Glenn Stevens: Issues in payments systems

Remarks by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Annual General Meeting of the Australian Payments Clearing Association, Sydney, 23 October 2014.

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Thank you for the invitation to speak on the occasion of Australian Payments Clearing Association's (APCA) Annual General Meeting. The Reserve Bank and APCA have a long history of working constructively as they carry out their respective responsibilities in Australia's payments system. We both have an interest in ensuring a safe, efficient and competitive payments system that meets the needs of end-users.

When I last addressed an APCA gathering in May 2012, we were at a particularly interesting juncture for the payments industry. The Bank was approaching the end of a two-year period of public discussion and consultation about innovation in the payments system. This extensive public process, involving all the key industry players, and users of the payments system, had not been done before. After a roundtable attended by most members of the Payments System Board, numerous meetings at staff and management level, extensive feedback about published material and so on, the Bank released the conclusions of its Strategic Review of Innovation in the Payments System in June of that year. The Reserve Bank regards that document, and the process that led up to it, as a landmark for the payments system in Australia.

Interestingly enough, the Innovation Review was not mainly motivated by concerns, on our part, that innovation was not occurring, even though it was sometimes claimed that the regulatory regime inhibited it. On the contrary, we were seeing, and continue to see, rapid innovation in some elements of the system, as financial institutions, payment schemes and a variety of other players seek to deploy new technology to compete with one another or to draw business away from traditional payment forms like cash and cheques.

The most obvious recent example is the use of contactless payments. In mid 2012 relatively few of us would have made a contactless payment. Now they have become second nature to most of us and Australia has become the leading contactless market in the world. While this does not represent a fundamental change in underlying payment systems, it is a quite significant change in the way consumers interact with the payments system and changes the cost of payments to both merchants and consumers. Our recent diary survey suggests that the adoption of contactless has largely reflected a switch from traditional contact-based card presentment, but that there has also been some displacement of cash, particularly at smaller transaction sizes.[1]

We are also now seeing the roll-out by several players of mobile-phone-based point-of-sale card acceptance facilities, where an intermediary provides a merchant some form of attachment to a smartphone or tablet, turning that phone or tablet into a card-acceptance device. This has significant potential to spread further the appeal of electronic payments to smaller businesses.

At the same time, a clear trend towards online commerce and online banking is leading to a rapid increase in remote – as opposed to point-of-sale – payments. This is likely to be an area of increased competition, but is also the focus of increased efforts to improve the security of payments. Overlaid on all this is a proliferation of new models for using existing payment methods and indeed some proposals to change fundamentally the way we think about payments.

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1 Ossolinski C, T Lam and D Emery (2014), 'The Changing Way We Pay: Trends in Consumer Payments', RBA Research Discussion Paper, No 2014–05.

The one area where there has been less progress than we might have expected in 2012 is "mobile wallets" for point-of-sale payments, i.e. where a consumer's card or account information is incorporated into a phone application and the phone becomes the consumer's payment device. Of course, this may well change quickly at some point.

So innovation is proceeding. It would seem premature to expect that we have seen the apogee of technological development in the payments space. More likely it will continue, in ways that are impossible to predict, but are likely to be "disruptive" – the adjective of choice these days.

But there is a key caveat here. Innovation in the payments system is not just a matter of technology – as remarkable as the extent of technological advance has been. We have had rapid innovation in areas where individual entities can innovate on their own, or where a central scheme has the capacity to push innovation out to its members and/or users. These innovations can provide significant benefits, but by themselves are not enough, in the Bank's view, to deliver the policy goals set for the Payments System Board in its mandate. The setting within which innovation occurs also matters. The Innovation Review recognised that, in networks, where the ability of one institution to deliver value to its customer is dependent upon how well it can connect with all the other institutions and their customers, the full flowering of innovation depends to no small extent on system architecture, as well as governance.

The technical architecture – for example, hub-and-spoke architecture versus bilateral links – can make it easier for new or established players to take advantage of technological change to bring new services to customers, or harder. Governance around processes can be accommodating to change or resistant to it.

Overall, the record in Australia in instances where innovation requires cooperation between established players, especially where one or more of them feels the need to protect an existing line of business, is mixed. We are all aware of important cases where things have run into the sand.

This isn't just a problem for the industry. It's a problem for the users of the system as well. Innovation in the "cooperative space" – where no single entity has control – is critical because it is this space that determines the limits on the services that the rest of the payments system can provide.

These issues have been a matter of concern for the Payments System Board for quite a long time. The Board has always seen fostering innovation as part of its "efficiency" mandate under the *Payment Systems (Regulation) Act 1998*. An important speech by Philip Lowe as long ago as 2005 focused on payments system architecture (in particular the bilateral nature of a number of important payment systems), the limitations of governance arrangements and the challenges for the industry in making cooperative investment decisions. His overall observation was that the then-existing arrangements were hindering innovation.[2]

Of course the technical architecture of systems is largely a legacy of decisions taken in an earlier era, probably for good reason at the time. Changing that architecture is difficult and costly, though that is not a reason not to try and certainly not a reason not to adopt better architecture for new systems. The establishment of EPAL, for example, has provided an opportunity to improve the network architecture of the eftpos system to allow it to better adapt to the demands of the modern economy.

There have also been some important developments in industry governance. First, APCA itself has this year implemented some significant reforms to its governance. The new board structure includes representatives of the major banks, the mid-sized and foreign banks and

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[2] Lowe P (2005), 'Innovation and Governance of Payment Systems', address to Banktech.05 Conference, Sydney, September.

the credit unions and building societies. It also includes an independent chair and two other independent directors. New types of players are also represented at other levels within the APCA structure, better reflecting the make-up of the modern payments system. APCA's willingness to make these changes is to be commended.

Second, APCA and the Reserve Bank have also worked jointly towards the formation of a new body that is intended to take a higher-level, more strategic view of the payments system. This is a direct response to one of the important conclusions of the Innovation Review – that some of the difficulties that institutions faced in undertaking collaborative innovation might be alleviated by the creation of a body that would have senior-level representation from a wider range of organisations than have traditionally been members of APCA.

The resulting body is the Australian Payments Council. The Council, which will have its first meeting next week, comprises 14 members, including from institutions typically represented on APCA's Board, plus representatives of payment schemes, retailers with their own payments infrastructure and other payment services providers. The Council will have an independent chair and representatives from APCA and the Reserve Bank.

The formation of the Council is a very important development. The Payments System Board expects it to take an industry-wide view as to how the payments system can better meet the needs of end-users. On that basis, the Board looks forward to active engagement with the Council.

That in no way indicates that we see a lesser role for APCA. On the contrary, APCA's role continues to be very important, including in some aspects of self-regulation and facilitating industry collaboration in determining rules and standards for the five different clearing streams that APCA oversees. APCA has also been active in thought leadership and advocacy for the payments industry. For example, APCA is currently playing a role in thinking about transitioning payments to the digital economy. It has published a series of "Milestones" reports – the most recent in July – looking at developments in the use of payments, and in particular the decline of cheques and the transition away from cheques and cash towards electronic payments. Not surprisingly, the reports highlight that use of electronic payments is continuing to grow strongly, while use of the traditional "paper-based" payments is falling.

This, I might add, is consistent with the findings in the Bank's recent consumer use survey. Our study – the third of its type – provides transaction-level data from a survey of over 1,000 consumers. It found that cash remained the most frequently used means of payment in 2013, though its use had declined noticeably over the previous three years. Cash accounted for 47 per cent of the number and 18 per cent of the value of all payments in 2013, down from 62 per cent and 29 per cent respectively in 2010. Cash was used particularly intensively for low-value transactions, with consumers using cash for around two-thirds of payments under $20.

While the use of cash is declining relative to other payment mechanisms, it will continue to have a role in the economy. Indeed, as the Bank has noted previously, banknotes on issue have for a long period grown broadly in line with the nominal growth in the overall economy. And the consumer use survey suggests the amount of cash in respondents' wallets grew between 2010 and 2013. Together, this evidence suggests that cash continues to have a significant role – not just for small-value transactions, but also both as a store of value and for precautionary use when other means of payment are not available. This is one of the reasons that the Reserve Bank is undertaking its Next Generation Banknote program, which will ensure that Australians can continue to have confidence in the nation's banknotes as an effective means of payment and secure store of wealth. But this is not inconsistent with the Bank's desire to encourage the efficient use of electronic payments.

A more marked decline is evident in the use of cheques. The number of cheques written in Australia peaked around 1995. Since then, the number of cheques written each year per capita has fallen by more than 80 per cent (from 45 to 8). Over the same period, the number of electronic payments per capita has risen by more than 400 per cent. As the use of cheques has fallen, the per-cheque cost to financial institutions and businesses has generally risen. The market has, and continues to, respond to these pressures by looking for more efficient ways to process cheques, but they are clearly the highest cost payment instrument, as will be confirmed when the Bank releases its payments cost study later this year.

This decline in the use of cheques, a very expensive payment instrument, is one that the private and public sector will have to manage. Part of that will involve the introduction of effective and readily available substitutes for users, and initiatives such as Superstream and eConveyancing are likely to be part of this.

Central to the industry's efforts to develop new payment products and services will be the New Payments Platform (NPP). I would like to use my remaining time to make some comments about this important project.

A key point in the Innovation Review process was the industry roundtable held in 2012, focusing on the familiar themes of payments system gaps, governance and architecture. My recollection of the discussion was that there was fairly widespread acceptance that the industry would need to find a way to make some bold decisions about cooperative investments in payments system infrastructure not too far down the track. This has been echoed in subsequent views expressed by some of the key players.

The Reserve Bank agreed. The Payments System Board has seen its own role as acting as a catalyst for that cooperative investment. In the Conclusions to the Innovation Review, the Board announced its intention periodically to set some strategic objectives or general goals in terms of the services that the payments system should be able to provide to end users.

The five strategic objectives that the Board set in 2012, after lengthy consultation and with, I think it can be said, a wide consensus within the industry, were as follows:

- all direct entry payments to be settled on a "same day" basis
- the ability to make retail payments in real-time
- the ability to make and receive payments outside of normal banking hours
- the ability for payments to carry more complete remittance information
- the ability for payments to be addressed in a simpler way than using a BSB and account number.

The first of these, the same-day settlement of direct entry payments, was achieved in 2013. It is therefore now possible for recipient financial institutions to make funds available to their customers sooner, without incurring credit risk. The Bank worked closely with the industry to facilitate same-day settlement, including the introduction of new liquidity arrangements for exchange settlement accounts at the Reserve Bank.

These new liquidity arrangements will also be important as the industry moves to meet the other four objectives from the Innovation Review. On those other objectives, the Payments System Board set out a proposed timeframe. It also offered one piece of guidance, namely the suggestion that it would be desirable to have all payments system participants connecting to a central hub or hub-like arrangement in any new payments infrastructure, as opposed to continuing with the numerous bilateral linkages that have proved to be not particularly conducive to either innovation or competition. Beyond that, the Board did not seek to dictate particular technical details of the solution, accepting that the industry itself should provide the roadmap to the agreed destination.

One initial concern was that industry participants might respond with a number of separate solutions, but no clear path forward. APCA has played a constructive role in helping the industry to come together to form a project that will meet these four strategic objectives.

Initially, a small committee developed a proposal for new payments infrastructure that is now being called the New Payments Platform. After this proposal was welcomed by the Payments System Board in February 2013, a broader group of 17 institutions came together to fund the initial development of the project. The participating institutions have been going through the final stages of vendor selection in the recent period. This has been an industry-driven process, in pursuit of the goals articulated by the Board, and to which the industry has committed.

We have detected considerable interest internationally in this approach – not just the design features being proposed for the NPP, but also the way the central bank and the payments industry are seeking to work collaboratively to achieve major change.

This approach, however, is not without its challenges. It requires that industry leadership and collaborative spirit to be maintained over a sustained period. At various key moments the project faces the risk of that spirit breaking down.

The Reserve Bank is fully aware of how complex and far-reaching this project is, and how costly. Our own contribution to the settlements architecture is a major project for us as well. Having said that, let me also say, very clearly, how important the Bank sees it that the industry deliver on its collective commitment to deliver real-time, accessible payments to the community.

The Bank is also aware that there could be a temptation along the way to seek to constrain the system, so as to conform to existing boundaries and business models. This is where the broader governance arrangements now in place need to take into account the interests of users and the need for the system to be open to competition, not just the interests of the existing players.

We – the industry and the Reserve Bank itself – are building a piece of national infrastructure. We should take every opportunity to increase its potential value to the nation, rather than limiting it for fear of where it might take us. The biggest risk with this project is probably not a technical one. It is the risk that, in 10 or 15 years' time, we will look back and see that we missed an important opportunity to provide something that will fully and efficiently support the payments needs of our economy. We owe our citizens a better outcome than that. We have to deliver, one way or another, the architecture and products that they will need into the future.

It is not as though things are standing still in other jurisdictions. In the area of real-time payments, we have seen major initiatives launched in Sweden and Singapore – countries we would often view as comparators in terms of their income levels and market structures. The Swedish system was launched in December 2012 with a service known as Swish, which enables households to send real-time payments via their mobile phones on a 24/7 basis, 365 days a year. Singapore's system, known as FAST, was launched in March this year. These two initiatives have wide participation, including by all the larger banks in those countries and many of the smaller institutions. There are some other countries, with lower income levels, lower penetration of electronic payments and without universally "banked" populations, that have also made the leap to fast retail payments. These include Mexico with its SPEI system, South Africa with Real-Time Clearing and India with its Immediate Payments Service. Is there a plausible reason to accept Australia falling behind?

Delivering the NPP is also, in my opinion, in the interests of the Australian financial institutions, which are at the heart of payments today. It can be expected to lead to further growth in electronic payments and a reduction in costs. It will maintain the ongoing relevance of the current players. If those players do not provide Australian end-users with the services they want, surely others will seek to do so. Alternatively, the Reserve Bank would be duty bound to consider a regulatory approach.

So our message to the industry is: stay the course. Continue the goodwill and prodigious effort that has brought you to this point. Deliver on the commitments you have collectively made. Let us together build a payments infrastructure that is efficient, open to competition and that will support innovation into the future.

I thank APCA and its officers in particular for the efforts they have made, and continue to make, in the NPP and across the payments landscape. And I wish the broader payments industry success in its efforts to improve Australia's payments system and look forward to ongoing cooperation between the Bank and the industry.