in Sri Lanka from 75% to 65% in the same period, indicating the dominance of cheques. I believe the situation is the same for other countries in the SAARC region.

1.3 In spite of these changes, a notable difference between high value and retail payment systems is that the high value payments have become customer-centric, while the retail payment systems have had limited success in securing customer centricity. Cross-border retail payment systems are also fragmented. Compared to high value payment systems, retail payment development is evolutionary and not revolutionary.

1.4 In general, users expect the payment system to possess three fundamental characteristics. First, it must have <u>integrity</u>, i.e. transactions must be safe, reliable and secure. Second, it must be <u>competitive and efficient</u>, i.e. the cost of making payments should be as low as possible. Third, it must be <u>accessible and inclusive</u>, i.e. available to all and include all.

1.5 As long as people see one or two of the above characteristics and accessibility, in particular, they are comfortable and do not clamour for major changes. This complacent attitude is a common challenge in retail payment reforms. People are also not too worried about the systemic risks or payment system crashes and their impacts on the wider financial system. Hence, there is no pressure for change from users although, from the policy makers' point of view, there are many risks. In this context, while preserving public preference for accessibility, the regulators and policy makers need to provide the policy and regulatory framework, while the private sector should capture critical mass by introducing new payment methods and instruments; promoting widespread access to such instruments; and removing any impediments to accessibility. This is a clear entry point and a good opportunity for both public and private sectors to coordinate their efforts.

1.6 Despite their inherent weaknesses, automated teller machines, debit cards, automated clearing house networks and credit cards have reached critical mass. However, smart cards and some e-cash systems, electronic bill payments and person-to-person internet payment methods are yet to catch up. Accessibility, but at a high price, can also put off people from opting to use such payment methods or instruments. Similarly, if there are no service providers to facilitate transactions, card usage cannot be made popular and people may continue to use cash, as they are uncertain whether the substitute or new instrument is as accessible as the old ones. Despite inherent inefficiencies of cheques, they are still popular due to easy accessibility, although the regulators keep worrying about the systemic risks involved in cheques. That's why, in the recent past, India, Sri Lanka, Singapore and many others have introduced cheque imaging or fully automated cheque clearing processes. Given the reduced time from t+5-7 to t+1-2 and facilities at regional level, in Sri Lanka, people now tend to use more cheques compared to cards or electronic payments, which is a worry. The public policy objectives of payment system development thus demands that we allay the fear of non-accessibility and, where possible, offer appropriate incentives to users to move out of paper-based inefficient instruments.

1.7 Preserving the public policy goals is easier where the regulator is also the retail payments service provider. However, where the service provider is not the regulator, it is hard to coordinate and preserve the character of accessibility. The UK regulators have taken bold steps to outsource the service provider's role and concentrate on the regulatory role, while USA, Sri Lanka and India are still trying to strike a balance between the dual roles, which we have inherited for decades.

2. Retail payments outlook and prospects

2.1 Retail banking is still the main force in banking, and is likely to stay that way for the foreseeable future, despite the relentless growth of investment banking, corporate banking and other forms of services. In 2006, retail banking business accounted for euro 1,220 bn in revenue, or about 57% of the global banking revenue pool of euro 2,150 bn. The world over, banks continue to open branches and attempt to make their branches more attractive for retail payments. Sri Lanka, India, Bangladesh and many of the SAARC countries are members of the South Asia Free Trade Agreement (SAFTA), Asia-Pacific Trade Agreements (APTA), The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), Comprehensive Economic Partnership Agreement (CEPA) and several other trade agreements. During 2002-2006, exports in the SAARC region as a ratio of world exports rose from 1.09 to 1.29 percent, of which India accounted for more than 75 percent. Although firm numbers are not available for 2007, exports are estimated to have increased at a significant rate followed by higher cross-border payments. Prospects and outlook, therefore, for Asian region trade, and consequently retail payments, are good.

3 Transforming challenges to new opportunities

3.1 <u>Challenges and complexities</u>: Retail payments development is very challenging due to numerous complexities and is much more difficult to modernize than large value payments. In order to complete even a small payment, it is necessary to have appropriate and acceptable payment instruments, an institutional set up, an enabling legal environment, infrastructure, processing procedures and money/fund transfer mechanisms. There are enough opportunities to change this situation, if all stakeholders are committed to introducing innovations, with appropriate safeguards. We need to look at some of the practical ways of starting this transformation.

3.2 Discourage cash and paper-based instruments: Progress in the use of electronic payments has been slow in our region due to numerous reasons. Cash is the most popular mode of face-to-face payments for retail transactions. Cash does not require the user to go to specific places, use computers or special equipment to originate or settle a transaction. Moreover, the payment is final. Given the user preference and convenience, cash and cheques still dominate as payment instruments in many countries. Businesses also prefer cheques because of inherited cash management processes, legacy of accounting systems or reluctance by their governments to transact in electronic payment instruments. If there are cheque clearing delays or frequent cheque returns, small businesses have no choice but to borrow for short periods, perhaps at exorbitant interest rates, from informal sources. They also prefer cheques as they can make late payments through post-dated cheques and other deferred instruments. A payment through a cheque is not final and the availability of funds to the payee takes days. Cheques carry considerable credit risk and the payment can be assured only with a cheque guarantee scheme. Although cheque returns is considered a criminal offence, banks in many countries are reluctant to take appropriate steps to deal with cheque returns, due to fear of recovery of loans and advances from customers.

3.3 Automation of cheque clearing: The cheque clearing process and its modernization have been taking place in many countries. Asia, Singapore, India and Sri Lanka have changed their existing laws and introduced cheque imaging and truncation systems, which have changed the whole process of cheque clearing and reduced processing time and transportation costs. The Sri Lankan experience shows that banks modernized their back-office systems to accept electronically presented cheque information and link branches to the central cheque clearing center at LankaClear to provide end-to-end cheque processing, by crediting the proceeds to customers' accounts on t+1 or t+2. This has had a significant impact in the rural and outstation areas in Sri Lanka, where businesses waited for 7 days or more to get cheques cleared. The system has also helped to reduce geographical barriers between regions and districts. Small businesses have begun to roll over finances better and faster. However, although it is advantageous to customers, the inefficiencies inbuilt in paper-based instruments continue to remain. Where possible, therefore, the use of cheques should be discouraged.

3.4 Promote electronic retail payments and telecommunication systems: The first step towards promoting electronic retail payment systems is to provide low cost current and savings accounts that can be accessed with a cash dispenser card. The use of non-cash payment instruments, in particular, mobile and telephone banking can be promoted together with the use of high security standards, which would ensure reliability of the payment instrument. Although the payment options for e-commerce or e-money are catching up, there still remains a significant demand for increased efficiency in the delivery channels of these instruments. The ATM machines have now extended their scope to provide a wide range of services. Singapore has introduced an e-Giro system, which enables participating banks to effect transactions using browser-based PCs at their offices, while in other countries, rural and small businesses access through the use of telecommunication facilities is fast developing.

3.5 Introduce Common Payment Switches (CPSs): The CPSs can be used for managing the clearing of retail fund transfers initially among banks, but they are common platforms for local retail transactions, online real time fund transfers and for miscellaneous retail payments across banks. Through CPSs, both operators and customers will enjoy benefits of service outside banking hours, reduction of administration work and paper handling, on-line availability of information, ability to integrate future services, reduction of settlement risks on retail transactions, etc. Accordingly, the participating banks will be able to effect customer/bank initiated transactions relating to: third party transfers (account-to-account transfers), bank transfers, bill payments, inward remittances, statutory payments such as taxes, local government rates, inter-bank transactions, direct debits and local credit card transactions. Above all, CPSs, will help reduce bank charges on financial transactions and pass on benefits to customers. Korea and Thailand have facilitated real time settlement of retail payments from person to person (P2P) or business to business (B2B) through CPSs, which is considered to be an affordable and an effective method of facilitating retail payments.

3.6 Ladies and gentlemen, it is for us to convert these challenges to opportunities. I believe that if policy makers, regulators, bankers and service providers work in a coordinated manner with a commitment to improve the retail payments in the region, we will be able to reap the benefits in the near future. I would like to mention a few areas that require urgent attention.

3.7 <u>Improve inter-operability and facilitate supply chain transactions</u>: Many financial products are not linked to financing the supply chain transactions, such as purchases, transportation, marketing of produce of farmers' small businesses, SMEs and micro enterprises, because many retail payment instruments and mechanisms are not interoperable or flexible enough to facilitate supply chain transactions. Farmers and small businesses use more cash at harvest times and both cash and cheques during post harvest periods. It is time to make a move to provide supply chain transactions with cards or direct credits and debits by providing electronic infrastructure or money transfer facilities through telecommunication technology. Adopting new technology or upgrading IT networks and infrastructure of retail payment systems is required to improve safety and efficiency gains. Service providers should look for volumes and turnover, rather than highly priced payment instruments. The users must feel that the payment instrument is secure and that the level of technology permits savings on operational costs. The issuance of cards with ATM, point of sales and e-money functions would help the user to use the same card for a variety of purposes.

3.8 <u>Enhance awareness and transparency</u>: Limited awareness of the available payment instruments, their advantages and disadvantages, and a lack of transparency have deterred the use of retail payment instruments by the general public. A review conducted by the Reserve Bank of India for the year ended March 31, 2007 reveals that the level of awareness and familiarity with payment services offered by banks were at varying degrees. This, in fact, has been one of the major inhibiting factors for migration from one retail payment instrument to another. Banks need to promote merchants in small cities to enhance the acceptance of cards at merchant locations and make users aware of the facilities. Another important feedback in India's survey was that there is a clear need for transparency in service charges on credit and debit cards.

3.9 <u>Attract retail remittances through innovative methods</u>: The denial of access to the retail payment system was also seen in small-scale cross border transfers. Bank and non-bank financial institutions and money transfer agents use their own costly and proprietary instruments for remittance transfers. The inability or inaccessibility to use the full potential of the formal remittance infrastructure has resulted in the mushrooming of popular informal systems, such as "Hawala" and "Undial", with a significant loss of foreign exchange to the banking system and perhaps to the entire country, indicating the loss of opportunities due to the inheritance of ad hoc retail payment systems. Penetrating successfully into this critical area of business is a challenge, but there are plenty of opportunities for banks. The "Padala" system in the Philippines and the agency banking system through mobile telephones introduced recently in Sri Lanka are examples of success stories. In the Philippines, telecom companies offer remittance services through mobile phones and e-money, i.e. stored value. The sender pays cash to one of the service providers, who sends a secure text message to the mobile phone of the receiver in the country. The "last mile" of service is provided by banks and financial institutions, the postal network or their agents or representatives. If remittances can be channeled through a single low-value bulk payment mechanism, the cost per transaction could be reduced. Once domestic connectivities are upgraded, they can be extended to cross border retail payment systems by ensuring safe and efficient remittance transfers. Similarly, the domestic postal systems can be connected to the global postal network and the Giro payment mechanism used for cross-border remittance transfers.

4. Framework for retail payment development

4.1 How do we seize the existing or emerging opportunities or create new ones? I hope many suggestions and initiatives may come up during the rest of the day. Let me mention a few of the major steps. The framework suggested here is by no means a well-designed blueprint for retail payment development in the region. It is only an effort made to put together a few thoughts. The key elements are not in any particular order either, but for convenience, I have categorised the key elements into policy and operational aspects.

4.2 In order to enable retail payments to play a critical role in financial inclusion, it is necessary to develop a comprehensive, medium-term framework that facilitates the reform process. Once a framework is prepared, all stakeholders need to operate within the framework designed to achieve common goals. Although the culture and patterns vary from country to country, it is clear that retail payment system reforms require the involvement of both the public and the private sector. In the public sector, the central bank's or monetary authority's involvement is essential, because they are responsible for monetary policy and for the preservation of public confidence in money. The private sector is equally important, as it has the most relevant information on the payment preferences of the people and is directly involved in providing payments services. The optimal mix depends on the level of development of the financial market, but a more active role has to be played by the authorities to achieve the public policy objectives of retail payment reforms.

4.3 Policy elements

4.3.1 Central banks to play a catalytic role: Central banks should be at the centre, take the leadership and coordinate the development process as other stakeholders tend to have vested interests. While it is important to enhance oversight and supervisory functions by the central banks and ensure that governance arrangements for infrastructure and service providers are in place, it is also necessary to ensure that such arrangements do not lead to unnecessary restrictions on competition and innovation.

4.3.2 Stakeholder participation: It is essential that central banks engage in effective participation and secure cooperation from all stakeholders in the payment systems, through establishing National Payment Councils (NPC) or National Payment Committees/Advisory Councils etc. India, Sri Lanka, Pakistan and some others have already established NPCs and they are the highest level policy making authorities for development of national payment systems. Banks have a good opportunity to give their inputs at these meetings, especially on operational matters.

4.3.3 Declare public policy objectives of retail payment system development: The undeclared and unsaid public policy objectives have been a contributory factor for ad hoc retail payment system developments in the past. We need to avoid this lacuna by getting the policy authorities to announce the public policy objectives, such as providing safe and efficient retail payment services, enhancing access to finance and financial inclusion, offering payment services at affordable prices, preserving customer and user rights, providing a legal and regulatory framework and supporting the development of effective standards and infrastructure arrangements.

4.3.4 Customer-centric strategy and fair treatment to customers: Retail payment reforms should go beyond the current requirements and be able to cater to future requirements, given the rapidly expanding trade and financial transactions in the region – primarily in India and some other countries. The strategy should include guidelines to move towards open and standardized customer-centric systems. The retail payment system operators and service providers should attempt to achieve the following outcomes to ensure that the customer is treated fairly:

i. To begin with, relevant initiatives should be embedded in the corporate culture of the organization. This requires leadership at senior management level;

ii. Products and services marketed and sold in the retail payments market should be designed to meet the needs of identified customer groups and targeted accordingly. Customers in different groups should be advised appropriately. This would help to reduce misleading advertisements, which often use various gimmicks to attract customers;

iii. Customers should be provided with clear information and kept appropriately informed before, during and after the point of sale. Products should maintain acceptable standards and meet customer expectations. This involves transparency on the part of service providers; and

iv. Customers should not be faced with unreasonable post sale barriers imposed by banks and financial institutions or service providers, forcing them to purchase supplementary products and services.

4.3.5 Ensure fair treatment to customers: Treating customers fairly throughout the life of a payment product, as well as at service points, is an essential theme that should be focused on by all stakeholders. In this regard, it is necessary to establish principles-based regulations on payment related activities rather than compliance or rules-based regulations. The regulations should relate to the payments mode or the payments product life cycle and the payments culture in each country. The principles and related reviews should seek to accomplish the provision of solutions to significant and persistent problems in the distribution of products in the retail segment of the payment services, and to build financial capability, i.e. equipping customers with the skills and knowledge needed to achieve a fair deal.

4.3.6 Established customer protection and rights, and legal framework: The retail customers and their rights should be protected in the legislation. Several countries have passed separate laws to achieve this. In the Payments and Settlements Act, the Central Bank of Sri Lanka has included a separate section on customer protection. In 2005, the Reserve Bank of India established regulation and supervision within its Payment and Settlement Act. It is imperative that customer rights are looked after as many financial institutions and service providers have been accused of customer exploitation. In addition to protecting customer rights, the legal and regulatory framework should keep pace with changing circumstances and promote innovation and integration to suit customer needs. There should also be regulatory provisions to remove any restrictions to market entry and product development, especially for those who try to link retail payment instruments with the high value payment systems.

4.3.7 Setup standards and governance structure: International standards and practices have been established for credit and debit cards. The joint efforts for introducing micro processing chip or tamper proof cards and security solutions in the credit and debit cards should be encouraged to foster Internet payments. Setting standards by the authorities would promote developing off the shelf software solutions to automate systems and integrate different systems. The general guidelines for retail payments development issued by the Bank for International Settlements in 2005 sets out guidelines, but they are basically policy or regulatory related matters. The information technology industry needs to take an initiative in preparing guidelines and governance structures to meet standards on a self-regulatory basis.

4.3.8 Operational elements: The framework should set out operational responsibilities for the other stakeholders. The most important of these are

i. Explore new technological capabilities: Policy makers and regulators should attempt to discourage preference by vendors, system operators, financial institutions, service providers and users in defending inefficient and old systems, which have hidden benefits or other comforts. Priority should be given to use up-to-date technology for transactions routing mechanisms, security systems and codes for inter bank clearing and settlement mechanisms.

ii. Efficiency and risk control: Many developing countries, in general, and South Asia in particular, are characterized by a heavy use of cheques, which indicates that the retail sector is far from being optimal from the point of view of efficiency and risk control. Central banks and all stakeholders in the retail payments arena need to take early action to reduce the cheques and design a strategy to incentivise users to move towards other electronic payment instruments. It is also important to correct the wrong impression that cheque processing through Automated Clearing Houses (ACH) is cheaper than investment in electronic payment systems and on line processing. The view that outstation and rural customers are reluctant to use electronic cheques or credit and debit cards is no longer true.

iii. Involve governments: Government involvement in the development of retail payment system is a key, although it has become one of the difficult tasks. Many government transactions are in cash or by cheque, and governments are not keen to acquire modern payment infrastructure or recognize the benefits of using newer payment instruments. One obvious reason for this is the ready access governments have to state banks' cash items in process of collection, which enables immediate credit to governments. Efforts are now being made by some countries such as the Philippines and Eastern European countries to involve governments in retail payment development by diverting revenue receipts from income tax, custom duties and other income sources through modern retail payment instruments.

iv. Establish confidence in payments media: Either the service providers, the regulators or consumer protection authorities, or all of them jointly, should ensure that new products are safe and efficient and that they have public confidence in them. Pushing efficiency too far could adversely affect public confidence in payment instruments. For example, moving aggressively into credit cards, which are considered to be efficient and safe payment instruments, has also resulted in numerous frauds and risks, and this has begun to scare people. New technologies break physical distance barriers enabling efficient real time transactions, but the critical factor is network security, which should ensure access only to a person's own funds. New delivery channels for retail payments such as the Internet, on-line personal payments, electronic bill presentments, telephone, e-cheques or e-invoices are becoming popular, although they do not always assure the same level of security as some of the other products. Tamperproof cards are generally considered to be safeguard against credit card frauds, but the relevant software appears to be expensive. Financial intermediaries are not keen to invest in such safeguards. Even if they do, they will pass on the costs to customers, which will defeat the affordability purpose. Vendors and service providers need to be flexible to pass on the benefits of technological advances to a larger group of users. Demand driven innovations should also be promoted and vendors should look for volumes and turnover, rather than high-priced software sales.

5. Agenda for SAARC region payment systems development

5.1 The banking community in India as well as in other SAARC countries need not reinvent the wheel. There is good news. Following a request made by the SAARC country

Governors, a SAARC Payments Initiative has been set up to take forward the payment reforms in the region. Within this Initiative, a SAARC Payments Council (SPC) has been set up, consisting of high level officials from SAARC central banks who are also the Chairpersons or senior members of their national payment councils. SPC will be the policy making authority for both high value and retail payments. The organisational structure is considered a very practical one, because of the involvement of all national stakeholders in the national payments councils, which will provide a good forum for the banking community and all service providers to give their inputs for retail payments developments in their own countries, as well as in the region. Currently, Sri Lanka chairs the SPC and a Secretariat has been set up in Colombo to facilitate operational processes. SPC has already prepared a road map for the first year and a rolling plan for the medium term.

6. Conclusion

6.1 In concluding, let me re-emphasize that technological advances and changing industry structures are two key forces that impact on payment system developments, of which retail payments is a critical component. However, attention to public priorities, i.e. integrity, accessibility, efficiency and the safety of new retail payment methods, has been low. There is, therefore, an urgent need for coordination between policy makers/regulators and the private sector to ensure that they cater to the general public.

6.2 There is a clear role for banks, service providers and technical solution providers in the SAARC countries to take forward the region’s retail payments development. First, we need to understand the environment in which we work by estimating gaps in the systems. The SPC has already begun the preliminary work in this regard. Banks in the SAARC region will have to coordinate with their respective central banks and national payment councils in taking forward the SAARC payment initiative.

6.3 Development of the retail payment system is crucial for the development of financial markets in South Asia, particularly at a time at which faster growth requires supportive financial services. It is necessary for all stakeholders to be involved in the area of payment system development in preparing a realistic agenda within the national jurisdiction, as well as taking into consideration cross country legislation. In doing so, it is essential to understand the critical issues in the retail payments area and try to minimize the inefficiencies and improve safety issues involved in some of the popular payment modes.

6.4 The NPCs and the regulatory bodies should make all attempts to persuade retail payment service providers to use common national and inter-regional and infrastructure and fostering the standardization and harmonization of retail payment systems. The high cost involved in retail payment systems processes is not necessarily due to the large volumes or the wide array of payment instruments, but due to the use of a large number of proprietary infrastructure systems by service providers and the passing on of these high costs to users. While introducing customer-centric products, it is important to ensure that customers are protected and their rights are preserved. I hope some of the opportunities mentioned above and many others that will be highlighted during the rest of this Summit will be taken up by the banking community and service providers and that they will work closely with the SPC to take the region’s payment system development process forward.

Thank you.