The Role of the Board

The Board's responsibility and powers

The Payments System Board was established on 1 July 1998 with a mandate to promote the safety and efficiency of the payments system in Australia, and the backing of strong regulatory powers. That mandate was expanded in September 2001 when the Board was also given responsibility for the safety of systems that clear and settle securities transactions in Australia.

The Reserve Bank's formal involvement in the payments system was one of the key reforms to Australia's financial regulatory structure recommended by the Financial System Inquiry (the Wallis Committee). The Inquiry concluded that Australia's payments system fell short of international best practice – particularly as far as the efficiency of retail payments was concerned – and questioned whether the existing governance arrangements based on co-operation between participants, with only a limited role for the Reserve Bank, could be relied upon to lift Australia's performance. The Inquiry saw the Board as a "separate and stronger structure" within the Reserve Bank to give it greater authority to pursue improvements in efficiency and competition in the payments system.

The Board's mandate in the payments system is set out in the amended *Reserve Bank Act 1959*. The Board is responsible for determining the Reserve Bank's payments system policy and it 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 regulatory powers which support this mandate are set out in three separate Acts. Pivotal is the *Payment Systems (Regulation) Act 1998*, under which the Reserve Bank may:

- "designate" a particular payment system as being subject to its regulation. Designation is the first of a number of steps the Bank must take to exercise its powers;
- determine rules for participation in that system, including rules on access for new participants;

- 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.

These powers are intended to be exercised if the Bank is not satisfied with the performance of a payment system in improving access, efficiency and safety, and other means of achieving these objectives have proved ineffective.

The Reserve Bank formally exercised these powers for the first time in April 2001, when it designated the credit card schemes operated in Australia by Bankcard, MasterCard and Visa as payment systems subject to its regulation. This action followed the publication in October 2000 of a study on debit and credit card schemes in Australia – undertaken jointly with the Australian Competition and Consumer Commission (ACCC) – which identified a number of shortcomings in competition in the provision of credit card services, and subsequent advice from the ACCC that alternative approaches to addressing these shortcomings under the *Trade Practices Act 1974* did not appear promising. In December 2001, after discussions with a wide range of interested parties, the Reserve Bank released a consultation document on reform of credit card schemes in Australia, proposing standards and an access regime that will promote greater efficiency, transparency and competition in the Australian payments system. These developments are described later in this Report.

The Reserve Bank's powers under the two other relevant Acts are designed to strengthen the legal underpinnings of the Australian payments system. The *Payment Systems and Netting Act 1998* allows the Reserve Bank to clarify the legal rights and obligations of participants in payment systems that operate both on a real-time gross settlement (RTGS) basis or on a multilateral net basis. Under the *Cheques Act 1986*, the Reserve Bank may determine that a settlement system for cheques is a "recognised" clearing and settlement system, allowing cheques cleared through that system to be deemed dishonoured if the financial institution on which they are drawn is unable to provide the funds.

The broadening of the Board's mandate to encompass securities clearing and settlement facilities was foreshadowed in last year's Report, and was confirmed with the passage of the *Financial Services Reform Act 2001* in September 2001. The additional responsibility is a recognition of the importance of safe and well-functioning clearing and settlement facilities for financial instruments to overall

financial system stability and to Australia's standing as a centre for global financial services in the Asia-Pacific region, and of the Reserve Bank's interest and expertise in these matters.

The new regulatory regime, established as part of the Government's Corporate Law Economic Reform Program (CLERP), has however taken a somewhat different form than that envisaged a year ago. At that time, the proposals were for a single statutory regime for the licensing and regulation of clearing and settlement facilities. Regulation was to be the responsibility of the Australian Securities and Investments Commission (ASIC), unless "the Minister" (ie the Treasurer or a Minister in his portfolio) declared that a *particular* clearing and settlement facility was of sufficient significance to the stability and integrity of the payments system that it should be regulated by the Payments System Board.

Since then, the rationalisation which has taken place in securities clearing and settlement arrangements in Australia has prompted a revision of the proposed allocation of regulatory responsibilities between the Reserve Bank and ASIC, to one based on a sharing of responsibilities along functional lines. The new arrangements enshrine the single statutory regime with licensing by the Minister, who will also have power to disallow changes to facility rules, to suspend or cancel licences and to issue directions to facilities. The Reserve Bank has formal responsibility for ensuring that *all* clearing and settlement facilities conduct their affairs in a way that is consistent with financial system stability. As part of this role, the Reserve Bank has the power to set and monitor compliance with financial stability standards for clearing and settlement systems. ASIC has responsibility for all other matters, such as those relating to corporate governance, market integrity and investor protection. Because it is particularly well-equipped to do so, ASIC also has responsibility for undertaking any legal action to enforce compliance with the requirements of either agency, including financial stability standards.

As with the payments system, the Board has been given responsibility to determine policies with respect to clearing and settlement facilities while the powers to carry out those policies, which are set out in Part 7.3 of the *Corporations Act 2001*, are vested in the Reserve Bank. Under recent amendments to the *Reserve Bank Act 1959*, the Board's mandate in this area is to ensure, within the limits of its powers, that the powers and functions of the Bank under Part 7.3 of the *Corporations Act 2001* are exercised in a way that, in the Board's opinion, will best contribute to the overall stability of the financial system.

The new regulatory regime comes into force in March 2002, with a two-year transition period for securities clearing and settlement systems that are not explicitly regulated under the existing regime. The development of the Bank's financial stability standards is discussed later in this Report.

The functional approach to regulation under this new regime is common in the financial sector, both in Australia and overseas. In most instances, the regulatory responsibilities and functions of the agencies concerned are clearly defined; occasionally, however, the activities of one regulator may impinge on those of another and, if not carefully co-ordinated, may impose an unnecessary compliance burden on regulated entities. The Reserve Bank and ASIC have released a Memorandum of Understanding (MOU) intended to promote transparency and regulatory consistency and help prevent unnecessary duplication of effort.

The Board's approach

The Board has now been in operation for three years. As it has turned out, safety and stability issues have not dominated its agenda, a testament to earlier initiatives to make the Australian payments system more robust, particularly the introduction of the real-time gross settlement (RTGS) system for high-value payments. Rather, the Board's main focus has been the pursuit of greater competition and efficiency in the retail payments system. This is the area in which the Financial System Inquiry issued its call to action; it is also the area in which the Board's own work has confirmed that there is scope for significant improvement. The Inquiry itself placed weight on Australia's heavy dependence on cheques and saw potential for substantial gains in efficiency through a greater uptake of electronic means of payment. While this is clearly so, the Board acknowledges that there is a good deal more to the question of payments system efficiency than the substitution of electronic payments for cheques.

The payment instruments available to Australians – whether they be cash, cheques, debit (EFTPOS), credit and charge cards or direct entry – have a number of different dimensions. One is the quality of service, covering such features as the speed with which payments are processed, convenience and accessibility for users and the reliability and security of the payment instrument. A second dimension is the cost to financial institutions of providing each of the payment instruments; a third is the structure and level of fees and charges levied for their use. Broadly speaking, an efficient retail payments system is one in which the relative prices of payment instruments reflect demand conditions and their relative costs, so that users have appropriate signals on which to base their

choices. Promoting efficiency in this way is a major policy objective of the Board. Efficiency does not mean, however, that the lowest cost payment instruments should necessarily prevail; on the contrary, Australians benefit from having a range of payment instruments from which to choose, provided they are prepared to meet the costs of the services they use. In this sense, markets for payment instruments are little different from other markets. First-class hotels co-exist with camping sites and expensive restaurants with take-away outlets. The community benefits from this diversity of choice even though the camping site and take-away meals are less costly to produce; it would not do so, however, if consumers did not have to meet the cost of their more expensive choices and these costs were borne by others.

Price signals are very likely to be one of the factors that explain the continued popularity of the cheque as a payment instrument, despite its high cost to providers. In some cases, inertia or fear of customer opposition have left financial institutions reluctant to pass on the resource costs of using cheques. In others, financial institutions follow a clear strategy of offering a package of deposit, lending, payment and other services to customers in which some services are subsidised by others.

Competition is the mechanism that, in the normal course, drives markets to outcomes that benefit the community. In an active competitive market, prices allocate resources efficiently to meet demand while the free movement of resources ensures that, over time, firms earn no more than a competitive return on their investments. Successive Australian Governments have made a strong commitment to promoting competition and this is echoed in the Board's mandate in the payments area. Markets for payment services, at the same time, can admit a role for co-operation between participants. Modern payment systems are complex networks of linkages between financial institutions, which generally need to co-operate to build and operate them. Co-operation in some areas can clearly be in the public interest. For example, the implementation of technical standards for electronic payments reduces costs to institutions, improves the speed of processing and reduces error rates, enhancing efficiency and convenience for consumers. In other cases, the establishment of shared or centralised processing and distribution facilities can reduce costly duplication. Modern payment networks are unlikely to develop without some private-sector regulations on technical standards and procedures and co-operation on at least some aspects of physical infrastructure.

However, when co-operation between competitors interferes with the normal competitive mechanisms, the public interest

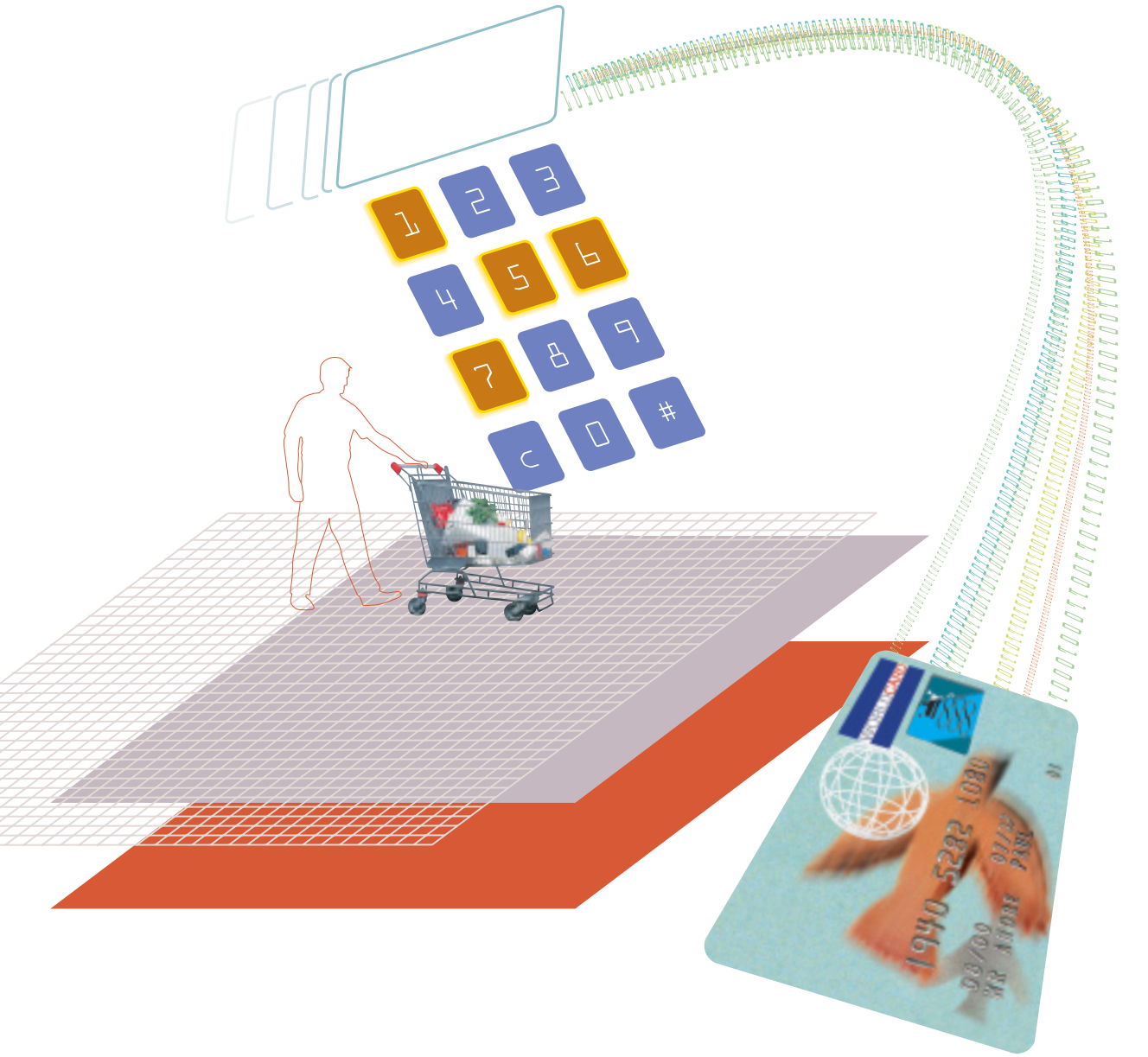
case is much harder to make. It is against this background that the Board, along with regulatory agencies in other countries, has from the outset taken a close interest in card payment networks, particularly credit card schemes which operate under a number of restrictions imposed by their members. These restrictions involve the collective setting of wholesale ("interchange") fees, restrictions on the freedom of merchants recovering their credit card costs from cardholders and restrictions on entry to the schemes. The Board has concluded, after extensive consultation and detailed evaluation, that these restrictions in credit card schemes in Australia are not in the public interest. The pricing of credit card services, in which interchange fees and restrictions on merchant pricing play an integral role, is sending consumers a quite misleading signal about the cost to the community of different payment instruments, while barriers to entry are quarantining the credit card schemes from competitive pressures. Overall, the community is paying a higher cost for its retail payments system than is necessary.

The reform measures proposed by the Reserve Bank, and discussed in the next part of this Report, are designed to end credit card scheme restrictions that prevent competitive forces from operating as they should. The Bank is not adding a further layer of regulation to the credit card market; on the contrary, the reform measures, taken together, will ensure that where competitive forces have not been allowed to work because of card scheme restrictions, they will now be better able to do so. In endorsing these reforms, the Board has no view about the "right" mix of payment instruments in Australia; that is for consumers to decide in the market place in response to appropriate price signals. Giving greater rein to the price mechanism also underlies the Board's approach to overhauling interchange fee arrangements in ATM and debit card networks in Australia, a task to which industry participants, working with the Reserve Bank, have now begun to turn.

In a completely different context, the complexity of modern payment networks and the need for co-operation in technical matters has another consequence which is relevant to the Board's mandate – the difficulty of achieving innovation and progress in payment systems. False starts and stuttering reform are not an uncommon experience. The electronic presentment and payment of bills via the Internet is an example of a business opportunity that is proving difficult to bring to fruition. Expectations a year or so ago that such initiatives might develop quickly remain unfulfilled, in the face of disillusionment with the dot.com environment but also because of the need to build arrangements that allow customers banking with one financial

institution to pay billers whose accounts are at another. Understandably, financial institutions may be cautious about signing up to industry initiatives over which they might exert only limited control and where they see many of the benefits accruing to competitors; at the same time, systems developed solely by one institution can rarely achieve the necessary market penetration. As a result, progress can sometimes be frustratingly slow.

Beyond its on-going monitoring of developments in this area, the Board is willing to work with industry participants if that would help to exploit the potential of electronic commerce. It would see its role as that of catalyst, bringing to bear a combination of analysis, facilitation and encouragement; without a catalyst, many initiatives can go unexplored or undeveloped. The Board has already played this type of role in developing consumer safeguards for the use of direct debits, which are probably the most efficient means of paying regular bills or recurring obligations. Work with billing organisations has resulted in a Charter for Direct Debit Customers, first published in last year's Report, but subsequent reminders that the direct debit system needs to be made yet more user-friendly confirm that the Board's involvement in this area is not finished.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