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## THE ROLE OF THE BOARD

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### THE BOARD'S RESPONSIBILITIES AND POWERS

The establishment of the Payments System Board on 1 July 1998 was one of the major changes to Australia's financial regulatory structure flowing from the Financial System Inquiry (the Wallis Committee). The Reserve Bank's previous informal oversight of the Australian payments system was substantially upgraded, with the granting of a formal mandate to the Board to promote safety and efficiency and strong regulatory powers in support.

These new arrangements arose out of the Inquiry's conviction that Australia had work to do to bring its payments system up to international best practice, certainly as far as efficiency was concerned. In the Inquiry's view, a payments system steered only by co-operative arrangements between participants, as had been the case in Australia, could not be guaranteed to deliver on the objectives of public policy, particularly the goal of improving efficiency. The Inquiry also acknowledged that the safety of the payments system was integral to overall financial stability, which was a long-standing Reserve Bank responsibility.

The Board's mandate is set out in the amended *Reserve Bank Act 1959*. The Board is responsible for determining the Reserve Bank's payments system policy and must exercise this responsibility in a way that will best contribute to:

- controlling risk in the financial system;
  - promoting the efficiency of the payments system; and
  - promoting competition in the market for payment services, consistent with the overall stability of the financial system.
- The relationship between the Board and the Bank is that the Board determines policies with respect to the payments system and the powers to carry out those policies are vested in the Bank. These powers, which are wide-ranging, are set out in three separate Acts. The centre-piece is the *Payment Systems (Regulation) Act 1998*, under which the Bank may:
- "designate" a particular payment system as being subject to its regulation. Designation is simply the first of a number of steps the Bank must take to exercise its powers;
  - determine rules for participation in a designated system, including rules on access for new participants. The Reserve Bank now has the capacity to decide on questions of access to the payments system, since access is an important determinant of efficiency;
  - set standards for safety and efficiency for that system. These may deal with issues such as technical requirements, procedures, performance benchmarks and pricing; and
  - arbitrate on disputes in that system over matters relating to access, financial safety, competitiveness and systemic risk, if the parties concerned wish.



The *Payment Systems (Regulation) Act 1998* also gives the Reserve Bank extensive powers to gather information from a payment system or from individual participants.

The Government's intent was that the Bank would treat these powers as "reserve powers", to be exercised if other means of promoting efficiency and competition proved ineffective. Accordingly, the Government built considerable flexibility into the new regulatory regime. Under this co-regulatory approach, the private sector will continue to operate its payment systems and may enter into co-operative arrangements, which may be authorised by the Australian Competition and Consumer Commission (ACCC) under the *Trade Practices Act 1974*. However, if the Bank is not satisfied with the performance of a payment system in improving access, efficiency and safety, it may invoke its powers. It may then decide, in the public interest, to set access conditions or impose standards for that system. In doing so, it is required to take into account the interests of all those potentially affected, including existing operators and participants. Full public consultation is required and the Bank's decisions can be subject to judicial review.

The Reserve Bank also has specific powers under the *Payment Systems and Netting Act 1998* and the *Cheques Act 1986*, which are designed to strengthen the legal underpinning of the Australian payments system by clarifying the rights of participants. These powers were explained in the Board's first Report.

Looking ahead, the Board will acquire additional responsibilities as part of the Government's ongoing Corporate Law Economic Reform Program (CLERP). The draft *Financial Services Reform Bill* proposes, inter alia, a single statutory regime for the licensing and regulation of clearing and settlement facilities. Licensing would be by "the Minister" (ie the Treasurer or a Minister in his portfolio) while regulation would be the responsibility of the Australian Securities and Investments Commission (ASIC), with a significant role for self-regulation. However, in consultation with the Reserve Bank and ASIC, the Minister may declare that a particular clearing and settlement facility is of sufficient significance to the stability and integrity of the payments system that it should be regulated by the Payments System Board. Such a declaration would remove that facility from the coverage of the (amended) Corporations Law and place it under a comparable regulatory regime in the *Payment Systems (Regulation) Act 1998*. This would involve gathering and assessing relevant information, ensuring that the facility operates safely by, for example, vetting its rules and procedures, and imposing any conditions necessary on the operator's licence.

The Government's intention is that the legislation would come into effect by mid 2001. Once it does, the Reserve Bank and ASIC will enter into a Memorandum of Understanding setting out areas of common interest as well as information-sharing and co-ordination arrangements.

## THE BOARD'S APPROACH

The Board's priorities over its first two years have been shaped by the preliminary stocktake which it undertook, early in the piece, of the efficiency and safety of the Australian payments system. The findings were summarised in the Board's first Report. Broadly speaking, the stocktake confirmed the conclusion of the Financial System Inquiry that there was scope to reap significant gains in efficiency in the retail payments system. At the retail level, Australians have enthusiastically embraced electronic means of payment, particularly debit and credit cards. However, the payment instrument that is most costly to provide – the cheque – remains the most frequently used non-cash instrument, while the most efficient way of paying regular bills – direct debits – has found limited customer acceptance. The pricing of some payment services also lacks a compelling rationale and is distorting the payment choices facing consumers. From the safety perspective, in contrast, the stocktake found that Australia had a very robust payments system by international standards.

Against this background, the Board's main focus over 1999/2000 has been the pursuit of greater competition and efficiency in the retail payments system.

Retail payments arrangements are coming under increasing scrutiny in other countries as well. In the United Kingdom, a report for the UK Government, *Competition in UK Banking* (the "Cruickshank Report"), concluded that the UK payments system needed major reform and recommended the

establishment of an independent payments system commission to help secure price transparency and efficient wholesale pricing. In the United States, major court action asserting anti-competitive behaviour by credit card associations is under way, on two fronts. Existing retail and commercial payments systems are also facing challenges in many countries from the rapid growth of electronic commerce.

The evolution of the retail payments system is determined, fundamentally, by consumer demand, technology and competition in the market place. The Board does not have a blueprint to guide this evolution, and it would be presumptuous of it to direct resources or seek to "pick winners" amongst competing technologies. That is the role of the market. For the market to work efficiently, however, users of payment services should pay for those services and the prices they pay should broadly reflect the costs of production. Retail payments systems may fail one or both of these tests. In some cases, this is simply a legacy of the era in which there was considerable cross-subsidisation in banking, resulting in payment services often being provided free or well below cost. Even now, however, some providers do not have a good grasp of the costs of producing payment services and, where they do, it has not been easy to move to cost-based pricing in the face of customer opposition. In other cases, such as credit card schemes, fees and charges to customers are based on wholesale fees which are determined by financial institutions at one step removed from end-users. Credit cardholders



themselves do not face any costs at the time of a transaction because there are no transaction fees and card scheme rules prevent the passing on of costs to cardholders. The normal requirement that an efficient market should signal to the consumer the resource cost of the service is missing.

Hence, the encouragement of transparent pricing for payment services, broadly reflective of costs, has become a major policy objective of the Board. If this can be achieved, consumers will be well placed to make decisions that lead to a more efficient retail payments system. That system will almost certainly involve greater use of electronic payment mechanisms and reduced, though still continued, use of cheques. The durability of the cheque should not surprise. Provided charges for cheques reflect the relative costs involved, cheques have a place as a convenient and flexible payment instrument for many Australians. In the same way, there is nothing inherently inefficient in using a full-service, rather than a self-service, petrol station provided the buyer faces the correct relative prices.

The Board's approach to meeting this policy objective, within a co-regulatory regime, can be illustrated by two of its initiatives during 1999/2000. The first is the study of interchange fees and conditions of entry in debit and credit card schemes, which has been undertaken jointly with the ACCC. The study has now been published and its conclusions are summarised in the next part of this Report. In the information-gathering phase, the Board deliberately eschewed the use of its statutory powers in favour of an

approach based on co-operation, and it was pleased that most participants in card schemes responded in that spirit. Participants were also given every opportunity to explain their understanding of the rationale for interchange fees and access arrangements. In a small number of instances, however, the Board found it necessary to use its formal powers under the *Payment Systems (Regulation) Act 1998* to obtain information.

The study explains the workings of debit and credit card schemes, the role and level of interchange fees and, where relevant, the methodologies used by financial institutions responsible for negotiating or setting fees. Card schemes are complex and the rationale for interchange fee arrangements is often not well understood, even by some of their participants. Publication of the study is intended to fill a clear gap in the information available to the community about the operation of card schemes. The Board regards this as an important part of its role. At the same time, the study has identified shortcomings in competition in the provision of card services, which have raised the cost to the community of the retail payments system. These shortcomings need to be addressed, in the first instance by the financial institutions involved, if Australia is to benefit from improved competition and efficiency in debit and credit card schemes.

A second Board initiative has been the promotion of direct debits. Once established, direct debits are probably the most efficient means of paying regular bills or recurring obligations, but this instrument has not

found ready acceptance in Australia. The infrastructure for direct debits is well established, in the form of systems and procedures co-ordinated by the Australian Payments Clearing Association (APCA). Recent changes have made the procedures more flexible for the institutions involved, but were not directed specifically at winning over consumers to direct debits. The Board reached the view that greater take-up would require the introduction of consumer safeguards of the kind that had proven successful abroad, but had not been tried in Australia. It has been working with billing organisations to develop such safeguards. The outcome is a new Charter for Direct Debit Customers, described in the next part of this Report, which gives consumers clear control over their bill payments. Billing organisations are free to commit to this Charter (a number have already done so) and use it as the basis for promoting direct debits to the Australian community. The Board saw its role as a catalyst for change in this area and, with the Charter now agreed, it can step back from this involvement.

In contrast to these specific initiatives, the Board's involvement in the development of electronic commerce is at a more embryonic stage. Australian businesses have been quick to harness the speed and flexibility of the Internet to improve the efficiency with which they communicate and do business with one another. However, the payments side has been lagging, in Australia and other major countries, and considerable gaps have opened up between the payment demands of e-commerce and what established payments

systems can deliver. One reason has been the inherent need for higher standards of security and reliability for payments systems than for less critical communications, which can make them more inflexible and harder to change. Another reason is that traditional providers of payment services have tended to be less fleet-footed than the dot.com companies leading the e-commerce charge. Magnifying the problem is the fact that a single payment provider cannot reform a payments system; it must convince other providers of the need for change and to make the investment that would bring it about. The result, too often, is movement at the pace of the slowest.

In following developments in this area, the Board has been mindful to distinguish issues that are clearly proprietary, between payment providers and their customers, and those that have a broader industry dimension. As the Financial System Inquiry highlighted, it is in this latter area that markets for payments services and co-operative governance arrangements can work imperfectly and give rise to public policy concerns. For the moment, the Board's priority is to monitor the payments solutions which emerge in the e-commerce area, to satisfy itself that they meet users' expectations of flexibility and efficiency but without compromising safety and security.

