PAYMENTS SYSTEM BOARD

ANNUAL REPORT 2002 RESERVE BANK OF AUSTRALIA

Payments System Board

It is the duty of the Payments System Board to ensure, within the limits of its powers, that:

- the Bank's payments system policy is directed to the greatest advantage of the people of Australia;
- the powers of the Bank which deal with the payments system, set out in the *Payment Systems (Regulation) Act 1998* and the *Payment Systems Netting Act 1998*, are exercised in a way that, in the Board's opinion, 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; and
- the powers of the Bank which deal with clearing and settlement facilities, set out in 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.

ISSN 1442-939X

Overview

The mandate of the Payments System Board of the Reserve Bank is to promote safety, efficiency and competition in the payments system in Australia and, in a recent extension of its responsibilities, to promote the safety of systems that clear and settle securities transactions in Australia's wholesale financial markets. This broad and evolving mandate is a recognition of the importance of robust payments and settlement systems for the overall stability of the Australian financial system, a longstanding central bank concern. It is an acknowledgment, as well, that the market and governance arrangements prevailing in Australia over a long period have not been conducive to efficient resource allocation and vigorous competition in the payments system.

For some time, the Board has focused its efforts on the retail payments system, through which consumers and businesses make their payments. The Board's own work has confirmed that there is scope for significant improvement in this area. Retail payments patterns in Australia are now changing at what seems a relatively quick pace. Technological advances are enhancing the features and the range of choice of payment methods. For many consumers, electronic means of payment are supplanting the traditional cheque, although the "smart card" revolution remains elusive and e-commerce has yet to develop an effective replacement for the cheque for business use.

As in other markets for goods and services, price incentives facing users of the various means of payment are also shaping payments patterns. The Board's concern has been that, in the rapidly growing area of card networks (credit cards, debit cards and ATM networks), price incentives are not the outcome of normal competitive processes. They are the outcome, instead, of arrangements for wholesale ("interchange") fees – fees paid between financial institutions – that have proven rigid over time and immune to competitive pressures, and of restrictions on entry to the card networks, both explicit and informal. In Australia's highly concentrated banking system, the fee structures for the main competing payment methods are set by the same group of banks and other deposit-taking institutions. This is not an environment, in the Board's judgment, in which current price signals can be relied upon to ensure that consumers confront the cost of their payment choices and that resources are allocated to their most efficient use.

Against this background, the Board has embarked on a major reform of card networks that is intended to allow normal market mechanisms to operate more effectively in the Australian payments system, in the community's interest. A key part of this agenda was completed in August 2002 when the Bank, after extensive consultations, announced its reforms to credit card schemes in Australia. These reforms are described in the body of this Report. In this case, the Bank used its formal powers in the payments system not to regulate the credit card market, but to end scheme restrictions already in place that do not allow competitive forces to work.

Reform of interchange fee arrangements in debit card and ATM networks has followed a different path and timetable. Industry participants were initially reluctant to embrace the Board's broad agenda but the finalisation of credit card reforms has added impetus to industry reviews of existing arrangements. To this point, the Board has been content to limit the Bank's role to that of facilitator, bringing industry participants together and helping to develop options for reform in both debit card and ATM networks, but stepping back more recently to see whether an industry-led consensus could be developed and implemented in a timely fashion. Considerable progress on reform to debit card interchange fees has been made over the past year and a proposal to reduce these fees to zero is currently before the Australian Competition and Consumer Commission. Industry commitment to reform of ATM arrangements has been much slower to develop but proposals for a "direct charging" regime that would replace ATM interchange fees have recently been put out for public consultation.

The Board strongly supports proposed reforms to debit card and ATM networks that would bring to an end the ossified structure of bilateral interchange fees. Such reforms, accompanied by the removal of current (informal) barriers to entry to these networks, will deliver more efficient and transparent pricing of debit card and ATM services and a significant reduction in transaction fees for users. In the Board's view, the sensible timetable for debit card reform is one that coincides with credit card reform, with ATM reforms following as soon as is practicable.

The safety of payments and settlement systems has become a matter of increasing international attention, particularly in the wake of the severe shocks to the global financial system over the recent period. Compliance with accepted payments and settlement standards now forms part of assessments by international financial institutions of a country's vulnerability to financial disturbances. Australia continues to be well served by its domestic high-value payments system and the Board is closely monitoring the evolution of international standards. In the safety and stability area, an important milestone in 2002 was the commencement of operations by CLS Bank, a special-purpose bank that settles foreign exchange transactions in major currencies, including the Australian dollar. The Board has been a strong supporter of this global initiative, which significantly reduces foreign exchange settlement risks for member banks. Over the past year, a particular priority for the Board has been the development of financial stability standards for securities clearing and settlement systems, to give effect to its new responsibilities in this area. These standards are designed to ensure that Australia's crucial "back office" systems are able to withstand shocks, whether from the inability of a participant to meet its obligations or an operational failure. The standards have already been the subject of a public consultation process and are expected to be released in final form shortly.

The Australian Payments System

Each day, the Australian community – consumers, businesses, financial institutions and governments – makes millions of payments to acquire goods and services, or to transact in financial and other assets. These payments can be made in cash or a variety of non-cash means, including cheques, credit and debit (EFTPOS) cards and a range of specialised high and low-value electronic payment systems. Non-cash payments total around $170 billion daily, the equivalent of Australia's Gross Domestic Product every four days. Together, the individual payment systems, the infrastructure that supports them and the organisations that operate them make up the Australian payments system.

The payments system covers two broad classes of payments: *retail* payments by consumers and businesses and *wholesale* payments to settle transactions in financial markets. Retail payments account for almost all payments by number but only a small part of the total value of payments; in contrast, wholesale payments are small in number but, being typically for very high values, account for most of the value of payments.

These arrangements, which can be quite complex, involve initiation of the payment – for example, by a customer writing a cheque or presenting a credit card – and some form of communications network that allows payment messages to be sent to all the relevant parties. When both the payer and the beneficiary have their account at the same financial institution, the payment can be completed on the books of that institution through a debit to the payer's account and a credit to the beneficiary's account. Where the payer and the beneficiary have their accounts at different financial institutions, the payment messages are exchanged or cleared between the institutions and funds are transferred in turn between the institutions. This last step is known as settlement between financial institutions (often called interbank settlement) and is usually done by debiting and crediting the accounts which the respective financial institutions hold at a settlement institution, usually the Reserve Bank.

The operations of some individual payment systems in Australia are co-ordinated by the Australian Payments Clearing Association (APCA); other systems are operated by domestic and international card schemes or independently by groups of financial institutions. Individual payment systems are governed by sets of rules normally determined by members. These rules deal with the requirements for participation in the system (e.g. which institutions can offer the particular payment service or what institutions need to do to offer the service), how

AUSTRALIA: PAYMENTS BETWEEN FINANCIAL INSTITUTIONS 2002

	RETAIL	WHOLESALE
Purpose	Retail and commercial payments	Foreign exchange, money market trades, corporate payments
Mechanism	Cash, cheques, direct credits and debits, cards	Real-time gross settlement
Daily turnover*	$20 billion	$120 billion
Average daily number*	9.5 million	20 000

*Excluding cash. Numbers and values of payments between financial institutions understate the total for the Australian community because they exclude payments between customers of the same financial institution.

While they vary considerably in detail, individual non-cash payment systems have a great deal in common. Each involves arrangements that allow the settlement or discharge of payment obligations through the transfer of funds from the accounts of payers to the accounts of beneficiaries.

the payment instructions are cleared between institutions, the procedures for determining each institution's settlement obligations and how settlement takes place.

Retail payments

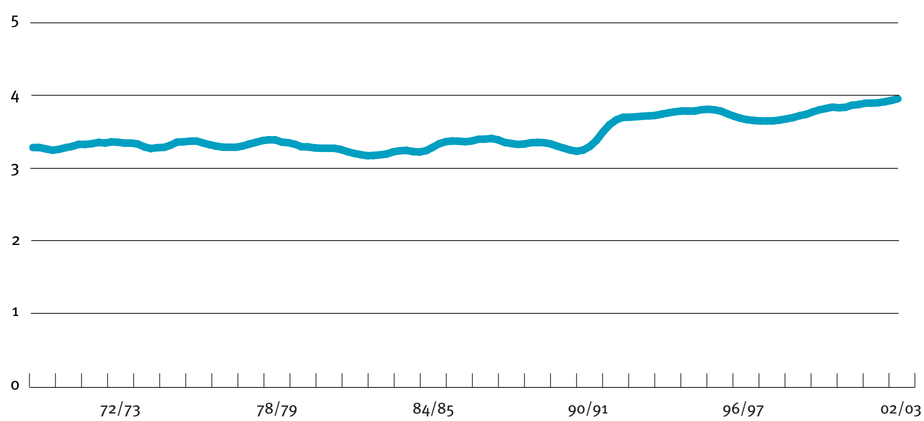
In its initial stocktake of the Australian payments system, published in its 1999 Report, the Payments System Board highlighted two particular characteristics of retail payments in Australia – the well-entrenched use of cash and the popularity of the cheque, for a long time the most frequently used non-cash means of payment. Australia was then one of a number of industrial countries, along with the United States, the United Kingdom, Canada and France, that used cheques extensively. Within a few short years, this characterisation has changed. Cash continues to be an important payment method in Australia but cheques have been clearly displaced by electronic means of payment.

Whether proxied by the ratio of currency (notes and coins in the hands of the non-bank public) to GDP, or by withdrawals from ATMs, cash remains a significant means of payment, especially for small-value payments. Despite earlier expectations, smart cards and "electronic money" have made no inroads on cash payments in Australia (or in most other countries). At the same time, the number of non-cash payments per capita has been rising strongly. Some substitution away from cash has undoubtedly taken place but other factors are also relevant. Many local authorities, utilities and insurance companies, for example, now offer quarterly or monthly payments in lieu of less frequent payment schedules. And payments are now being made (usually monthly) for services not previously available, such as cable television, Internet and mobile phones.

A number of considerations shape the choice of payment method for consumers and businesses. One

CURRENCY

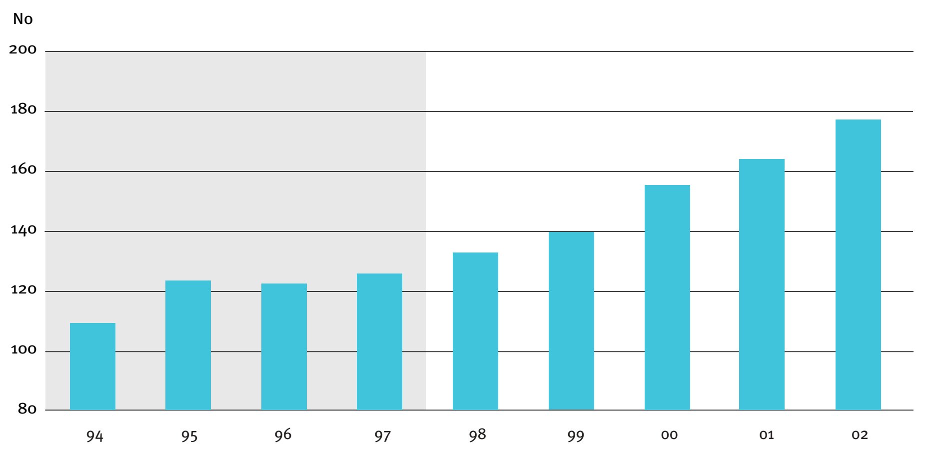
Per cent to GDP



is the quality of service, covering such features as the speed with which payments are processed, the convenience offered and the reliability and security of the payment method. Another is the structure and level of fees charged by financial institutions providing the payment services. Tastes and demographics also play a part. Technological advances which have improved the speed, convenience and flexibility of different payment methods have been a significant influence on the changing payments landscape in Australia over recent years. So, too, have been the price signals facing the user. This is most apparent in the growth of card-based payments. Credit card transactions have been rising sharply for some time – the number of credit card payments per head has quadrupled over the past decade – and the credit card has now become the most frequently used means of payment in Australia. Debit card (EFTPOS) usage has also been growing but at rates that have been outstripped by credit cards over recent years. As the Board has noted in earlier Reports, these divergent trends are not surprising in view of the structure of fees charged by financial institutions for providing card payment services. Consumers using a debit card generally pay a transaction fee to their financial institution (beyond a fee-free threshold) for accessing their own funds; credit cardholders who pay off their outstanding balances each month pay no transaction fees, and may be paid in the form of loyalty points, for using the funds of their financial institution.

Direct credits to customers' accounts at financial institutions have continued to grow steadily. The Commonwealth Government has provided an important lead in this area in paying social security benefits and other government disbursements by direct credit rather than by cheque, at a considerable saving in costs. Businesses are also making growing use of direct credits

NON-CASH RETAIL PAYMENTS PER CAPITA



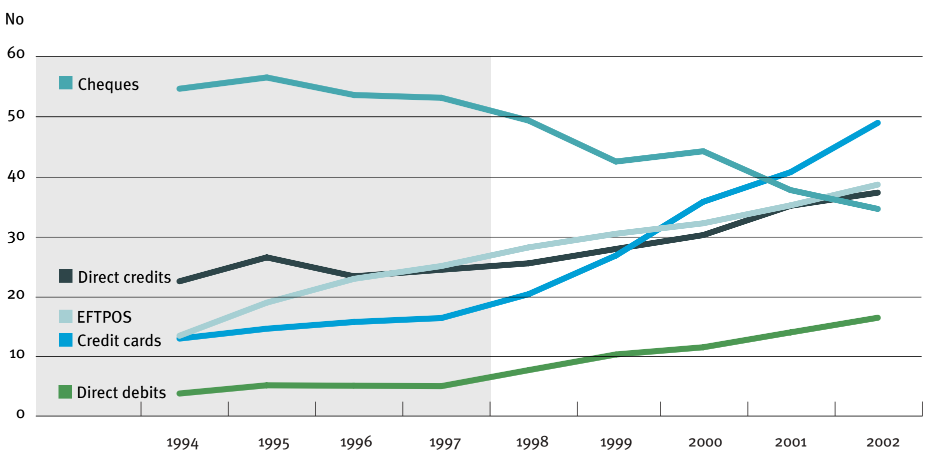
for recurring bulk payments of salaries, pensions, interest and dividends, where the beneficiary needs no special explanation of the payment credited to their account.

Australians are also showing greater willingness to use direct debits as a means of paying regular bills or recurring obligations. Over the past five years the number of direct debit transactions per capita has trebled, albeit from a low base. One reason behind this greater take-up has been the introduction of some basic consumer safeguards by billers. Another is the growing recognition by billers that direct debits are a very efficient and low cost means of payment. The number of billers offering a direct debit payment facility has also trebled over the past five years; the system has been better publicised; and many billers now offer discounts to customers who sign up to pay by direct debit rather than by more costly means.

The growth of electronic payment mechanisms has been at the expense of cheques. Although cheques remain a convenient and flexible means of payment for many Australians, consumers appear to be keen to embrace the newer payment technologies and may also be responding to increased fees for writing cheques, as financial institutions seek to recover the relatively high costs of providing this payment service. Businesses are the main users of cheques and their usage also appears to be trending down. However, the value of cheques written by business remains substantial – many businesses have yet to find an electronic replacement for cheques that allows the flexible reconciliation of payments with invoice data.

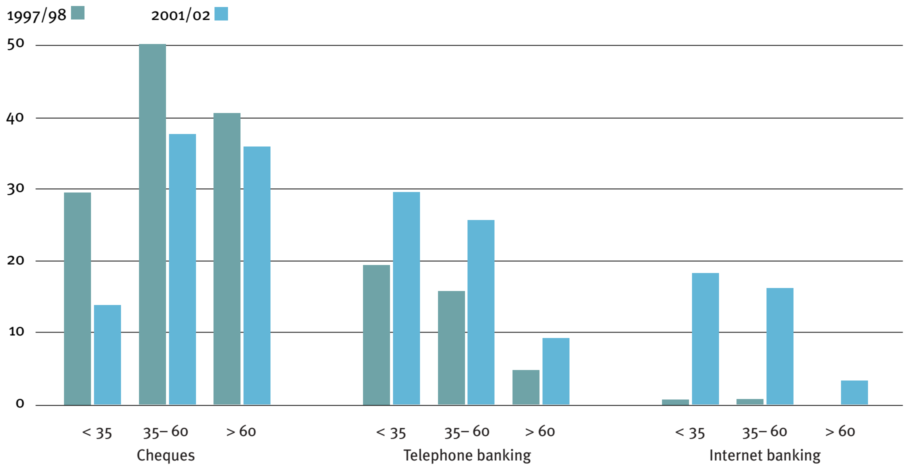
NON-CASH PAYMENTS PER CAPITA

Per year



USE OF PAYMENT CHANNELS

Per cent of age group



Source: Roy Morgan Research

Survey data provide some further insights into the changing pattern of retail payments for consumers. Over the past four years, a smaller proportion of survey respondents have written cheques, and a higher proportion have made electronic payments. In 2001/02, around 22 per cent of survey respondents had used telephone banking, and 13 per cent had used Internet banking, in the month prior to the survey. Younger consumers, generally with greater access to technology and perhaps a greater willingness to apply it, make much less use of cheques.

Wholesale payments

Wholesale ("high-value") payments account for most of the value of payments settled between Australian financial institutions, although the number of such payments – around 20 000 each day – is relatively small. These payments are to settle transactions in wholesale markets in government and other fixed-interest securities, the Australian dollar leg of foreign exchange transactions and a range of time-critical corporate transactions. Around 90 per cent of the value of interbank payments is settled through Australia's real-time gross settlement (RTGS) system, introduced in June 1998 and operated by the Reserve Bank. Under this system, all high-value payments are settled individually, as they are made, using funds in institutions' Exchange Settlement Accounts at the Reserve Bank.

There are two high-value payment streams which settle on an RTGS basis. Austraclear is an electronic depository and settlement system for Commonwealth Government Securities (CGS) – a role it assumed from the Reserve Bank in February 2002 – and for other debt securities. The SWIFT Payment Delivery System (PDS) is the main vehicle for making payments which do not have an associated securities transaction. (The RTGS system also settles directly a range of other interbank transfers.)

RTGS TRANSACTIONS 2002

Daily average, March-December

	SYSTEM	VALUE ($ billion)	NUMBER (Thousands)
CGS, other fixed-interest and money market transactions	Austraclear	30.3	2.6
Foreign exchange, corporate transactions, etc	SWIFT PDS	88.5	17.1
Other interbank transfers	RTGS	6.4	0.2

Overall, RTGS payments average around $120 billion each day.

The role of the Board

The Payments System Board of the Reserve Bank was established on 1 July 1998 with a mandate to promote safety, efficiency and competition in the Australian payments system. In September 2001, 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 a response to the recommendations of the Financial System Inquiry (the Wallis Committee), which had concluded that Australia's payments system was not at international best practice, particularly as far as the efficiency of retail payments was concerned. The additional responsibility for securities clearing and settlement facilities is a recognition of the importance of safe and well-functioning facilities of this type for overall financial system stability, an enduring central bank concern.

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 vested in the Reserve Bank and are set out, in the main, in the *Payment Systems (Regulation) Act 1998*. Under this Act, 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. The Act does not define or limit the matters on which the Reserve Bank may determine standards; 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.

As with the payments system, the Board has been given responsibility to determine policies with respect to the safety of clearing and settlement facilities while the powers to carry out those policies 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 Reserve Bank, which are set out in 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 Reserve Bank itself has formal responsibility for ensuring that clearing and settlement facilities conduct their affairs in a way that is consistent with financial system stability. As part of this role, it has the power to set and monitor compliance with financial stability standards for clearing and settlement systems.

The new regulatory regime for securities clearing and settlement systems came into force in March 2002, with a two-year transition period for systems that were not explicitly regulated under the previous regime.

The Board's approach to its mandate has been outlined in previous Reports. The balance of this Report provides details of the Board's activities in carrying out its responsibilities over the past year.

Competition and Efficiency

As noted earlier, the choice between different payment methods is influenced most directly by their features and by the fees and charges for their use. The workings of the market place ought to determine which payment systems flourish, creating revenues for providers and benefits for users, and which do not. The Board has no view about the "right" mix of payment methods in Australia. Rather, its role is to promote efficiency and competition in the payments system to ensure that the market does provide users and providers of payment services with appropriate price signals on which to base their choices.

The strength of competition can, of course, be affected by the rules which govern the operation of individual payment systems, which are generally determined by the operators and participants in these systems. Co-operative arrangements between competitors are a feature of modern payment systems, with their complex linkages among financial institutions, and they can play an important role in underpinning the safe and orderly operation of these systems. However, self-interest may not coincide with the public interest where such arrangements restrict the interplay of competitive market forces. Inevitably, the rules and governance arrangements of individual payment systems have been a focus of attention for the Board. The main focus has been on card payment systems – credit cards, debit cards (EFTPOS) and ATM networks – where earlier analysis by the Reserve Bank, in conjunction with the Australian Competition and Consumer Commission (ACCC), showed that competition was not working as it should.

Credit card schemes

During 2002, the Board finalised its reform of credit card schemes in Australia.

The Board has, since its establishment, expressed concern about the structure of price incentives in the card payment market in Australia, which clearly favour the use of credit cards over debit cards. Credit card users are effectively "subsidised", in the sense that they are charged less than the cost of the credit card payment services they use (or are even offered rebates in the form of loyalty points). Banks and other deposit-taking institutions promote the credit card most actively because it is the payment service for which they receive the highest return, even though it is one of the most expensive for merchants to accept. The Board's concern about this structure of price incentives is that it is not the result of normal competitive processes. Rather, it is the consequence of the restrictions imposed by the credit card schemes and their members and the fact that it is the same group of banks and other deposit-taking institutions that sets the fee structures for credit cards and the other main payment systems in Australia.

Credit card scheme restrictions involve the collective setting of wholesale ("interchange") fees – fees paid to financial institutions which issue credit cards by financial institutions which provide services to merchants – restrictions on the freedom of merchants to pass through their credit card costs to cardholders and restrictions on entry to the schemes. The Board has concluded 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 methods, 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.

Although extensive consultations and analysis preceded the step, the reform process began in a formal sense in April 2001, when the Reserve Bank designated the Bankcard, MasterCard and Visa credit card schemes in Australia as payment systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*. The Bank announced that it would proceed to establish, in the public interest, a standard for the setting of interchange fees and, if necessary, a standard for merchant pricing of credit card purchases, as well as a regime for access to these credit card schemes. The Bank did not designate the "three party" card schemes in Australia, American Express and Diners Club, which do not have collectively determined interchange fees nor restrictions on access enforced by existing members. These latter schemes did, however, impose restrictions on the freedom of merchants to recover credit and charge card costs from their cardholders, and the Bank confirmed that any decisions it took in this area would apply to all card schemes in Australia.

Following designation, the Reserve Bank undertook a detailed evaluation of whether the main restrictions established by the credit card schemes were in the public interest. It gave high priority to the consultation process, receiving views on the operation of credit card schemes in Australia from over 30 separate organisations. A commissioned report by an international expert in network economics also helped the Bank assess the various submissions.

This consultation process culminated in the publication of a Consultation Document in December 2001, in which the Reserve Bank set out its proposed reforms to the designated credit card schemes in Australia and provided extensive discussion of the purpose and effect of these reforms. The reform measures involved:

- an objective, transparent and cost-based methodology for determining interchange fees;
- freedom for merchants to pass through to cardholders the costs of accepting credit cards; and
- a more liberal access regime that allowed for the entry of specialist credit card service providers, both issuers and acquirers, to be supervised by the Australian Prudential Regulation Authority (APRA).

A further extensive round of consultations, as required under the Act, was undertaken before the reform measures were finalised. The Reserve Bank received submissions from 28 organisations before the specified deadline of 15 March 2002, including from the designated and "three party" card schemes, financial institutions, other payments providers, merchants and consumer representatives, as well as submissions from a number of members of the public. Comments and other material were received after the submission deadline, and the Reserve Bank considered these also. All organisations that made formal submissions were invited to discuss them with Reserve Bank staff. In all, 52 such meetings were held between mid March and August 2002, including 15 separate meetings with the designated credit card schemes.

With the exception of the designated credit card schemes, the overall tone of the submissions received was one of acceptance of the need for reform of credit card schemes in Australia, although views on the preferred details of such reforms varied considerably. The designated credit card schemes opposed each of the Reserve Bank's proposed reforms, claiming them to be unnecessary and not in the public interest. Financial institutions and their respective industry associations broadly accepted that interchange fees in credit card schemes should be determined on the basis of an objective, transparent and cost-based methodology, but argued that the categories of costs that the Reserve Bank proposed were too narrow. In general, financial institutions did not object to the removal of scheme restrictions on merchant pricing or to the proposed more liberal access regime. Most merchants, and the consumer organisations which offered views, expressed strong support for the reforms.

After a comprehensive review of the views and issues raised in submissions and discussions, the Board endorsed a package of reforms to credit card schemes in Australia designed to promote transparency, competition and a more efficient allocation of resources in the Australian payments system. The Board was not persuaded by arguments that allowing normal market mechanisms to operate more effectively in the payments system is against the community's interest. Although the purpose and likely effect of the reforms were unchanged from the proposals made in December 2001, a number of suggestions for simplifying the drafting and providing greater flexibility to the designated card schemes and their members were incorporated in the final measures. The Board acknowledges the constructive input of many parties during the consultation process.

The reform measures, which were announced on 27 August 2002, comprise:

- a *standard on interchange fees* that involves an objective, transparent and cost-based benchmark against which interchange fees in the designated credit card schemes can be assessed. The cost-based benchmark for each scheme will set a ceiling on average interchange fees in the scheme, and will be based on the costs incurred by card issuers in processing and authorising transactions, fraud and fraud prevention, and funding the interest-free period. Each scheme must recalculate the benchmark at least every three years. The standard becomes effective on 1 July 2003 and associated changes to interchange fees must be implemented by the end of October 2003. Regulations under the *Payment Systems (Regulation) Act 1998* are being finalised to ensure that participants in the designated credit card schemes complying with this standard will not be in breach of the *Trade Practices Act 1974* in doing so;
- a *standard on merchant pricing* that removes the restriction imposed by the international credit card schemes on the freedom of merchants to charge according to the means of payment. This standard came into effect on 1 January 2003; and
- an *access regime* that allows specialist credit card institutions authorised and supervised by APRA to apply to participate in the designated credit card schemes, and that removes any restrictions or financial penalties that disadvantage scheme participants seeking to specialise in acquiring. APRA is currently finalising the regulatory framework and prudential standards that will apply to the new class of specialist credit card institutions.

American Express and Diners Club each gave an undertaking to the Reserve Bank to remove their restrictions on merchant pricing when the standard on merchant pricing came into force.

The Reserve Bank's reforms are consistent with the broad objectives of the Government's competition policy and have received bipartisan support. They will allow normal market mechanisms to work more effectively in the Australian payments system and reduce its overall costs to the community. This will be achieved through:

- lower merchant service fees as a direct consequence of reduced interchange fees, which will pass through to the community in the general level of prices. Average interchange fees are expected to fall by up to 40 per cent in 2003;
- greater market discipline on merchant service fees because of the freedom of merchants to pass through their credit card costs to cardholders;
- more efficient and transparent pricing of credit card services to cardholders and merchants; and
- greater competition in the provision of credit card services to cardholders and merchants from the entry of non-financial corporations of substance.

The Board will monitor the impact of the reform measures on an ongoing basis and report to Parliament, in the usual way, through its Annual Reports. The Board will also undertake a major review of credit and debit card schemes in Australia after five years and, on the basis of that review, will consider whether the reform measures remain appropriate.

In September 2002, MasterCard International and Visa International each filed an application in the Federal Court to have the reforms overturned. In developing the reforms, the Reserve Bank has acted consistently with its obligations and powers under the *Payment Systems (Regulation) Act 1998,* and at law, and it is vigorously defending the reforms. The hearing is expected to commence in mid 2003.

Debit card payment networks

In Australia, the structure of interchange fees for proprietary debit card (EFTPOS) payments is virtually unique: interchange fees are paid by the card issuer to the acquirer and are negotiated bilaterally rather than set at a system level. In other countries the flow is to the card issuer or there are no interchange fees at all, as is the case in the two most heavily used debit card payment systems – Canada and the Netherlands. The fee structure in Australia may have been relevant in the establishment phase of the EFTPOS network in the early 1990s, as an incentive for merchants and their banks to invest in the infrastructure needed to accept transactions and switch them to issuers. On the basis of data provided by participants, however, the Reserve Bank/ACCC study of debit and credit card schemes, released in October 2000, concluded that there was no convincing case for an interchange fee in Australia's debit card payment system, in either direction. The bilateral interchange fees, which have hardly changed since they were introduced, are a major determinant of fees charged by issuers to their cardholders. The interchange arrangements also appear to be a barrier to new entrants, who must negotiate a multitude of interchange fee contracts with other participants before they can compete effectively.

Initially, industry participants showed little willingness to review these arrangements. Over the course of 2002, however, as the momentum for credit card reform built, there was growing acceptance of the sense in reforming debit card interchange fees at the same time as those for credit cards, so that consumers and merchants can face more efficient prices for both means of payment.

Early in 2002, the Reserve Bank convened a series of meetings of industry participants to explore options for debit card reform. The industry group consisted of the largest direct participants in the EFTPOS network, including one large merchant. Industry views on reform are quite diverse and strongly held; for this reason, the Reserve Bank encouraged the industry group to seek public input into the reform process. In July 2002, the industry group released a paper, prepared with Reserve Bank assistance, which outlined three basic options for reform: retention of the current arrangements (with small modifications); adoption of collectively determined interchange fees calculated on a cost-based approach; or abolition of interchange fees altogether.

Following publication of the paper, the industry group met with interested parties to discuss the options. At the group's request, the Reserve Bank stepped back from its direct role in facilitating reform efforts; this is fully consistent with a "co-regulatory" approach under which industry participants have an opportunity to progress reform. In the end, significant differences in commercial interests have remained, both within the industry group and among other interested parties. Banks, building societies and credit unions have recently applied to the ACCC for authorisation of a proposal to reduce debit card interchange fees to zero. The Board strongly supports this proposal, and expects the reduction in interchange fees, if authorised, to be passed immediately and fully to debit card users through lower transaction fees.

The Board believes that reform also needs to address the issue of access to the EFTPOS network (and similar considerations apply to ATM networks). Potential new entrants claim that it is extremely difficult to overcome the operational and commercial hurdles to establishing the required bilateral links with all of the major banks. Unlike the APCA clearing streams for cheques, for example, where each institution is obligated to pay any valid cheque drawn on it that is presented by another institution, APCA members are not obligated to exchange EFTPOS payments with all other members. Instead, individual interchange agreements must be negotiated before one institution will accept EFTPOS transactions from another. One bank alone can effectively "hold up" access for any new participant by delaying the technical connections and the signing of interchange agreements, even when the new participant has clearly met APCA's technical requirements. The Board believes that these *ad hoc* bilateral arrangements are not beneficial to the Australian payments system and can be a significant barrier to new entrants. Since merchants usually prefer to have one financial institution provide both credit card and debit card acquiring services, the bilateral arrangements also mean that the Bank's opening-up of access to credit card schemes might be less effective than otherwise.

A concern of the Board that is yet to be resolved is the interchange fee arrangements in one particular debit card product – the Visa-branded debit card. Depending on the selection made by the cardholder, issuers of this card can earn the same interchange fee rate as that for credit cards for what are essentially debit card transactions. Although the product has some features that are typically associated with scheme credit cards, such as "money back guarantees" for cardholders and the ability to use the cards for card-not-present transactions, the Board sees no case for simply applying credit card interchange fee rates to Visa debit card transactions. In last year's Report, the Board set out two steps which, in its view, are necessary to deal with this issue. On the technical level, Visa debit card transactions need to be identified separately from Visa credit card transactions at point-of-sale, as they are in some other countries. On the pricing level, card issuers will need to demonstrate that a case can be made for a collectively determined interchange fee for Visa debit card transactions that would meet the appropriate public interest test. The Board understands that the Visa debit card product is under review and it is not yet able to assess whether any proposed changes will meet its public interest concerns.

ATM networks

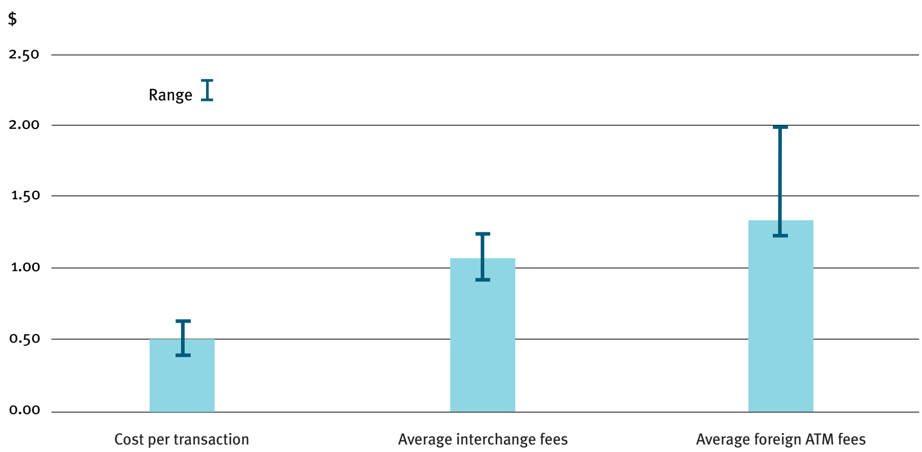
An overhaul of ATM interchange fee arrangements is the third plank in the Board's reform agenda for card payment networks.

ATM interchange fees in Australia arise whenever cardholders of one financial institution use an ATM owned by another financial institution (so-called "foreign" ATM transactions). The fees are paid by the card issuer to the ATM owner, which incurs costs in providing a cash dispensing service to the issuer's customers. The fees are determined by bilateral negotiation.

The Reserve Bank/ACCC study found that cardholders using another institution's ATM pay "foreign ATM fees" that are considerably more than the cost of providing the service, and that competitive forces are not working to bring interchange fees and "foreign" ATM fees more into line with costs. The interchange fee arrangements effectively prevent ATM owners from

ATM COSTS AND FEES

Cash withdrawals



Source: CANNEX Australia & Reserve Bank of Australia competing on the basis of price or services provided, since they do not receive any more or less revenue from users for changes in the quality of service or the cost of providing it. The study considered an alternative pricing regime – that of "direct charging" – that would encourage competition and greater transparency in the pricing of ATM services. Under this regime, there would be a direct relationship between the ATM owner and cardholders wishing to withdraw cash. The ATM owner would charge customers of other financial institutions a transaction fee which would be clearly posted at each ATM. That fee would be debited to the cardholder's account along with the cash withdrawal, and the resulting amounts settled between card issuers and ATM owners as at present.

The industry's response to these issues has followed much the same pattern as debit card reform – the convening of a meeting of industry participants by the Reserve Bank, detailed discussions within the industry group of different regimes for charging for "foreign" ATM transactions and, more recently, a stepping-back by the Reserve Bank from its role as facilitator to enable an industry-led solution to be reached. However, the process has been more protracted than that for debit card reform. Industry participants have now released for public consultation a proposal that ATM interchange fees be replaced by a regime under which each ATM owner would be free to levy charges – disclosed at the point of transaction – directly on customers. Card issuers would also be free to charge their customers directly for "foreign" ATM transactions.

The Board strongly supports this proposal. In its view, a direct charging regime will result in lower and more transparent fees on "foreign" ATM transactions and, over time, an expansion in the quality and range of ATM services available to consumers. Given the long period of review and discussions which has already passed, the Board sees no compelling reason why the industry could not finalise the proposed reform in 2003.

Direct debits

The Board has supported industry initiatives to promote greater use of direct debits as a very efficient means of paying regular bills or recurring obligations, and it welcomes signs that Australian consumers are more ready to adopt this payment method.

The major initiative has been the introduction of safeguards that give consumers greater confidence that they will be able to stop any incorrect payments under direct debit arrangements. These safeguards are enshrined in the Charter for Direct Debit Customers, first published in 2000, which guarantees service levels for retail customers. The Charter confirms that customers will be given adequate notice of debits to be made to their accounts and will be able to stop the debit if they believe that they have been incorrectly billed, provided they give the required notice. Recently, APCA has introduced more streamlined procedures that allow customers to cancel direct debit authorities directly through their bank, building society or credit union. Customers can now quickly cancel direct debit authorisations and stop individual payments through either their financial institution or the biller; financial institutions cannot deflect requests back to the biller.

Useful though they are, these consumer safeguards do not provide any guarantee of a refund if the bill is disputed after payment. In the United Kingdom, where direct debiting has much wider acceptance, "direct debit guarantee" arrangements provide that if a customer claims a mistake was made in having a direct debit made to their account, their financial institution will refund them immediately, and the refund is not limited by amount or time. Although refunds are initially paid by the financial institution, they are borne by the billers under an indemnity. A review of the Code of Banking Practice (the Viney report), conducted for the Australian Bankers' Association (ABA), recommended that the Code include a requirement that banks seek to amend APCA's rules to provide for a guaranteed refund along UK lines, as a way of ensuring greater protection to consumers, and that this be done by no later than 1 July 2002. The ABA endorsed the Viney recommendation and, in last year's Report, the Board encouraged APCA to bring it to fruition as soon as possible.

The outcome is a disappointment. The recommendation relating to a guaranteed refund was omitted from the revised Code of Banking Practice launched in August 2002, and no amendments have been made to APCA's rules to facilitate the introduction of a guarantee. The Board regrets that the industry has failed to grasp an important opportunity to further the use of a very efficient payment mechanism.

Purchased payment facilities

In the mid 1990s, the birth of Internet commerce and the commercialisation of smart cards were widely perceived to be leading towards an electronic payments revolution. High-profile trials of products such as the Mondex "electronic purse" (a smart-card-based payment system) and Internet-based "e-cash" caught the attention of media commentators and regulators. The Financial System Inquiry, reporting at the height of public interest in electronic money systems, took the view that these new payment facilities had the potential to become an important element in the Australian payments system. The Inquiry wanted to ensure that participants other than banks could compete in these new technologies but, in the interests of protecting consumers, recommended to the Government that providers of such facilities be subject to prudential regulation. As a result, the Reserve Bank was given wide-ranging powers for the regulation of "purchased payment facilities" under the *Payment Systems (Regulation) Act 1998*. Section 4 of the Act requires that the "holder of stored value" backing such a facility – that is, the entity receiving the proceeds from the sale of the facility – either be prudentially regulated by the Reserve Bank, exempted by the Bank from regulation or be an authorised deposit-taking institution (ADI) supervised by APRA.

Since that time, electronic money systems have generally been commercial failures or, at best, have underperformed expectations. Many of these systems were designed by technical specialists who developed impressive technology to interface with users but may not have fully appreciated the importance of back-office clearing and settlement and the associated costs and complexity. Other products that were designed as substitutes for cash at point-of-sale ran up against the reality that cash is very efficient and effective for high-volume, low-value transactions. Only a few countries (including Singapore, Hong Kong, Belgium and Sweden) have achieved relatively wide usage of general-purpose stored-value cards.

In Australia, like most other countries, the bulk of electronic money products in operation are card-based means of payment not available for general-purpose payments. They are used in "closed" environments, such as universities, or for purchases of specific goods or services only. Closed-system cards include cards provided by State and Territory governments for use in transport, libraries, parking and other community services. Several tertiary institutions have developed student cards that consolidate identification and purchases of campus services. Some new payment methods have developed out of the need to improve the efficiency of payment in specific markets. Such systems are typically established by the organisation providing the goods or services and include prepaid transport cards, disposable phone cards and electronic gift certificates that allow pre-payment for purchases at a specific merchant or group of merchants. Health benefit member cards with a stored-value function have also been trialled, but usage has been low.

Some rationalisation of the regulatory framework for purchased payment facilities in Australia has taken place, and further rationalisation might be needed. The *Payment Systems (Regulation) Act 1998* created the potential for duplication of resources and regulatory burden between the Reserve Bank's role in overseeing the safety and efficiency of payment systems and APRA's responsibilities to supervise specific institutions which, in many cases, also provide payment services. To address this concern, in June 2000 a regulation was enacted under the *Banking Act 1959* to allow APRA to supervise purchased payment facilities which have deposit-like characteristics. The criteria for supervision by APRA are that the product is available on a "wide basis" as a means of payment and the stored value is redeemable by the user on demand.

Although it is yet to authorise any facilities under this regulation, APRA is expected to become the supervisor of purchased payment facilities that achieve material size, since any successful payment product will probably need to be redeemable on demand in order to ensure consumer confidence. Purchased payment facilities with narrow applications or limited usage will, however, remain outside APRA's purview. Many of these systems were operating before the Financial System Inquiry and the value of funds held by providers of these facilities is small; hence, they are unlikely to raise concerns on financial stability or payments system integrity grounds. The Board sees no need for the Reserve Bank to regulate the holders of stored value in these cases. Accordingly, an exemption from regulation will be issued for small and limited-purpose purchased payment facilities (up to a threshold in stored value outstanding), or facilities that are guaranteed by an ADI or government.

It is possible that a small number of purchased payment facilities may emerge – primarily those in a start-up phase or with usage restrictions of some sort – that fall outside APRA's supervision and the class exemption. The Reserve Bank is discussing the appropriate regulatory framework for such facilities with the Australian Securities and Investments Commission (ASIC), which has assumed a consumer protection role under the *Financial Services Reform Act 2001* that is particularly relevant for smaller purchased payment facilities. The objective of the discussions is agreement on a division of responsibilities between APRA, ASIC and the Reserve Bank that is consistent with the respective roles of the three agencies in the financial system.

Safety and Stability

Robust arrangements for clearing and settlement of payments and other financial obligations are crucial to overall financial system stability. Recognising this, policymakers have developed high-level standards – in the form of the *Core Principles for Systemically Important Payment Systems* and the *Recommendations for Securities Settlement Systems* – that are now internationally accepted as representing minimum requirements for good practice in this area. Observance of these standards forms part of assessments by the International Monetary Fund and the World Bank of the soundness of a country's financial system. Australia has not yet been subject to such an assessment. Nonetheless, the Board has judged that Australia rates highly against these international standards, a judgment it will revisit on an ongoing basis as the standards take on greater operational content. Over the past twelve months, two main issues relating to safety and stability have been on the Board's agenda. One is the introduction of CLS Bank, a global initiative to reduce foreign exchange settlement risk, which commenced operations in September 2002. The other is the development of financial stability standards for securities clearing and settlement systems, for which the Board now has regulatory responsibilities.

Foreign exchange settlement risk

The reduction of risks associated with the settlement of foreign exchange transactions has been a continuing priority for the Board, and it has been a strong supporter of private-sector efforts to strengthen settlement mechanisms. These efforts have focused on the development of a "continuous linked settlement" mechanism, known as CLS Bank.

A foreign exchange transaction involves the payment of one currency for another. Before CLS Bank commenced operations, the settlement of each leg could occur only in the domestic payment system of each country, often in different time zones and using correspondent banks to settle on behalf of banks not represented locally. The settlement processes were not co-ordinated and there was the risk that one party could pay out the currency it had sold, but not receive the currency it had bought, because its counterparty or its correspondent bank had failed to deliver. Even if this failure were due only to short-term operational problems, the party expecting funds would have remained without those funds and there could be "knock-on" effects if the funds were needed to complete another transaction, either in the foreign exchange or domestic markets. The amounts involved in foreign exchange settlements can be very large – the Australian dollar leg of foreign exchange transactions exceeds A$100 billion on some days – so the scope for disruption was substantial. Australian banks were also particularly disadvantaged by the time zone: over 90 per cent of Australian dollar trades are against the US dollar, which was settled some 14 to 16 hours behind Sydney.

CLS Bank is a special-purpose bank which links the settlement of both legs of foreign exchange transactions in eligible currencies. Banks using the service maintain accounts with CLS Bank in each currency and transactions are settled simultaneously across these accounts. Settlement takes place on a "payment-versus-payment" (PvP) basis – to minimise its exposure to member banks, CLS Bank settles transactions if, and only if, each member retains an overall positive balance across its currency accounts after each settlement. Settlement risk is eliminated because CLS Bank ensures that one party cannot pay out the currency it has sold, but not receive the currency it has bought, because its counterparty or the counterparty's correspondent bank has failed to deliver.

Development of CLS Bank began in 1997 as an initiative of a group of major international banks. Though its implementation proved to be a protracted process, the Board is pleased to note that CLS Bank commenced live operations on 9 September 2002, settling transactions in seven "first wave" currencies – the Australian dollar, Canadian dollar, euro, Japanese yen, pound sterling, Swiss franc and US dollar. CLS Bank expects to add the Danish krone, Norwegian krone, Singapore dollar and Swedish krona to the original currencies around the middle of 2003 and has endorsed in principle the inclusion of the Hong Kong dollar and New Zealand dollar in mid 2004.

Inclusion of the Australian dollar in the CLS arrangements required a number of regulatory actions and changes to operating procedures in Australia's domestic payment system. As a formal step, the Reserve Bank was asked by the Federal Reserve Bank of New York (which is the primary supervisor of CLS Bank) to approve the inclusion of the Australian dollar as an eligible CLS currency. In common with the central banks of the other "first wave" CLS currencies, approval was based on the minimum standards and principles for central bank oversight set out in the *Report of the Committee on Interbank Netting Schemes* (the Lamfalussy Report), published by the Bank for International Settlements in 1990. These were the standards in place when the development of CLS Bank got under way.

Individual transactions are settled by CLS Bank on a gross basis but, to keep liquidity needs in each currency to a minimum, banks need to pay in only their net short position or receive from CLS Bank only their net long position. To ensure the finality and irrevocability of these net payments by Australian members, CLS Bank has been declared a "netting market" under the *Payment Systems and Netting Act 1998*. Payments to and from CLS Bank are made through the relevant domestic real-time gross settlement (RTGS) system. In Australia, CLS Bank required an Exchange Settlement Account at the Reserve Bank for this purpose, and an application for such an Account was approved by the Payments System Board before CLS Bank commenced operations.

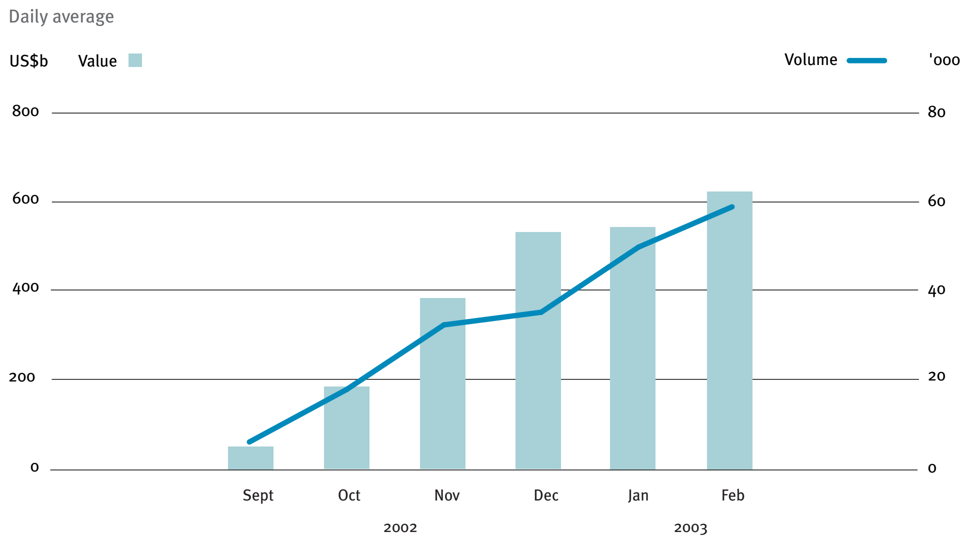
The CLS settlement process operates during a five-hour window, from 7.00 am to mid-day Central European Time. Depending on the time of year, that window closes between 8.00 pm and 10.00 pm in Sydney. Recognising the difficulties that this narrow window presents, the CLS arrangements give priority to settlements in the Asia-Pacific region, the aim being to complete these settlements two hours earlier than in the other regions. For its part, the Reserve Bank has extended the operating hours for Australia's RTGS system to synchronise them with the core hours of CLS Bank and Australian banks participating in the CLS system have extended their operating hours as well. The tight daily timetable means that operational problems in CLS Bank or its members could be disruptive to the CLS system, and to domestic payments systems more broadly. To minimise this risk, CLS has invested heavily in its own risk management and business continuity plans and requires its members to meet strict operational and technical standards.

Although payments to CLS Bank are made on a net basis, they can on occasion be large and, in Australia, they occur late in the day. To assist banks in managing their liquidity, at a time when most Australian markets have closed, the Reserve Bank introduced a new facility designed to meet periodic and potentially large demands for intra-day liquidity at relatively short notice. The new facility, announced in July 2002, widens the range of acceptable collateral for intra-day repurchase agreements to include selected bank bills and certificates of deposit.

Since it commenced operations, the number and value of foreign exchange transactions settled by CLS Bank have grown strongly. Taking all eligible currencies together, around 60 000 transactions valued at US$600 billion are now settled each day; the Australian dollar leg of transactions accounts for around 1 200 transactions each day valued at around A$22 billion. Further strong growth in CLS activity is expected over 2003 as additional members and non-member banks, and their customers, settle through the CLS system.

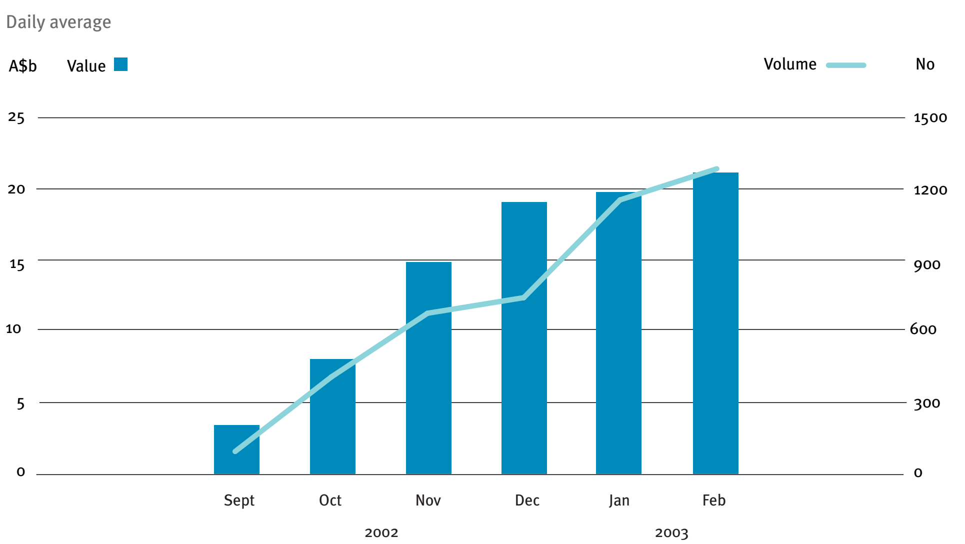
CLS Bank is now making a significant contribution to the reduction of foreign exchange settlement risk, a longstanding objective of central banks, but it does not eliminate other risks associated with the finalisation of foreign exchange transactions, such as operational and liquidity risks. In the case of correspondent banking arrangements, for example, the CLS system actually results in a greater concentration of risks. The settlement of foreign exchange payments has always required banks to use correspondent (agent) banks in centres where they are not represented or their presence is not large. Many foreign banks use large Australian banks to settle their transactions in Australian dollars while Australian banks use large New York banks to settle transactions in US dollars. Banks may hold balances with their correspondent bank and incur a credit risk; alternatively, they may receive credit from the correspondent bank, in which case the latter takes on a credit risk. Banks have the opportunity to undertake careful due diligence before

CLS SETTLEMENTS: ALL CURRENCIES



Source: CLS Bank
In measuring total settlements, CLS Bank records both sides of each trade settled. The sale of A$10 million for US$5.5 million, for example, is counted as a settlement with a combined value of US$11 million.

CLS SETTLEMENTS: AUSTRALIAN DOLLARS



Source: CLS Bank
In measuring settlements in individual currencies, CLS Bank counts only the relevant side of each trade settled. The sale of A$10 million for US$5.5 million, for example, would be measured as an A$ settlement with a value of A$10 million.

assuming such credit risks and are in a position to closely monitor and manage them. The CLS system gives a pivotal role to correspondent banks – in Australia, seven banks settle their own Australian dollar transactions directly with CLS Bank and settle all other Australian dollar transactions on behalf of other CLS members and their customers – and heightens the importance of prudent credit risk management in correspondent banking relationships.

Central banks are closely monitoring the CLS arrangements through a sub-group of the Committee on Payment and Settlement Systems at the Bank for International Settlements, chaired by the Federal Reserve Bank of New York and including the Reserve Bank.

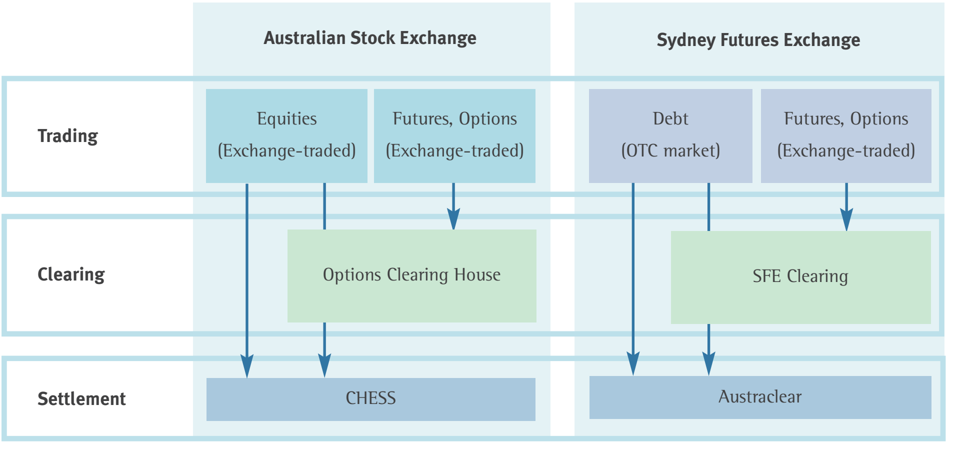
Securities clearing and settlement

Facilities that clear and settle transactions in securities such as bonds and equities, and in derivative instruments such as options and futures, are a critical part of Australia's financial architecture. The efficient and safe operation of these "back office" functions helps to ensure that disturbances, of external or domestic origin, do not spread throughout the financial system.

Clearing and settlement take place after market participants have entered into a transaction in a financial instrument. *Clearing* is the process of transmitting and reconciling instructions following the transaction, and calculating the obligations to be settled. Clearing may involve the netting of obligations and also the "novation" of the original trade to a central counterparty. *Settlement* is where the obligations of parties to the transactions are discharged. In a securities transaction, this typically involves the delivery of a security in return for payment; in a derivatives transaction, it usually involves only a one-way payment.

Clearing and settlement can be completed on a bilateral basis between the parties to the transaction but, in many circumstances, the process is conducted under the rules of an organised body. Where an organisation in Australia provides a regular mechanism for parties involved in financial product transactions to meet their obligations to each other, it is deemed to be a "clearing and settlement facility" and is required to hold a clearing and settlement facility licence under the *Corporations Act 2001*. Licences have been granted to the Australian Stock Exchange's ASX Settlement and Transfer Corporation (ASTC) (which operates the Clearing House Electronic Subregister System or CHESS) and Options Clearing House (OCH), and to the Sydney Futures Exchange's SFE Clearing Corporation (SFECC). Under transitional arrangements, another subsidiary of the Sydney Futures Exchange, Austraclear, is not required to obtain a licence until 11 March 2004.

AUSTRALIA'S CLEARING AND SETTLEMENT FACILITIES



As part of the new regulatory framework, the Board has formal responsibility for ensuring that licensed clearing and settlement facilities conduct their affairs in a way that is consistent with financial system stability. To this end, the licensed facilities are required to comply with financial stability standards set by the Reserve Bank. These standards aim to ensure that each licensed facility identifies and properly controls the risks associated with its operation; they proceed from the premise that the primary responsibility for risk management lies with the board and senior management of the facility. The Board has been overseeing the development of financial stability standards, which take a separate form for central counterparties and securities settlement systems because of the difference in their risk profiles. The Reserve Bank issued draft standards for public comment in November 2002 and expects to release its final standards around April/May 2003.

Standard for central counterparties

Central counterparties interpose themselves between the two parties to a trade and become the buyer to every seller and the seller to every buyer. As such, they become parties to trades and take on the same risks as any other market participant. If a party cannot meet its obligations to a central counterparty, the central counterparty could face liquidity pressures and eventual losses; if such difficulties were to threaten the solvency of the central counterparty itself, the consequences for financial stability could be severe. In Australia, OCH acts as a central counterparty for some transactions undertaken on markets operated by the Australian Stock Exchange, and the SFECC for futures and options and some debt transactions.

A central counterparty usually provides three key services to its members: the netting of financial obligations arising from trades; the calculation of resulting settlement positions; and a guarantee that trades will be settled, even in the event that one of the original parties to the trade is in default. These services commence when the original contract between buyer and seller is replaced, or "novated", with two separate contracts – one between the buyer and the central counterparty, and the other between the central counterparty and the seller.

Central counterparty arrangements provide a number of benefits to financial market participants. Novated trades may be netted, which can mean substantial savings for members in the value of cash and securities needed to meet their obligations. In addition, a central counterparty takes on the credit risk associated with the trading of its members and manages this risk centrally. Members are able to concentrate on monitoring their credit risk against the central counterparty rather than the creditworthiness of other market participants. The corollary of these arrangements is that a central counterparty concentrates risks within the financial system. If these risks are not managed prudently, a central counterparty may be a source of systemic risk in the event of shocks to financial markets or to the economy more broadly. A range of specialised risk management procedures is available to a central counterparty for managing its credit risks. These include participation requirements that ensure that prospective participants have sufficient financial substance, and the use of "margining" techniques, settlement guarantee funds and pre-determined loss-sharing rules that provide the central counterparty with funds to cover the failure of participants. A central counterparty and its participants also face operational risks associated with business systems and procedures, and legal risks related to operating rules and participation agreements. These risks are present for most organisations but can be particularly important in central counterparties if they threaten critical financial infrastructure.

The Bank's draft financial stability standard for a central counterparty requires that it "... conduct its affairs in a prudent manner, in accordance with the standards of a reasonable clearing and settlement facility licensee in contributing to the overall stability in the Australian financial system, to the extent that it is reasonably practicable to do so". The Bank has set out a number of minimum requirements, and associated measures to be taken, which it considers are relevant in determining whether a clearing and settlement facility has met the standard. The requirements include:

- a well-founded legal basis;
- participation requirements that promote safety and integrity and ensure fair and open access;
- identification of the impact the facility has on the financial risks incurred by participants;
- settlement arrangements that ensure that exposures are clearly and irrevocably extinguished on settlement;
- appropriate systems, controls and procedures to identify and minimise operational risk; and
- reporting to the Reserve Bank.

There are also measures that are specific to central counterparties because of the risks they assume through novation. These address the nature and scope of novation; the risk-control arrangements of the central counterparty; default procedures when a participant is unable to fulfil its obligations to the central counterparty; and governance arrangements.

The Bank has issued guidance notes which provide further detail on how a licensee can meet the standard.

Standard for securities settlement systems

Securities settlement or "scorecard" systems maintain a record of title to securities and ensure that title changes take place according to instructions from the seller of the securities. Their main purpose is to record changes in ownership; in contrast to central counterparties, the systems do not become a counterparty to the trades they record. In Australia, there are two scorecard systems – the Austraclear system for debt securities, owned by the Sydney Futures Exchange, and the CHESS system for equities, owned by the Australian Stock Exchange.

A securities settlement system which acts as a scorecard provides a mechanism for counterparties to a securities transaction to meet their obligations to each other. The final settlement of a securities trade involves up to three steps: title to the security needs to be transferred from seller to buyer; funds must be transferred from the buyer's to the seller's deposit account at their respective financial institutions; and, where buyer and seller hold accounts at different financial institutions, funds must be transferred from the buyer's financial institution to that of the seller across Exchange Settlement Accounts at the Reserve Bank. These steps need to be linked to ensure that transfer of securities occurs if, and only if, cash payment occurs. Such "delivery-versus-payment" (DvP) arrangements guarantee that the change in ownership of securities is final and irrevocable, freeing the buyer of a security to undertake further transactions with that security.

A securities settlement system does not take on credit risk and is not exposed to daily financial market volatility. Nonetheless, such systems do generate risks. DvP arrangements need to be robust in all circumstances so that settlement exposures between participants cannot build up. Systems also face legal risks that participants do not have clearly defined and enforceable title to securities, and operational risks that arise through the business activities of the facility.

The Bank's standard for securities settlement systems has the same objective as that for central counterparties, viz. that the licensee must conduct its affairs in a prudent manner and in a way that contributes to the overall stability of the Australian financial system. The Bank has also set out a number of minimum requirements that are common for both central counterparties and securities settlement systems. Other measures, however, are specific to securities settlement systems because of the scorecard nature of their business. These address, for example, the certainty of title to securities for participants and the mechanisms for dealing with the external administration of a participant.

Under the new regulatory framework, the Reserve Bank's responsibilities complement those of the Australian Securities and Investments Commission (ASIC), which has responsibility for corporate governance matters, market integrity, investor protection and all other matters pertaining to clearing and settlement facilities. ASIC also has responsibility for undertaking any legal action to enforce compliance with the requirements of either agency, including financial stability standards. 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. In accordance with this MOU, the Bank has consulted extensively with ASIC on the drafting of the financial stability standards, and the agencies have also exchanged information in the preparation of their respective annual compliance reports to the Minister.

Glossary of Terms and Abbreviations

ACCC – Australian Competition and Consumer Commission

Acquirer – an institution that provides a merchant with facilities to accept card payments, accounts to the merchant for the proceeds and clears and settles the resulting obligations with card issuers

ADI – authorised deposit-taking institution

APCA – Australian Payments Clearing Association Limited

APRA – Australian Prudential Regulation Authority

ASIC – Australian Securities and Investments Commission

ASTC – ASX Settlement and Transfer Corporation

ASX – Australian Stock Exchange

ASTC – ASX Settlement and Transfer Corporation

ATM – Automated Teller Machine

Austraclear – a securities clearing and settlement system

Card issuer – an institution that provides its customers with debit or credit cards

CHESS – Clearing House Electronic Subregister System

Clearing – the process of transmitting, reconciling and in some cases confirming payment instructions prior to settlement; it may include netting of instructions and the calculation of final positions for settlement

CLS Bank – Continuous Linked Settlement Bank

Designation – the formal notification of action taken to exercise powers conferred by legislation

Direct debit – a pre-authorised debit on the payer's bank account initiated by the recipient

DvP – Delivery-versus-Payment

EFTPOS – Electronic Funds Transfer at Point of Sale

Interchange fee – a fee paid between card issuers and acquirers when cardholders make transactions

OCH – Options Clearing House

PvP – Payment-versus-Payment

RTGS (real-time gross settlement) – a payment system in which processing and settlement take place in real time (continuously)

Settlement – the discharge of obligations arising from fund transfers between two or more parties

SFE – Sydney Futures Exchange

SFECC – Sydney Futures Exchange Clearing Corporation

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