

Cheques and the Payments System¹

Introduction

Cash and cheques were virtually the only means of payment available to most Australians until Bankcard credit cards were introduced a little over 20 years ago. Only in the past decade or so has there been a credible and concerted challenge to the dominant role of cheques for non-cash payments. Today we are seeing the emergence of many alternative payment arrangements; at the same time, banks and others are under pressure to wind back elements of cross-subsidisation and to price services to recover costs.

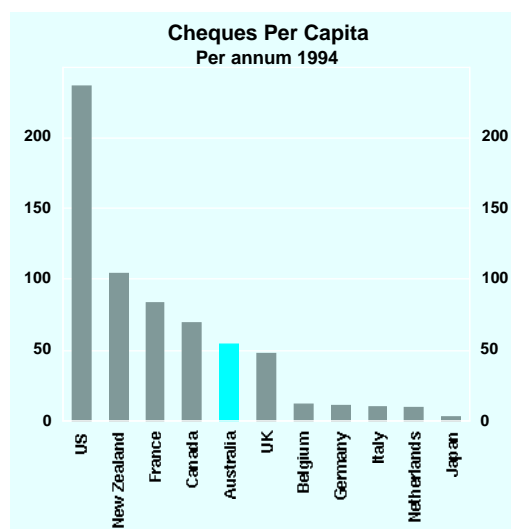
Trends in Cheque Usage

The graph compares Australia's current level of cheque usage with other countries that have relatively advanced payments systems.

In terms of the number of cheques written per head of population, Australia, with a figure of 55 per year, ranks relatively highly in the international league. The situation does not change very much if other paper-based means

of making payments are included. Countries that have historical connections with the United Kingdom – the United States, Canada and New Zealand – figure prominently. The United States in particular, with an average of 237 cheques per head each year, still has a payments system dominated by cheques. Australia, relative to other Anglo Saxon countries, is now at the lower end of the spectrum in terms of cheque usage.

In contrast, cheques are not widely used in Japan or in most countries of Western Europe. Italy and Japan's low use of paper-based



1. Edited text of a speech by Mr N.C. Mackrell, Head of Financial System Department, to the AIC Conference, The Future of Cheques, Sydney, 16 May 1996.

payments is in large part explained by their extensive use of cash. Other Western European countries have traditionally used direct-entry-style giro systems for making payments. The credit transfer characteristics of these giro systems facilitated the migration of a significant proportion of payments onto electronic platforms. Customers wishing to make a payment using a giro system lodge an instruction at their bank, which then passes on the value and payment details to the beneficiary's bank. This process allows the paying bank to check the payer's details (such as the signature and funds availability) *before* the beneficiary receives the payment. The paper payment instruction can be truncated at the beginning of the payment process, with no subsequent need to send it to another financial institution for verification or other purposes.

Cheques continue to play an important role in the Australian payments system. Each day, around 3 million cheques worth over \$17 billion are written by individuals, businesses and, to a declining extent, governments. This represents a little under 40 per cent of the number and 35 per cent of the value of non-cash payments. Fifteen years ago cheques accounted for about 85 per cent of the number of non-cash payments in Australia and almost all of the value.

Table 1 shows how the situation has changed over the past 15 years in the face of competition from newer payment instruments. During this period:

- the share of total non-cash payments made using cheques fell dramatically to be less than 40 per cent;
- credit cards became a mature product, accounting for around 10 per cent of the total number of payments;
- automatic teller machines (ATMs) achieved widespread acceptance;
- direct credit payments increased dramatically. (Efforts by the Commonwealth Government to transfer payments from cheques to direct entry were highly successful by world standards and only a handful of these payments are still in the form of cheques);
- EFTPOS emerged as an important new payments mechanism, taking a 13 per cent share of total payments; but
- in contrast, direct debit payments continued to account for only 4 per cent of non-cash payments.

There has been no actual decline in the number of cheques issued over the past 15 years. In fact, there were roughly 33 per cent more cheques issued in 1995 than in 1980, a point that is often ignored by those advocating cheaper or more technically efficient alternatives. While the newer instruments, especially direct credits, undoubtedly restrained the stronger growth that would otherwise have occurred in cheques, their main effect has probably been to satisfy community needs additional to those that were being met by existing payment instruments.

By the mid 1990s, another payment instrument – specialised high-value electronic transfers to settle securities markets transactions and wholesale foreign exchange transactions – had displaced the cheque as the dominant payment instrument in terms of the *value* of payments. Cheques and other paper-based payment instruments accounted for around 60 per cent of the value of non-cash payments in 1991 (see Table 2). They now account for only around 35 per cent. This is a

Table 1: Types of Payments
Percentage of total number of transactions

	1980	1995
Paper (cheques, credit transfers)	85	38
Low-value EFT		
Direct credit	3	18
Direct debit	4	4
ATM	1	17
EFTPOS	Nil	13
Credit cards ^(a)	7	10
High-value EFT	Nil	(b)
Total	100	100

(a) Includes paper-based credit card transactions.

(b) Less than 10,000 transactions per day.

trend which seems set to continue, with the introduction of Australia's real-time gross settlement (RTGS) system scheduled for 1997.

Table 2: Value of Payment Instruments
Relative importance in percentage terms

	1991	1995
Paper	59	35
Low-value EFT	2	2
High-value EFT	39	63
Total	100	100

Waves of Competition

Australia entered the 1980s with cheques still the main payment instrument for non-cash transfers of value. In practical terms there was little in the way of an alternative payment instrument available to business and consumers. It was only natural that cheques would be used to fill a whole range of roles and transferring value in a broad range of situations. The fact that cheque services appeared to be virtually costless to those using them, and had a solid body of legal underpinning, added to their appeal.

Since 1980, competition in payments services has intensified, given major impetus by decisions to deregulate the financial system and advances in technology which seems increasingly to drive the industry.

This competition could be seen as having arrived in a series of overlapping waves. The first wave was the introduction of bank-issued credit cards. Subsequent waves have included the introduction of ATMs, direct credit payments and EFTPOS.

Typically, new payment instruments have been introduced into the payments system by banks and other payment providers to meet a perceived customer need (or to reduce costs). In marketing terms, the historical record shows something of the *life cycle* of these products. These new products and services proceed through the life cycle phases from their introduction – and all that goes with the selling of a new product and a new technology

– through subsequent phases of public acceptance, growth and, eventually, maturity.

The introduction of bank credit cards in the 1970s involved a major marketing and educational effort on the part of the banks, trying to convince Australians to change patterns of behaviour that were deeply ingrained. The arrival of the cashless society and the early demise of cheques as the inevitable consequence of the seemingly boundless potential of this new payment instrument were widely predicted in the initial enthusiasm for credit cards. In reality, there was only gradual acceptance of credit cards at first, followed by a period of rapid growth during which the public became fully aware of the potential and the limitations of this form of payment instrument. Over a relatively short period of time credit cards matured as a product. Payments made using credit cards have held steady at around 10 per cent of non-cash payments for some years.

One reason why credit cards did not displace cheques other than at the margin was that, unlike the United States, Australia had not developed a culture of using cheques widely for point-of-sale purchases at retail and entertainment outlets. Credit card payments filled a niche that was served only partly by cheques. After a period of adjustment, the Australian public reached a position of balance with credit cards and cheques playing complementary roles. Their points of explicit competition are quite limited. But the role of cheques had been narrowed by the competition from credit cards, to be virtually excluded from use as a payments instrument for point-of-sale purchases.

The use of ATMs for withdrawing cash has now also reached a level of maturity. Rapid expansion of the use of ATMs saw the role of cheques as an over-the-counter instrument for withdrawing cash from banks decline dramatically, but this would have represented a small proportion of the total growth in ATM use. Again, ATMs provided a payment service additional to that provided by cheques and the role of the cheque was narrowed, sharply reducing its role as a *de facto* cash withdrawal slip.

The introduction of direct credit payments tells a similar story. During the introductory phases the potential of the technology in making payments directly into bank accounts by capturing the details on, and exchanging, magnetic tape rather than exchanging cheques heralded yet another announcement of the imminent death of cheques. Again, the direct credit product has matured to a position where it now holds around 18 per cent of all non-cash payments. Direct credit payments were offered as a substitute for cheques and had a noticeable impact, mainly in limiting the growth in cheque numbers. They effectively displaced cheques in one segment of the cheque-issuing market (ie cheques issued for high-volume and repetitive credit transfers such as social security and salary payments).

A Narrower Role

As a result of these and other forces, the role of the cheque in the payments system has been narrowed. It is no longer the multi-purpose payment instrument it was in 1980. Some of the roles it previously had have been trimmed away, in part due to automation. But for the most part, the competitive products that moved into segments of the payments system where cheques previously had a role have now reached product maturity.

The cheque is still popular with the general public for a number of reasons:

- cheques are seen to be a convenient way to make unplanned, *ad hoc* payments for any amount to anybody at any time and place (they simply require that the drawer has a cheque book, a pen and adequate funds in an account);
- the beneficiary doesn't require any purpose-built infrastructure to present the payment to the drawer's bank;
- cheques are a payment instrument that most people feel comfortable with; and
- the cheque is seen to be still a relatively cheap way to make a payment (notwithstanding the fact that almost all competing payment instruments cost less).

Among the full array of new electronic and card-based payment instruments that have been introduced over the past twenty years, none as yet seems to offer these features in the same measure as a cheque.

Many of the electronic alternatives, such as direct entry in its present form, lack flexibility and are not sufficiently user-friendly for general acceptance. Others, such as EFTPOS, require the use of specialised equipment that may not be readily available. In some of the higher-value payment systems, payments can only be made during normal business hours when the system is open.

Despite the continuing popularity of cheques, they are not without their faults in the eyes of consumers.

Some, such as the fact that beneficiaries don't receive certainty of payment on receipt, and the ever-present possibility of fraud, are hard to eliminate entirely. There have been some recent developments (including electronic cheque capture and cheque payment approval systems located at the point of sale) that may reduce these drawbacks.

But by far the most commonly voiced complaint from consumers centres on the industry policy of imposing a week's delay before customers are able to have access to their cheque deposit funds. This is a continuing source of frustration and annoyance for many consumers, who see the benefits of advanced technology everywhere. Many payments, such as EFTPOS, are debited to their accounts immediately. In world terms, Australia has a relatively fast clearing system for cheques, with the vast majority of cheques being debited to accounts on the day of deposit.

In fairness to the banks, depositors are usually paid interest on the value of cheques during the clearing cycle, even though the funds cannot be withdrawn. For some customers, access to funds is often given well ahead of the clearing cycle having run its course. The industry body responsible for the management of cheque clearing, the Australian Payments Clearing Association (APCA), has been supporting and assisting

work being undertaken by financial institutions which may shorten the clearing cycle. Development of common industry standards for the electronic presentment and electronic dishonour of cheques is well advanced. But the industry has focussed more on providing alternatives to cheques which fully exploit new technology (such as EFTPOS) rather than on trying to improve the clearing cycle for cheques.

The result is that progress towards a shorter clearing cycle for cheques has been painfully slow. Industry focus on this issue needs to be much sharper, if further damage to the industry's stock of goodwill is to be avoided.

From an industry perspective, the cheque is a costly payment instrument to offer. Despite advances in technology, there are still significant costs associated with the encoding, transportation and storage of cheques compared with other more advanced payment instruments. Banks generally claim that in the current low inflation climate, the income they receive on their cheque account business is not sufficient to cover the costs of providing the service.

A range of measures is being taken by individual banks and across the industry as a whole to lower the costs associated with the issue of cheques and improve customer service. At an industry level, APCA is coordinating several important initiatives, including:

- electronic presentment of cheques where the bank at which the cheque is deposited captures the details in an electronic format and transmits them electronically back to the issuing bank. The benefits of this system lie not only in cost savings but also in a significant saving in time taken to clear a cheque; and
- electronic dishonours will enable a cheque that is to be dishonoured to be 'returned' immediately to the bank of issue by electronic transfer rather than by using the traditional and time consuming paper methods that still represent the industry standard.

A number of banks are also seeing benefit in pooling resources. Cheque processing

operations tend to be costly. It is likely that Australia will follow overseas practice and see more of these shared-resource initiatives emerge in the future.

On the revenue side, banks generally feel they are undercharging for cheque services. They are, they claim, effectively being forced to cross-subsidise cheque-clearing services, and that this, in turn, works against an efficient allocation of their resources.

It seems inevitable that over time both the fees charged for the use of cheques and the costs incurred by banks in providing them will adjust to a position where cheque-clearing services return an acceptable profit to the banks that offer them.

Do Cheques Have a Future?

Competition in recent years has driven cheques into what has emerged as its core role – general purpose *ad hoc* remote payments. In this role, cheques do not face credible competition from payment instruments that are currently available.

There are, however, still niches where the use of cheques has yet to be fully challenged:

- Direct-debit services generally have not been embraced by the banking industry. There are signs that this is changing as banks begin to promote the use of direct debit to pay utility accounts, insurance premia and the like.
- Financial Electronic Data Interchange services – which combine payment instructions with associated electronic sales orders and invoices – have not been well embraced by banks, although slow progress is being made.

An important milestone for the Australian payments system will be the implementation of Real Time Gross Settlement (RTGS) in 1997. This will offer new opportunities and new competition in the area of high-value payments. It will enable banks to make payments between each other for immediate and irrevocable value. This will result in new

payment products and instruments based around the concept of irrevocable transfer of credit funds – an efficient and virtually riskless service provided on equal terms by all banks.

The Australian public may be looking for a general-purpose payments service that has some of these characteristics: wide availability; finality of payment; low risk; and available for smaller sized payments. At the present time

they are using cheques because they have no real alternative.

It may be that some particular institution, or group of institutions, will be able to fashion such a service around the core high-value payment system offered by RTGS. Until then, cheques are likely to retain their important role in the payments system.