

Submission to the Reserve Bank of Australia

Strategic Review of Innovation in the Payments System: Conclusions

Initial Strategic Objectives

August 2012



About this document

This is the submission of the Australian Payments Clearing Association to the Reserve Bank of Australia's *Strategic Review of Innovation in the Payments System: Conclusions* document, issued in June 2012.

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1. About APCA and this Submission

This submission provides feedback to the Reserve Bank of Australia (RBA) and the Payments System Board (PSB) as requested in the *Strategic Review of Innovation in the Payments System: Conclusions* (Conclusions Paper).

The Australian Payments Clearing Association (APCA) is the primary industry vehicle for payments industry collaboration in Australia. It exists to advance the common interest of members and the interests of the Australian public in improving the Australian payments system. APCA seeks to do this by enabling competition and innovation, promoting efficiency and controlling risk in the Australian payments system.

APCA has promoted debate on systemic innovation in payments over many years, through publications such as the 2008 *Low Value Payments: An Australian Roadmap*, policy submissions, discussion papers, as well as convening the Australian Payments Forum (APF) and creating the APCA Stakeholder Forum.

APCA is mindful of the RBA's express desire for a coordinated industry response to the Conclusions Paper. This submission expresses the views of APCA as an industry body. It has been developed through the voting structures of the organisation, signifying that the views expressed here represent the coordinated views of the APCA member community.

APCA has invited our members to consider these views when preparing their own submissions. Members may choose to express support for the community views enunciated by APCA or to present a different view.

We have also considered the views of other industry participants, for instance through the APF meeting held on 13 August 2012 in Sydney.

2. Overview

APCA welcomes the Conclusions Paper as providing public policy direction for Australian retail payments. APCA is committed to working with the RBA and members on payment system evolution.

PSB and Industry Liaison

We welcome a proactive approach in setting out strategic objectives for the payments system and for a framework enabling a more direct interaction between the PSB and industry through an industry coordination body (such as a Payments Council).

APCA commits to working on the formation of a Payments Council. APCA also proposes the rapid formation of a Real-Time Payments Committee in the interim to develop the industry preferred approach to the “next generation” initial strategic objectives, including out-of-hours payments, richer data and simpler addressing and in particular real-time payments.

The Initial Strategic Objectives

APCA believes that there is broad acceptance amongst our members of the initial strategic objectives as public policy goals and strongly agrees that it should be industry’s task to determine the most efficient way to implement these objectives. We are committed to developing an industry-managed process to work towards the objectives. In this context, we see the time-frames set by the RBA for the strategic objectives as public policy targets. Greater clarity will be needed on how the objectives will be achieved before time-frames can be confirmed.

On the issue of same-day settlement of Direct Entry payments, APCA believes that intraday liquidity issues need to be resolved quickly to ensure an efficient and effective implementation of this reform. APCA does not believe further enhancements to Direct Entry beyond this are warranted while industry efforts are directed toward new separate real-time payments architecture.

Real-Time Payments Architecture

APCA sees significant merit in the development by the RBA of an enhanced settlement service that will support the faster settlement of retail payments.

APCA sees the Real-Time Payments Committee and proposed Industry Expert Working Group as developing an industry preferred approach on the “next-generation” initial strategic objectives by the end of 2012.

3. PSB and Industry Liaison

APCA supports the PSB's decision to periodically set and review high-level public policy objectives for the Australian payments system. APCA believes it is important for the PSB to consult on these objectives and to articulate their clear public policy requirements, as an input into system planning and coordination.

APCA welcomes the opportunity proposed in the Conclusions Paper to develop an enhanced industry coordination body (referred to here as a Payments Council) to engage directly with the PSB.

APCA sees a Payments Council as having two initial functions:

- to provide coordinated authoritative advice, on behalf of the payments community, to the PSB on the formulation of public policy objectives for the payments system; and
- to be the venue for industry debate and decision-making on how the industry will respond to public policy objectives as they are set.

APCA has offered to act as the facilitator and coordination venue for development of the Payments Council, and has received the encouragement of the RBA to commence work on this task while the RBA consults with stakeholders in parallel. We will continue to coordinate with the RBA as proposals develop.

Establishing a fully-resolved governance structure for the Payments Council will involve extensive consultation, if the wide range of industry perspectives are to be fairly taken into account. The structure will need to address issues of fair representation, allocation of decision-making rights, process for formulating industry decisions, the level of authority that might be attributed to such decisions, and how the body will be resourced and funded. APCA intends to develop a detailed model during the remainder of 2012, and has commenced discussions with industry stakeholders for that purpose. This would make the formation of a Council possible during 2013.

Despite the long-term significance of these governance developments, most of the industry's focus since the publication of the Conclusions Paper has been on the initial strategic objectives, and the industry's approach to meeting them. The rest of this submission is devoted to this. As the Conclusions Paper acknowledges, the proposed Payments Council would have provided the ideal forum for these deliberations, but cannot be formed quickly enough to do so.

Instead, APCA is in the process of forming a Real-Time Payments Committee (the Committee) to develop the industry's preferred approach to achieving the "next generation" initial strategic objectives. The Committee will comprise senior executives from the four largest banks, three representatives of smaller institutions, the APCA CEO and an independent chairperson. This would occur in parallel with RBA and APCA work on forming the final Payments Council, so that the Committee could in due course become a subcommittee of that body.

Section 6 outlines the Committee and its intended work in more detail.

4. Feedback on the Initial Strategic Objectives

In this section APCA has provided feedback on each of the initial strategic objectives set out by the RBA in the Conclusions Paper, as well as providing additional comments based on our consultations with members, APCA stakeholders and the wider payments community.

4.1 Same-Day Settlement of Direct Entry Payments

RBA's Objective: All Direct Entry payments should be settled on the day payment instructions are exchanged by the end of 2013.

Prior to publication of the Conclusions Paper, APCA's Board agreed to a same-day settlement policy for Direct Entry (DE) payments and agreed on an implementation model for three intraday settlements covering the first three daily exchanges by early 2014. The Conclusions Paper points out that the majority of DE payments value is contained in the last two BECS exchanges. The PSB expresses the view that industry should expeditiously move to same-day settlement of all DE payments.

APCA accepts same-day settlement of all DE payments as a public policy position. Accordingly, APCA intends to amend the previous industry policy to support five intraday settlements of BECS and is re-scoping the work already commenced to implement this model.

Consultation with BECS Participating Members and our expert working group on settlement evolution shows that while members are committed to implementing same-day settlement as soon as possible, there remain challenges in committing to the desired implementation timing at this stage. Accordingly, we will continue to implement five intraday settlements in BECS and will engage further with the RBA on timing.

4.1.1 A note on liquidity risk and management

APCA's members have raised concerns about liquidity risk and liquidity management in relation to same-day settlement of BECS. This is particularly the case for the last two daily exchanges and was an important factor in influencing the industry's endorsement of the three intraday settlements model.

Under current BECS settlement, FIs are able to predict their liquidity (or cash flow) requirements for each day, allowing them to manage their cash flows with a high degree of certainty. The move to full same-day settlement reduces this certainty and will make it difficult for FIs to manage their liquidity efficiently. This is an important issue for FIs and impacts not only their ability to settle in BECS but also the way in which liquidity is managed for use in other aspects of their businesses, such as borrowing and lending activities and foreign exchange swaps. In addition, non evening-agreed FIs currently cease participation in the cash markets at 5:15pm. Under a same-day settlement model, this would limit options for both evening-agreed and non evening-agreed FIs to manage cash reserves.

APCA notes and welcomes the RBA's assurances that it will continue to discuss these concerns with industry and that appropriate liquidity solutions will be put in place to address the issues raised. Industry is concerned that successful implementation of same-day settlement of DE payments could be delayed by lack of clarity on intraday liquidity support. We look forward to the RBA detailing the proposed new arrangements as soon as possible so that members can factor them into current implementation planning and business decision-making.

4.1.2 Operational risk

All FIs will have to implement operational changes to enable same-day settlement of DE payments and to manage the varied operational risks involved. One major change will be the need to have staff and systems available to manage the late settlements. For smaller FIs adding additional staff could have significant cost and operational implications. FIs will also need to make changes to treasury processes to operate effectively under a same-day settlement regime, which may require investment of considerable time and costs. The extent of this will depend on the details of new liquidity arrangements developed with the RBA.

Tier 1 BECS Participating Members who clear and settle DE payments on behalf of other FIs will have to review these arrangements to determine their effectiveness alongside same-day settlement. Both Tier 1 and Tier 2 participants will need to make substantial changes to their systems to ensure successful implementation of same-day settlement and Tier 2 participants in particular will need the opportunity to satisfy themselves that any new arrangements with their Tier 1 sponsors are acceptable. All of these issues will need to be taken into account as detailed implementation planning proceeds.

4.1.3 A note on other enhancements to DE

In the Conclusions Paper, there are references to other possible enhancements to the DE system. These include exchange and settlement of DE messages out of hours (page 9 of the Conclusions Paper) and various “hub” functions through the Low Value Clearing System (page 15 of the Conclusions Paper).

These matters are worth further exploration, but should not now be adopted as strategic objectives for the DE system. Much more analysis is needed on the cost and risk implications, as well as a deeper understanding of the market demand. The DE system was designed to efficiently process bulk payments files and has been highly successful in facilitating large volumes of low value transactions at a low cost. The system has also been flexible enough to support the development of additional payment services that were not initially envisaged, such as internet “pay anyone”. Its strength lies in extremely cost-efficient processing of high volumes across a wide diversity of payment types.

While APCA supports the objective of providing out-of-hours payments, out-of-hours official exchanges and settlements in DE is unlikely to be a good way to meet the objective. Out-of-hours posting to merchant accounts for retailing receipts is already becoming widespread without any need for change to DE, and given the small values involved, the associated credit risk is negligible relative to settlement risks routinely managed in the market.

Additionally, it is likely that any new real-time payments services developed in Australia (see Section 4.2 below) would be available on a 24/7 basis, and fill any remaining marginal gap in DE services. Users will eventually have the choice of very low cost, efficient and same-day (after implementation of same-day settlement) bulk payments, as well as real-time payments services available 24/7.

Each additional industry project increases the overall project risk for system renovation, leading to the risk of a too ambitious programme causing project disruption and delay. A much safer course would be for the industry to focus on the challenging objectives of same-day DE implementation and providing for new real-time payments.

4.2 Real-Time Retail Payments

RBA's Objective: There should be the capacity for businesses and consumers to make payments in real time, with close to immediate funds availability to the recipient, by the end of 2016.

Industry is moving to speed up payments flow, consistent with user expectations towards faster processing. Recent competitive developments in payments have been aimed at speeding up the payments service for end users. APCA therefore accepts the RBA's objective that there should be capacity for businesses and consumers to make payments in real-time with close to immediate funds availability by the recipient.

The real challenge is to determine how this objective is to be achieved. Although the PSB is clear that industry is best placed to determine the most efficient way to meet strategic objectives (page 25 of the Conclusions Paper), the Conclusions Paper includes extensive discussion of a particular model.

Rather than debating the merits of particular technical solutions, APCA proposes developing a preferred approach on real-time retail payments as detailed in Sections 5 and 6 of this submission.

4.3 Out-of-Hours Payments

RBA's Objective: There should be the ability to make and receive low-value payments outside normal banking hours by the end of 2016. This would include availability of the Direct Entry system and any real-time system. Ideally it would also involve the capacity for the settlement of card payment receipts during weekends and public holidays, so that receipts can be posted to merchants without generating interbank credit risk.

APCA accepts the RBA's objective to enable the provision of out-of-hours payments, but does not accept that the objective should stipulate which system or systems must provide this capability.

APCA believes that industry should determine how best to implement out-of-hours payments and that this objective could be achieved through a program of work to provide real-time payments services. Our preliminary view is that any new real-time payments functionality should provide 24/7 availability, subject to scheduled industry change windows to enable planning and management of ongoing system development and maintenance.

As discussed above in Section 4.1, APCA does not support committing industry to further extensive development of the DE system to support out-of-hours exchange and settlement, if at the same time industry is engaged in a major project to provide new real-time retail payments functionality with 24/7 availability. It is also clear that a liquidity solution for payments on weekends and public holidays would be required for DE payments to be settled at these times.

In relation to the availability of card payment receipts on weekends and public holidays, APCA sees this as a matter for acquirers to address with their customers, rather than forming part of the RBA's objective to make low-value payments available out-of-hours. Indeed, this issue is increasingly being addressed through competition.

4.4 Remittance Information with Payments

RBA's Objective: Businesses and consumers should have the capacity to send more complete remittance information with payments by the end of 2016.

APCA agrees that businesses should have the capacity for additional information with payments. The demand amongst consumers should be considered in the context of further work.

In 2008, APCA identified the ISO messaging standard as a possible solution to providing additional data with payments and undertook an initial gap analysis between Direct Entry and ISO20022 messaging. APCA developed and published in 2012 a non-binding ISO20022 schema for Australian payments. This represents the only detailed public exposition to date of how ISO20022 might be utilised in Australia. Recently, APCA has been working with members to determine how the schema can be utilised.

APCA's experience of working with members on the schema and in other forums indicates that many are actively engaged in developing their own client-facing ISO20022 applications to provide more data with payments and strongly support the development of a clear industry pathway. It is also clear that providing richer data with payments involves more than simply automating a paper invoice, because data requirements vary across industries. The challenge is to develop a framework that adapts to multiple and different industry requirements.

The RBA has suggested that one way to provide richer data with payments will be to include this capability as part of a new real-time payment system. APCA accepts that ISO20022 is part of the "next generation" initial strategic objectives and should be considered in the development of a preferred approach to real-time payments.

4.5 Simple Addressing of Payments

RBA's Objective: A system for more easily addressing retail payments to any recipient should be available. To the extent that this is provided by a new real-time system, it should be available by the end of 2017. This does not rule out earlier availability via other solutions.

APCA acknowledges the RBA's objective of providing for easier addressing of payments. Members are clearly interested in providing easier addressing methods to customers, as illustrated by the range of new services with this feature that are currently being rolled out.

Given the large amount of work that has been competitively undertaken by industry participants in this area, there is likely to be a range of potential solutions to investigate. An industry managed process to determine the best solution, either together with new real-time payments functionality or separately, would be the most effective way to achieve this objective. This "next generation" initial strategic objective is included in our thinking in Sections 5 and 6.

5. Real-Time Payments Architecture

The RBA proposes:

- an extension to RTGS to support real-time retail settlements; plus
- a single utility messaging hub to meet the “next generation” initial strategic objectives of real-time retail payments, out-of-hours payments, richer information with payments and (potentially) simpler addressing.

In APCA’s view, the development of real-time payments messaging to meet the “next generation” objectives should be led by the industry, with an early emphasis on identifying core infrastructure and competitive services.

This section explores some of the implications in relation to the RBA’s suggested model. In APCA’s view, other models are possible and may be preferable. Section 6 outlines the work that has already commenced within APCA’s membership to respond to the “next generation” objectives.

5.1 Real-Time Settlement through RITS

The RBA’s proposal to provide real-time settlement of retail payments through RITS has clear policy merit. It would provide competitively neutral infrastructure to support the entire low value payments marketplace.

APCA agrees that the RBA should take the lead on this development, but extensive and ongoing industry engagement will be required. Such a proposal has major implications for industry participants, large and small. A significant project in its own right, the real-time settlements proposal will have complex interdependencies with the proposed development of new real-time payments messaging architecture.

APCA also notes the RBA suggestion for reserved liquidity within exchange settlement account balances, which has significant implications for liquidity management and high value processing by ESA holders.

APCA looks forward to continuing to work closely with RBA on settlement evolution.

5.2 Real-Time Payments Messaging Architecture

APCA notes and shares the PSB’s desire for industry commitment to develop a preferred approach that will meet the “next generation” objectives. In the Conclusions Paper, there is a preference for a new central utility that will meet all policy needs at once.

However, the PSB’s statutory mandate includes the promotion of competition, as well as the promotion of efficiency. APCA accepts the need for new architecture, but the impact of the RBA’s proposed utility would have on Australia’s competitive payments marketplace has not been explored. It is therefore not clear whether this would be the best way of meeting the public policy objectives.

In APCA’s view, the preferred approach must:

- **identify and deliver the ubiquitous infrastructure** for Australian real-time payments (which at a minimum includes RBA’s settlement facilities);
- **promote competition amongst network operators** so as to maximise prospects of technological and business innovation in real-time payments methods; and
- **incentivise payment providers** (both incumbent financial institutions and new entrants) to rapidly develop and offer new real-time payment services to their customers, so as to maximise early adoption of real-time functionality.

5.2.1 Identifying ubiquitous infrastructure

Whatever form new real-time architecture takes, it will be the competitive marketplace that ultimately delivers new real-time services to end users. It will be important to define which segments of the payments value chain need to be ubiquitous, highly reliable infrastructure and which need to meet diverse and changing needs of end users.

Infrastructure will typically be uncontested, ubiquitous, relatively fixed and can be operated as a utility. But where there are diverse user needs and a desire for continuous innovation, services should be provided through a competitive marketplace, if innovation is to meet customer demand.

While it seems clear that real-time settlement infrastructure is a utility service, there are different views on whether other aspects of the proposed real-time architecture are infrastructure or competitive service. Some aspects of payments messaging may be infrastructural, such as message standards, and these can be provided through industry collaboration. Other aspects may be intensely competitive, with wide scope for service differentiation and innovation.

5.2.2 Promoting network competition to drive Innovation

A healthy competitive marketplace already exists for payments clearing. Alternative offerings are provided by multiple card schemes, BPAY, PayPal, and industry participants using DE as a base. Some of these offerings are already real-time to the end user, and by 2016, this is likely to be common. The innovation value of this competition is illustrated by rapid deployment of new technologies, including chip cards, contactless cards and new mobile payment services. Overseas, commercial card schemes are deploying person-to-person account-based real-time payments services. These services may not look like RBA's proposed architecture, but they provide similar services to end users.

It is unclear from the Conclusions Paper how it is intended that the proposed new utility will affect this competition. This goal should be to promote service delivery and innovation by encouraging network competition. APCA submits that the PSB should, in recognition of its competition mandate, explicitly adopt a policy of promoting competition amongst schemes and network operators and ensuring regulatory neutrality amongst competitors.

5.2.3 Promoting competitive innovation by participants

Financial institutions and other payment organisations are the ultimate providers of real-time payments to consumers and businesses. They do this commercially, driven by an open competitive marketplace. The policy objective of open access is one element of promoting beneficial competition, but is not, by itself, enough. Providers (incumbent or new entrant) need to see a market opportunity worth pursuing.

For example, it can be argued that this was a significant problem for the UK Faster Payments service. The development of the service involved five years of regulatory debate, a further three years to initially implement and then four years to achieve significant volume. This occurred in a payments environment much slower and less competitive than Australia's. The basic electronic payments system, BACS, had a three-day settlement cycle, there was no equivalent of BPAY, no competing domestic debit card system like Eftpos and internet "pay anyone" was not commonplace.

Arguably, in such a market the demand for a new real-time consumer service should have been very high: the only alternatives to a three-day wait were credit card or cash. But Faster Payments, conceived and executed as a compliance project, did not achieve substantial take-up until payment participants designed commercial products to take advantage of the service. In retrospect, it is clear that insufficient attention was given to this issue.

6. The Preferred Approach for Industry

APCA believes that industry must determine the preferred approach in a way that will not only achieve the objectives set out by the RBA, but that also promotes effective ongoing competition and innovation and maximises industry buy in.

Central to the development of a preferred approach will be the immediate establishment and operation of the Real-Time Payments Committee (the Committee) as discussed in Section 3, and an Industry Expert Working Group.

6.1 Real-Time Payments Committee

The Committee will be a small single-purpose committee composed of representatives from organisations with an investing interest in the development of real-time payments infrastructure. The Committee will be tasked with establishing the service proposition and operating model and associated high-level requirements for real-time payments.

The composition of the Committee will most likely be made up as follows:

- One senior representative from each of the four major banks;
- Three senior representatives from other financial institutions;
- An independent chairperson; and
- The APCA CEO.

The Committee will strive to produce the following deliverables by December 2012 to define an industry preferred approach for delivering on the initial strategic objectives:

- Service proposition and high-level operating model for how new real-time payments will be delivered;
- High level functional requirements for the services;
- Development pathway;
- Liaison framework with the RBA, including the PSB. Liaison between the PSB and the Committee would enhance prospects of success; and
- Stakeholder engagement model.

In undertaking this work, we see the Committee possibly engaging consultants and / or issuing a request for information to possible partners.

6.2 Industry Expert Working Group

The Industry Expert Working Group will be made up of industry experts nominated by the Committee members and will have a close liaison with the Committee. We anticipate this will involve significant industry resources, including possible medium-term secondment of member experts to work under an APCA program. The initial tasks of the Industry Experts Working Group will be to:

- Provide expert commercial and technical advice to the Committee in regard to meeting the “next generation” initial strategic objectives and determining the service proposition, high-level operating model and high-level functional requirements for real-time payments;
- Assist in establishing the development pathway for real-time payments and provide expert advice on the selection of solutions, partners and providers;

- Provide advice to the Committee and the wider industry on the implementation of the “next generation” initial strategic objectives as required; and
- Work with the RBA (as guided by the Committee) to establish the RBA’s new real-time settlement service.

APCA looks forward to working with the payments community and the RBA to deliver on payment system evolution.