

Industry Issues and Debates

In this year's Review, we have chosen three diverse subjects to highlight current issues in payments.

- \\ A longitudinal study of the perennial debate about governance of payment systems.
- \\ A focal point on the renewal of connectivity and networking in payment systems.
- \\ A broad pan across recent global developments against the background of the global financial crisis.

In Focus:
Industry direction
Developing industry consensus on the future evolution of the Australian payments system.

"In short, there were problems because there was no participant in the system thinking of the benefit to the system as a whole with the power to effect change. ...in many countries, this role is handled by a single private sector entity... For example, the credit card schemes have a central body responsible for governance, innovation and promotion. ...But that entity is missing in Australian payment systems." ⁽¹⁾

*Mr Glenn Stevens,
Governor, Reserve Bank of
Australia, 25 March 2009*

Governance – are we there yet?

In his first public utterance on payment systems earlier this year, the Reserve Bank Governor raised a long-standing and particularly thorny payments policy issue: effective system governance. He mused on the problems of good governance in "network industries" – those where market participants (for present purposes, banks and other payment institutions) must cooperate on "network" elements between them even as they compete on payment services to system users (all of us).

This issue is not new. It has been around since payments processing became automated and high-volume, thereby intensifying the need for system coordination. Industry and regulator alike have been expressing concern, and attempting reform, for more than 20 years.

Governance over the years

In 1988, the Australian Bankers' Association formed a "task force" to review clearing arrangements, which led in turn to a Reserve Bank-sponsored Reform of the Clearing System Steering Committee.⁽²⁾ Out of this, in 1992, came APCA – the first comprehensive attempt at Australian payments system governance, with a framework of clearing systems across cheques, bulk electronic, consumer and high value payments. APCA's technical and operational role was complemented at a policy level by the Australian Payments System Council (APSC), which advised the Treasurer on the development of the payments system. The governance problem was solved.

Or was it? By 1997, the Financial System Inquiry (FSI) was proposing radical change, including disbanding the APSC, on the basis that:

"APCA has been effective in facilitating new entry into the payments system and has been the forum in which improvements in the technical efficiency of the payments system have been negotiated and agreed. However, continued reliance on cooperative arrangements in the absence of specific performance benchmarks and clear public policy objectives, may impede the overall efficiency of the system."⁽³⁾



The FSI's nostrum was a Payments System Board (PSB) set up within the Reserve Bank, with statutory powers over system efficiency, technology and competition. APCA, the card schemes and BPAY would govern their respective systems within this policy framework. And so, around 10 years ago, the governance pendulum swung to the right in favour of greater public involvement. Now, surely, the problem was solved.

Well, apparently not. In 2005, with the PSB in place for six years, the Reserve Bank was again casting around for governance solutions:

"APCA itself, as an organisation, has relatively little authority, with the decision-making powers resting in the hands of the member institutions that make up the Board and the various management committees. ... Is there a case for a private-sector central body that has a broader mandate than simply being the keeper of the rules? This mandate could include promotion of various payment systems, the facilitation of access, and provision of leadership on some technology issues."

Dr Phillip Lowe, Assistant Governor (Financial System), Reserve Bank of Australia, 16 September 2005⁽⁴⁾

At the same time, payments participants were reconsidering system governance in card payments as Visa and MasterCard took on more commercial and competitive positioning. Over several years, APCA coordinated the development of new governance frameworks to improve access and competition in the ATM system – the ATM Access Code – and to provide a business development focus for the EFTPOS system in the face of increasing competition from international card schemes – EFTPOS Payments Australia Limited. Both developments were strongly supported by the Reserve Bank.

In fact, payments system governance developments have accelerated in recent years. The international card schemes have demutualised and commercialised, leading to a much stronger focus on international business development. BPAY and Cardlink have merged, to provide a stronger payment operations scheme to support MAMBO, BPAY's major new consumer payments development. APCA is now establishing a new governance framework for an industry-wide Community of Interest Network (COIN) – a communications layer open for use by all retail, consumer and bulk payment systems.

And yet, in 2009 the Governor remains troubled by the "governance question". The good news is that the particular problems he articulates – how to effect innovation and pro-competitive reform in Australian ATM and EFTPOS networks – are already being addressed by the industry. But clearly, broader structural concerns remain.

Competition and governance

So, are we there yet? That rather depends on where you want to get to. We need to tease out what system governance really means. It turns out that this vitally depends on quite a different question, which is this: should payment systems compete with each other?

Past governance debates tended to have a "utility" flavour to them – Payment systems were seen as basic infrastructure, with relatively little contestability between various systems – all the competitive action happened among payment institutions using the systems to offer payment services.

In the "utility" system view, there is a need to drive innovation and efficiency in payment services by encouraging greater competition amongst institutions. But at the same time, there is a need to promote effective coordination across these intense competitors, because that is the only way to promote evolution of the underlying (utility) payments system. Coordination can be done by the industry itself – which is often called "self-regulation" – or, it can be done by the regulator.

The thinking behind the establishment of the PSB largely followed this "utility" system view. Payment services were to be made more efficient by exposing banks to more competition; evolution of the underlying system was to be achieved through "specific performance benchmarks and clear public policy objectives" backed by statutory powers:⁽⁵⁾

"Open architecture will be critical to effective competition. Substantial cost savings in the payments system should be achievable through giving the PSB a clear mandate to improve payment system efficiency."⁽⁶⁾

Governance was therefore conceived as the way to achieve system evolution by ensuring coordination amongst the competing banks and other payment institutions. Hence the replacement of an advisory council with a muscular PSB: in the absence of commercial incentives towards coordination there seems to have been an expectation that there would be substantial government involvement, directly or indirectly.

The problem with the utility system view is that the world has moved on. Payment systems are no longer just the platforms for participant competition – they are competitors and increasingly commercial, profit-oriented ones to boot. This is clear from a glance at the railway billboard encouraging commuters to put it on BPAY, or the prime-time TV ads for Visa and MasterCard – "goes where EFTPOS can't". If payment systems are intense competitors, how should they be governed?

In some ways, this makes payments system governance less of a conundrum. A properly competitive market for payment systems and instruments should drive system efficiency and system innovation, and this means the need to provide governance or regulatory incentives for system evolution – the FSI's "specific performance benchmarks" – should reduce.

The industry governance challenge is principally to protect and enhance competition amongst systems. Ironically given its antecedents, much of the PSB's work since its inception has had this goal: to enhance competition amongst card schemes. Examples are changes to the surcharging and honour-all cards rules, as well as support for industry moves to establish EPAL and provide a new alternative for online payments.

To borrow Governor Stevens' words, someone still needs to think about the benefit to the system as a whole with the power to effect change. But in a world of system competition, the thought process is likely to be very different. Instead of trying to prescribe overall strategy, it will focus on setting the "rules of play" – minimum standards for all systems – and on promoting inter-system competition through common standards and ubiquitous connectivity. Each competing system should then be incentivised to design and execute its own forward evolution. All these issues are well and truly top-of-mind for the industry, as a review of the proceedings of the Card Payments Forum⁽⁷⁾ and the Low Value Payments Roadmap⁽⁸⁾ will attest.

So we may not quite be there, but we have certainly come a long way. If the new system governance structures now coming on stream evolve as they should, and we continue to see the healthy levels of industry coordination on larger industry direction issues of the last few years, we may finally be able to stop talking about governance.

(1) www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_apr09/Pdf/bu_0409_3.pdf

(2) APCA Annual Report 1992, p5.

(3) FSI Final Report, March 1997, p386.

(4) rba.gov.au/Speeches/2005/sp_ag_160905.html

(5) FSI Final Report Section 9.3,

(6) *Id.*, p411.

(7) cardpaymentsforum.com.au

(8) apca.com.au





Industry issues and debates (continued)

“Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat.”

Sun Tzu

The future of low value payments

One of APCA's major initiatives for 2009 and beyond is the development of the Community of Interest Network (COIN). The COIN is next generation connectivity for Australian payments – a network cloud using Internet Protocol to replace bilateral links using X.25 protocol. Initially created to handle ATM/EFTPOS real-time messages between financial institutions, it will also be used for cheque and direct entry transaction files.

There are two major components of APCA's work associated with the COIN. One is the development of the governance arrangements, procedures and rules. The other is transitioning member traffic from their old physical connectivity to the COIN.

The COIN is an industry-based tactical response to the impending “end of life” for existing X.25 based connectivity. Other solutions are possible, in particular, use of the SWIFT network for cheque and direct entry transaction files. But the COIN is the default option and as a result, will occupy significant member time and resources going forward.

However, the COIN is more than a tactical response. It is also one component of the *Low Value Payments Roadmap*, colloquially known as “the LVP Roadmap”, released by APCA in December 2008. With a particular focus on the direct entry system and cheques, the Roadmap was a result of consultation undertaken by APCA with industry stakeholders throughout 2008. It outlines a vision, framework and long-term agenda for industry collaborative work. It is premised on the idea that industry direction work by APCA can help guide future industry collaborative work, assist investment decisions and inform users and stakeholders of future industry direction.

Why an LVP Roadmap?

The spark for creating the LVP Roadmap was a perceived need identified by APCA members to address a number of historic issues associated with the cheque and direct entry clearing systems including declining cheque volumes, the existing bilateral architecture and risks associated with overnight settlement. Opportunities presented by new international messaging standards such as ISO 20022 and the aforementioned “end of life” for existing connectivity technology also emerged as critical issues during the consultation process.

Underlying all these issues was an acceptance that systemic innovation in network industries is not necessarily spontaneous and at times requires coordination. Yet there was also an acceptance of the criticality of promoting competition to foster product innovation and efficiency.

Developing the Roadmap

Balancing the expectation between identifying areas for industry collaborative work with promotion of competition demanded a focused yet open consultative process from APCA.

A working group of APCA members was established to oversee this work. The process included the publication of a consultation paper in May 2008 and a seminar in June 2008. The consultation paper invited written submissions, with over 20 received from a wide assortment of industry stakeholders. The working group reviewed the submissions and in turn developed the LVP Roadmap, which was approved by the APCA board in December 2008.



2018 Vision

The LVP Roadmap has a number of elements. These include i) a vision for 2018, based on anticipated user and participant expectations; ii) a topology for understanding the various competitive and collaborative layers; and iii) a solution path for the coming years, including a number of tactical initiatives within a strategic framework.

Though technology will radically transform what is achievable, the consultation suggested that the basic expectations of future users and participants will remain essentially what they are today. Users will continue to expect reliability, security, efficiency and convenience. Similarly, participants will be looking for a system that provides business potential, is globally aligned and enables risks to be managed.

The challenge for the 2018 vision is promoting innovation and choice in customer service while ensuring stability and efficiency in the underlying system. These two goals are to some degree in tension: on the one hand, customers will demand service innovation, diversity and contestability, leading to great complexity in payment products and services; and on the other hand, customers will expect system reliability, ubiquity and efficiency.

Topology for Competition and Coordination

The LVP Roadmap set out a topology, shown below, that seeks to identify the layers within low value payments and the degree to which competition and coordination are needed.

Components near the top of the topology are “user-facing”. It is here that diversity and contestability will yield the improvements in efficiency and innovation.

Nearer to the bottom are those components that require some element of coordination. Coordination may be delivered by government, regulators or else through industry collaboration. These components include settlement, messaging and physical network connectivity.

Solution Path

The COIN represents the new physical connectivity and is but one part of the “solution path” outlined in the LVP Roadmap.

A significant settlement issue arising from the consultation process is the risks presented by the 9am next day settlement. APCA is working with its members and the Reserve Bank (RBA) on the RBA’s “Low Value Payments Feeder” initiative, which will likely open up opportunities in the medium-term for more frequent settlement and, potentially, new “real-time” payment products and services.

An issue raised in the consultation was the restrictions associated with current direct entry messaging, in particular the limited number of characters for transaction reference information. The emergence of new international messaging standards, such as ISO 20022, presents potential opportunities and challenges, particularly if major users, such as large corporates demand alignment between domestic and international standards.

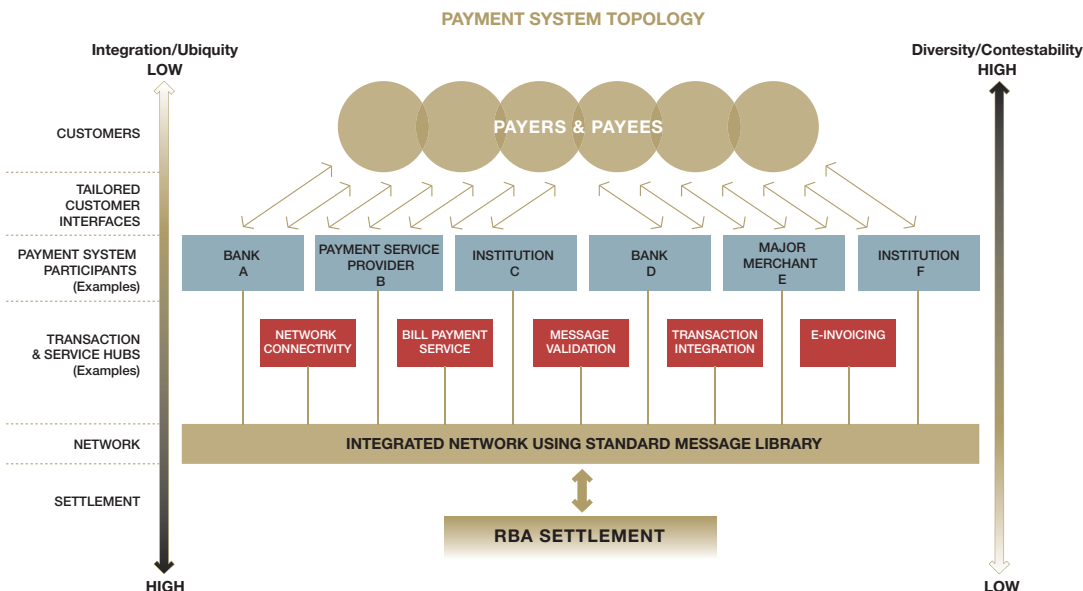
To this end, the solution path proposes the development of a messaging library, with the initial step being mapping and gap analysis work. This will facilitate an informed industry dialogue around the direction of messaging standards in Australia in the years to come.

The decline in cheque volumes was acknowledged in the consultation. There was a general consensus that the current direct entry system was not yet a “cheque replacement” for some routine payment activities and that a managed, orderly exit from cheques was preferable to a “rush to the door”. To this end, the LVP Roadmap recommends a project looking more closely at the future of paper payments. This would involve development of a long-term strategy by the end of 2010 for the management of the decline of paper payments, possibly including consideration of electronic alternatives and measures to reduce processing unit costs.

Conclusion

Some of the tactical solutions being advanced now, such as the COIN, address immediate issues, while other matters such as messaging standards, are more longer-term concerns. The sequencing and decision steps in the LVP Roadmap provide a measured approach towards the 2018 vision, with clear decision points along the way. It enables the short-term and medium-term tactical solutions, such as the COIN, to become building blocks towards creation of a platform for longer-term strategic work, such as consideration of new standard payment types and long-term network evolution. Both the vision and solution path will require periodic assessment in light of changes to the competitive market, technology and other environmental factors.

It remains APCA’s conviction that the industry consensus around the vision and priorities for action sets the industry on a sound, globally competitive pathway to the future.





Industry issues and debates (continued)

"We cannot settle for a return to the status quo. We must put an end to the reckless speculation and spending beyond our means; to the bad credit, over-leveraged banks and absence of oversight that condemns us to bubbles that inevitably bust.

Only coordinated international action can prevent the irresponsible risk-taking that caused this crisis. This is why I am committed to seizing the opportunity to advance comprehensive reforms to our regulatory and supervisory framework."

*US President Barack Obama,
24 March 2009*

Global developments in payments

The credit crunch of 2007-08 turned malignant in the final months of 2008 to become a worldwide financial crisis. The collapse of Lehman Brothers on 15 September 2008 proved the tipping point, driving a massive loss of confidence in financial services globally. The next six months became a flurry of mergers and rescue packages throughout the world. Australia escaped relatively unscathed compared to the deep structural changes occurring within the United States, United Kingdom and Europe.

By March 2009, conditions in global financial services had stabilised. However, prospects for the world economy remained uncertain as of mid-2009. GDP growth rates in the first quarter of 2009 were negative in most of the developed world (with Australia again being the exception, maintaining positive growth for the first half of 2009).

Payments system resiliency

Though the depth and severity of the current economic downturn has yet to play itself out, the shock of the recent events to the world financial system remains unquestionable.

Yet throughout this period, the international payments system proved resilient. In its April 2009 Payment Systems Oversight Report, for instance, the Bank of England said that despite the distress experienced within individual institutions and throughout the financial system, the payments system "did not act as a channel of contagion".

Toughness of the payments system is a tribute to previous and current industry participants which have built industry collaborative institutions that have withstood the current crisis. The future challenge is to continuously improve on these arrangements to deliver effective and efficient payment systems in a rapidly changing and increasingly challenging environment.

Regulatory response

The financial and economic crisis has seen a strong response from governments and regulators worldwide seeking to manage the fallout. The political response in a time of crisis can set the regulatory framework for decades to come.

Interestingly, the strength of the payments system was highlighted by the absence of payments and settlements from the agenda of the G20 Summit in April 2009 in London. There, developed countries, including Australia, agreed to an ambitious agenda for financial stability, new institutions and greater international coordination to address the current crisis and prevent future ones. Though tax havens, prudential requirements, corporate governance, risk management, credit rating agency regulation and accounting standards were all identified as areas requiring major reform in the final G20 communiqué – payments and settlement infrastructure did not rate attention.

While the G20 leaders did not specifically identify payments as requiring serious regulatory attention, there remain other indications that payments may get caught up in the more general trend towards tougher regulation. Similarly, major financial institutions are in for some challenging times as world political leaders construct a new regulatory architecture.

One area being swept up in the current pro-regulatory cycle is payment cards, often as a result of vocal criticisms from merchant representatives. On 22 May 2009, US President Barack Obama signed the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009. This legislation introduces a number of consumer protection measures including prohibiting certain fee and interest charge practices. A Canadian Senate Committee reported in June 2009 on the need for similar consumer protections in credit cards. The Committee also made recommendations about permitting merchant surcharging, though it did not specifically recommend the need to set credit card interchange fees.

Competition regulators in Europe and New Zealand are also pushing for changes to card scheme fees and practices. MasterCard Europe and the European Commission announced they had reached an understanding on cross-border interchange fees, to be effective 1 July 2009. As part of the understanding, MasterCard Europe announced that its intra-European Economic Area cross-border interchange fees would be no more than 30 basis points for credit cards and 20 basis points for debit cards. New Zealand Commerce Commission reached settlements with both VISA and MasterCard in August 2009, where the schemes agreed to alter their rules in New Zealand to permit merchant surcharging and enable issuers to set their own interchange rates subject to scheme-wide caps.

Payment system trends

Users also responded to the external financial and economic conditions. These saw two types of payment trends – short-term cyclical declines amongst certain instruments and channels as a result of deteriorating economic conditions and a continuation of long-term structural moves away from paper payments and towards card and electronic payments.

Global payment volumes did decline. SWIFT reported the first-ever drop in volumes in its 37-year existence. Data from UK Payments Administration (previously APACS) for the 12 months ending June 2009 notes that within CHAPS, the high-value RTGS system for the UK, values declined by 37 per cent – a clear reflection of underlying economic conditions that were deteriorating throughout 2008-09. Similarly, cheque values in the UK declined by 13 per cent during the 12 months to June 2009, but as part of a longer term decline in paper payment use since the early 1990s.

Conversely, the bulk electronic system in the UK, BACS, saw values actually rise by 2 per cent in the 12 months to June 2009. Faster Payments, which began in May 2008, saw a fourfold increase in monthly values between June 2008 and June 2009, pointing towards future growth. Direct entry volumes in Australia actually rose between May 2008 and May 2009, though values declined slightly.

In both North America and Europe, debit cards transactions continued to grow stronger than comparable numbers for credit cards. For example in the UK, the number of credit card purchases fell by 1.1% in 2008 from 2007 and total spending fell by 0.3%. Conversely, the value of spend on debit cards rose by 9.2% for the same period. Australia has seen similar trends, with credit card volumes and values static between 2007 and 2009, while debit cards have been enjoying double-digit growth in terms of both volumes and values.

The current economic downturn and its impact on users in major markets makes distilling cyclical and structural trends in cards somewhat difficult. Though the shift to debit was identified prior to the current crisis, time will tell whether the most recent consumer shift towards debit is primarily in response to current economic circumstances or part of the longer-term trend identified earlier this decade.

Industry collaboration

As governments, regulators and users have all responded to the crisis and its aftermath, so too has the payments industry. As already mentioned, the existing system has proven resilient to the crisis. However it is not only a matter of time before economic conditions improve and the demands for innovation, efficiency and competition grow.

It has often been through industry collaboration that the platform for innovation, efficiency and growth is established. As the “green shoots” grow, then the payments industry needs to position itself for future opportunities. The global financial crisis (GFC) has meant that, for the moment, governments and regulators have put competition concerns on the backburner as they address stability issues. However as economies recover we should expect a renewed focus on competition, as the GFC has reduced diversity within the market place through industry rationalisation.

Addressing concerns for competition, efficiency, innovation and growth is being facilitated overseas through new governance structures, commercialised schemes and new payment instruments. In the UK, the Payments Council received an overall positive assessment from the Office of Fair Trading, locking in a legitimate self-regulatory governance framework from innovation. In Canada, Interac, which operates the domestic debit card scheme in Canada, is seeking to change its current mutual structure to a for-profit structure to better position it to compete with the international card schemes. Cross-border industry collaboration, though even more challenging, will bear fruit with the proposed launch of SEPA Direct Debits in November 2009. New collaborative initiatives, such as the International Payments Framework (IPF), are seeking to facilitate cross-border payments.

Challenges going forward

Though payments were not swept up in the resulting regulatory response of the crisis, payment card systems are evolving and remain front of mind for government regulators throughout the developed world. The recent “status quo” decision by the Reserve Bank of Australia on interchange fee regulation will likely see less interest in Australian developments as other countries move to regulate credit card fees and practices domestically.

The impact of deteriorating economic conditions on users have injected a cyclical element into the long term trends away from paper based payments and towards cards (especially debit) and electronic payments.

Lastly, the challenge for industry remains in identifying and driving collaborative efforts, in the face of these challenging economic and regulatory conditions, that can meet the demanded improvements to drive innovation, competition and efficiency.