NON-BANKS IN THE PAYMENTS SYSTEM: A CENTRAL BANK PERSPECTIVE

Remarks by Philip Lowe, Assistant Governor (Financial System) prepared for the Federal Reserve Bank of Kansas City Conference on 'Nonbanks in the Payments System: Innovation, Competition and Risk', Santa Fe, 2–4 May 2007.

Introduction

I would like to begin by thanking Tom Hoenig and his team for once again putting together a fabulous conference. The Kansas City Fed continues to set the high-water benchmark for payments system conferences and I am delighted to have been invited to participate again.

As with the other panellists I have been asked to talk about the challenges that non-banks pose for central bank oversight of payment systems. This is an issue that the Reserve Bank of Australia (RBA) has spent quite a lot of time thinking about recently. As you might be aware, in the late 1990s, the RBA was given specific powers by the Australian Parliament to promote the efficiency and stability of the Australian payments system. In this respect we are a little different to many other central banks in that we have explicit legislated objectives not just in terms of stability, but also in terms of efficiency and competition. We have also been given formal powers in these areas and a separate board has been created in the RBA to exercise these powers. These arrangements grew out of recommendations of a wide-ranging inquiry into financial regulation in the mid 1990s. Amongst other things, this inquiry drew attention to difficulties facing non-banks in participating in the payments system.

To date, the part of the RBA's work that has attracted the lion's share of attention is the regulation of interchange fees. However, we have also introduced reforms to enhance the competitive environment, including by allowing non-banks to more easily provide payments-related services. In my remarks this morning I would like to share some of this work with you.

Given that I am the last speaker on what has been a long agenda, it seems sensible to begin by summarising my two key themes.

The first is that our general policy approach to oversight/regulation is best thought of as functional, rather than institutional.

This approach reflects the fact that many types of payment can be broken down into a number of separate functions. Each of these functions is potentially contestable, including by non-banks. What we have been trying to do is to obtain the benefits of this contestability, without unnecessarily adding to the risks in the system. Where non-banks do bring extra risks

– as they sometimes do – we have asked how the risks can best be managed, rather than simply excluding non-banks from the system.

I might add that one argument in favour of a central bank having the type of broad payments system responsibilities given to the RBA – rather than just a focus on stability – is that it more easily allows potential trade-offs between stability and competition to be recognised and analysed. This was certainly an important factor in the government's decision to give the RBA – rather than the competition regulator – responsibility for efficiency and competition in the payments system.

The second theme is that establishing a regime in which non-banks are able to play an active role is increasingly important.

As we have seen in other areas of banking – particularly lending – the entry of non-banks has provided an important source of competition, promoting substantial efficiency gains. The same is likely to be true in the world of payments and obtaining these efficiency gains is increasingly important. This reflects the fact that transactional banking services are now a key element in the relationship between many banks and their customers. If these efficiency gains are to be realised, the policy framework needs to be one that facilitates entry by ensuring that unnecessary barriers to the entry of non-banks do not exist. This is particularly important given the network characteristics of many payment systems.

The Payments Process

I said a moment ago that the payments process can be broken into its various pieces. I would now like to talk about those pieces and our approach to oversight/regulation.

At the risk of oversimplifying things, for most payments to occur three elements must exist.

The first is that there must be a store of value that can be accessed. The second is that there needs to be a system for exchanging payment instructions between institutions, sometimes loosely referred to as clearing arrangements. And third, there needs to be a settlement system, whereby value is moved from one account to another.

In the world of a few decades ago, all three functions – maintaining the store of value, developing and running messaging and processing systems, and having access to settlement systems – were almost always the exclusive preserve of banks. The world of payments was the world of banks and that was that. This was reflected in the view that it was only banks that could be allowed into the inner sanctum of the payments process – the settlement accounts at the central bank. In some countries, including my own, this idea led to legislative restrictions on the type of institutions that could issue cheques and other payment instruments.

The world of today is a lot different. Value does not need to be stored in bank accounts. Messaging and processing systems do not need to be run by banks. And in some countries, non-bank providers of payment services are able to have accounts at the central bank. As we have been discussing over the past couple of days, this new world opens up a whole range of possibilities. From my perspective, the central issue seems to be how you can best take advantage of these possibilities, without adding unnecessarily to the risk in the system.

Store of Value

In terms of the store of value used for transaction purposes, banks have long had a significant advantage. While I expect this advantage will continue, it is not unassailable. Indeed, non-banks may be able to develop new methods of payment that work best if value is held outside the banking system. From the point of encouraging competition and innovation, we need a regulatory regime that allows this to happen. But any regulatory arrangements also need to address the risks that can arise if significant stores of value usable for transaction purposes are held outside the banking system.

The main such risks seem to relate to consumer protection and the possibility of a loss of confidence in the store of value. From a central bank's perspective, the second of these is of more concern. If a loss of confidence did occur, it could cause problems for the particular payment method concerned, but it could also cause problems for other stores of value, raising broader financial stability issues.

In Australia, we have established a regime that deals with these risks, but in a way that does not stifle innovation. Under the regime, non-banks are able to hold a store of value for the purpose of offering transaction services to consumers. However, reflecting our functional approach to regulation, if the store of value has the general characteristics of a bank deposit – that is, if it is redeemable on demand in Australian dollars, and if the payment product can be used for purchases in a wide variety of situations – it is subject to prudential regulation by the Australian Prudential Regulation Authority (APRA), which is also the prudential regulator for banks and insurance companies.

As with other institutions that offer deposit-like accounts, institutions that offer this type of stored value need to obtain authorisation from APRA, which a few years ago created a new specialist class of regulated institution known as a Purchased Payment Provider. These institutions are subject to capital, liquidity and operational requirements, although they differ from those on banks reflecting the different nature of the risks. Purchased Payment Providers are not permitted to make loans and their operations are restricted to providing payment services.

Arrangements that do not have deposit-like characteristics are also potentially subject to regulation, but by the RBA, not APRA. We would, however, only consider using our regulatory powers in this area if payment schemes developed that held significant value and that could be widely used. We have made it clear that facilities such as gift card schemes, electronic toll schemes and pre-paid mobile phone accounts are not subject to regulation.

At the time this regime was put in place, there was considerable market speculation that certain types of non-bank payments, including electronic cash and smart cards, were about to take off in Australia. So far, this has not happened. The only scheme that has been authorised as a Purchased Payment Provider is PayPal, and the RBA has not used its powers to regulate any stored-value arrangements.

The generally slow development of new forms of stored value demonstrates just how difficult it is for both regulators and industry participants to predict exactly which types of payment methods we will be using in the future. While many payment schemes look appealing from a technology perspective, they have had trouble developing business models that are attractive to

both consumers and merchants. Perhaps one day such models will emerge; in the meantime, the regulatory environment needs to remain light-handed and focused on the key risks.

Messaging and Authorising Systems

The second element of the payments process is the systems that are used to pass instructions between institutions. There are two aspects of these systems that I would like to talk about. The first is access and the second is the technology.

Access is clearly important, for if an institution is unable to participate in the core messaging and authorisation systems on fair and reasonable terms, its ability to compete is likely to be significantly constrained. This has been a significant issue in Australia, with a number of non-banks complaining to the RBA that they have found it very difficult to gain direct access to some payment systems. This has left them with little choice but to work through existing participants, which are sometimes their direct competitors.

The main argument for restricting access seems to be that participants in a payment system can have actual or potential credit exposures to other participants. In the credit card system, for example, both acquirers and issuers can be called upon to contribute to a rescue package if one of the members of the scheme is unable to fulfil its obligations. In some other systems, the settlement arrangements can also expose participants to significant financial losses if the obligations of a member of the system are not met.

One way of controlling these financial risks is to restrict participation to banks. In my view, this approach is too narrow. It risks limiting competition and innovation, and is not always necessary to preserve the financial integrity of the system. Where non-banks do bring financial risks, these risks need to be managed, not avoided altogether by preventing access.

In Australia, we have confronted this issue and the RBA has used its powers to establish more liberal access arrangements for both the credit and debit card systems. We are also currently having discussions with the ATM industry about access reform.

In the case of credit cards, the schemes long had rules in Australia that effectively limited participation to banks. They also had rules that prevented a member from acting just as an acquirer, and imposed penalties on members whose acquiring business was much larger than their issuing business (the 'net acquirer' rules). These rules made it impossible for specialist acquirers to participate in the system.

Our view was that these rules were overly restrictive and limited competition and innovation. After it became clear that the schemes would not make changes voluntarily, the RBA used its regulatory powers to impose an Access Regime. This regime required the removal of net acquirer rules and made the schemes open up access to a new class of prudentially regulated entities known as Specialist Credit Card Institutions. These entities – like the Purchased Payment Providers discussed a few minutes ago – are supervised by APRA, with the supervisory requirements being tailored to the risks incurred. To date, two institutions have taken advantage of this regime: one on the issuing side and one on the acquiring side.

Significant access issues have also arisen in the domestic PIN-based debit card system which, unlike the credit card system, is based on bilateral agreements between the main participants.

For many years, new entrants complained about the difficulties of establishing the necessary bilateral agreements and technical connections with each of the existing participants. This was perhaps not surprising, given that the existing institutions had little incentive to negotiate arrangements that facilitated the entry of competitors.

Over a number of years the RBA worked with industry to establish better access arrangements and this work was completed in 2006. Under the new arrangements, existing participants must establish connections with access seekers that satisfy the relevant technical requirements. They must do so within a specified period and the amount they can charge to establish the connection is capped. Arrangements were also put in place to constrain the bilaterally negotiated interchange fees, so that negotiations over these fees could not be used in a way that frustrated access.

Under these access arrangements, any company that is licensed as a Specialist Credit Card Institution (SCCI) is able to establish the necessary links to provide PIN-based debit payment services to third parties. In addition, the access arrangements allow merchants to self-acquire PIN-based debit card transactions without being licensed as an SCCI, although if they wish to self-acquire credit card transactions they do need to be licensed. This difference reflects the additional financial obligations that acquirers in the credit card system take on. We have seen no public-policy grounds for limiting merchants' involvement in acquiring, provided that the risks are appropriately managed.

I said a moment ago, that there were two aspects of the messaging and authorisation system I wanted to focus on. The first was access. The second is the specific technology and processes used in a given payment system.

One could make the argument that central banks should pay very close attention to this technology and these processes as part of their oversight, given that problems in these areas could have system-wide and, possibly, systemic consequences. One could also argue that the social benefits of implementing appropriate arrangements for security and resilience are greater than the private benefits, and thus without public-sector intervention, private institutions will be prone to under-invest in these areas.

While one cannot completely rule out this line of argument, our view has been that in most payment systems, the users and the providers of the system have strong incentives to make sure that the system is robust and operates with a high level of security. We have not felt the need to become involved in these general areas. We have also been agnostic as to whether the various systems are best provided by banks or non-banks. Provided an institution is able to meet the relevant technical and security requirements, and the financial risks are managed, there seems little reason to distinguish between banks and non-banks.

Another aspect of payments system technology has, however, attracted our attention – that is, the arrangements by which participants make decisions about how the system and its technology are upgraded over time. As part of our oversight function we have focused on the potential difficulties of renovating payment systems, particularly where they are built around bilateral linkages. This has reflected concerns that the architecture upon which a number of Australia's payment systems is built is starting to slip behind best practice. Our approach has been to draw attention to the difficulties associated with industry-wide decision-making processes and the

governance arrangements in these systems. In response, industry is examining the RBA's concerns and we are hopeful that, in time, this will lead to some improvements in current arrangements.

Settlement

The third element of the payments process is settlement.

For many years, the RBA's policy was that only banks were permitted to have a settlement account with us. This was on the grounds that allowing non-banks to participate in the final settlement process could expose the system to unacceptable risk.

In the mid 1990s, however, we began a process of liberalisation. This reflected two developments. The first was the introduction of Real-Time Gross Settlement for the settlement of high-value transactions, which significantly reduced the risks in the deferred net settlement system. The second was complaints from some new participants that their ability to compete was constrained by not having access to a settlement account. They argued that having to settle through banks – which in many cases were their competitors – added to the complexity and cost of settlement and could give their competitors valuable insights into their business.

Under the current arrangements, which came into effect in 1999, an institution is able to have a settlement account with the RBA if it is:

- an actual or prospective provider of third-party (customer) payment services with a need to settle obligations with other participants; and
- able to demonstrate that it can meet liquidity demands, including during times of stress.

If the institution is not supervised by APRA and it participates in the deferred net settlement process it is required to lodge collateral with the RBA, except if it is always a net receiver of funds.

Again, our approach here has been to address the risks that can arise from non-banks having settlement accounts, rather than simply preventing them from having such an account. It is important to emphasise though, the settlement accounts are still restricted to *providers* of third-party payment services – they are not available to *users* of payment services.

Concluding Remarks

As I said at the outset, our approach to oversight has focused on the various functions involved in making a payment from one person to another. We have endeavoured to ensure that wherever possible, the provision of these services is contestable, and that the risks are adequately managed.

This approach – which reflects our responsibility for both efficiency and stability – has involved close co-operation between the central bank and the prudential supervisor, with the creation of new classes of regulated institutions. This has helped allow non-banks to compete with banks in various parts of the payments system, and for similar risks to be regulated in similar ways.

Looking forward, I suspect that banks will continue to be the main providers of payment services to businesses and individuals. Indeed, as we have all come to rely more on electronic

methods of payment, many banks have come to see the provision of transaction services as a source of strategic advantage. This is partly because once a web of electronic connections has been established between a bank and its customers, it can be difficult for that web to be disentangled, increasing the difficulty that a customer has of switching banks. In this environment, it is important that the regulatory arrangements applying to all parts of the payments process promote competition and innovation as well as address the relevant risks.

Thank you. ✬