Proposed merger between Armaguard and Prosegur

Submission to ACCC

October 2022

The Reserve Bank of Australia (the Reserve Bank) has prepared this submission (Submission) to the Australian Competition and Consumer Commission (ACCC) in response to the proposed merger (Proposed Transaction) application (the Application) submitted by Linfox Armaguard Pty Ltd (Armaguard) and Prosegur Australia Holdings Pty Limited (Prosegur) (together, the Applicants). The Submission provides a perspective on the cash-in-transit (CIT) aspects of the proposal, given the Reserve Bank is the sole issuer of banknotes in Australia. It also provides a perspective on the non-CIT aspects related to automated teller machines (ATMs), noting the Reserve Bank's responsibilities under the *Payment System (Regulation) Act 1998* (PSRA).

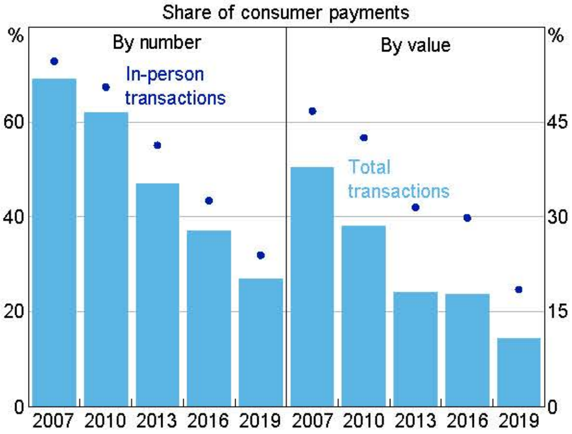
Overview

Cash landscape

One of the key objectives of the Reserve Bank is to ensure that the Australian public has access to good quality banknotes for as long as they want them. For now, this is being achieved; in 2021 around 95 per cent of people lived within 4 kilometres of a cash withdrawal point and 5 kilometres of a deposit point. However, the demand for cash is changing; with the share of transactions performed electronically continuing to increase, the use of cash for transactions is expected to continue its structural decline of the past decade or so. This would be consistent with the experience of a number of other countries, some of which are at lower levels of transactional cash usage than Australia.

The Reserve Bank's Consumer Payments Survey shows that the share of total retail payments made with cash fell from 69 per cent in 2007 to 27 per cent in 2019 (Graph 1). The share of payments made with cash for the subset of in-person transactions was a little higher, at 32 per cent in 2019. Despite lower transactional cash usage, cash is expected to remain an important means of payment in the future for certain parts of the community. For example, around 15 per cent of people used cash for 80 per cent or more of their in-person transactions in 2019.

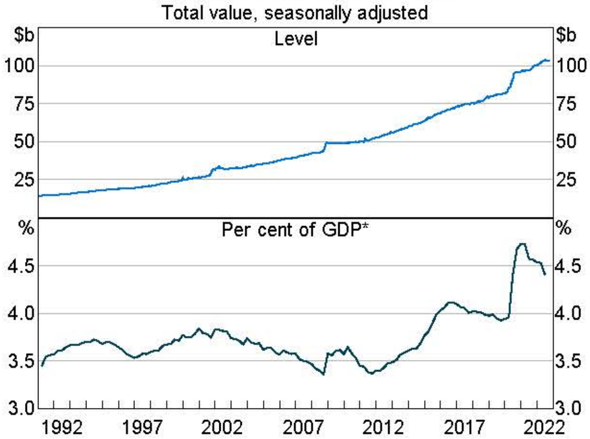
Graph 1
Cash Payments
Share of consumer payments



Source: RBA calculations, based on data from Colmar Brunton, Ipsos and Roy Morgan Research

Further, cash is an important back-up for electronic payment methods and is used as a store of wealth. The latter applies on a day-to-day basis, but becomes particularly important in times of economic uncertainty (as the COVID-19 pandemic highlighted). Indeed, despite the decline in transactional cash use, the value of banknotes on issue has continued to grow, and is around its peak as a share of GDP (Graph 2). This likely reflects the use of cash for precautionary and/or store-of-wealth purposes. The current low level of interest rates also makes holding cash relatively more attractive, due to the lower opportunity cost of holding physical cash (which earns no interest).

Graph 2
Banknotes in Circulation
Total value, seasonally adjusted



* Only includes holdings of banknotes and coins by the private non-bank sector
Sources: ABS; RBA

The wholesale banknote distribution system

The wholesale banknote distribution system involves the bulk movement of banknotes from the Reserve Bank to CIT companies' cash depots around the country.[1] Banknotes are then distributed from these depots to bank branches, ATMs and retailers, from where they are available to the public (retail distribution). Banknotes are returned to the Reserve Bank for destruction at the end of their life.

1 See RBA (2021c) for a more fulsome description of the cash cycle in Australia.

The issuance of banknotes from the Reserve Bank into circulation is facilitated by a set of agreements, known as the Banknote Distribution Agreements (BDAs). These are bilateral contracts between the Reserve Bank and participating institutions – currently the four major Australian commercial banks (the BDA Participant banks) who demand wholesale quantities of banknotes. The BDAs provide the contractual framework for the purchase and return of wholesale banknotes from/to the Reserve Bank. The Reserve Bank makes interest payments to BDA Participant banks on the value of quality-sorted banknotes they store in approved CIT depots (these banknote stocks are known as Verified Cash Holdings (VCH)); [redacted]. The Reserve Bank also has an interest in ensuring banknotes in circulation are of a good quality and, accordingly, the Bank provides incentive payments to the industry to remove poor-quality banknotes from circulation, including the Note Quality Reward Scheme (NQRS) (RBA 2022c, pp 12–13). These arrangements are also set out in the BDAs.

With a record level of banknotes on issue, the infrastructure and systems that facilitate banknote distribution, including the eventual return of banknotes to the Reserve Bank for destruction, will continue to be important over the years ahead, even as the day-to-day use of cash continues to decline.

Against this backdrop, the Reserve Bank launched a Review of Banknote Distribution Arrangements (the Review) in November 2021. The Review focused on identifying changes to make the wholesale banknote distribution system more effective, efficient, sustainable and resilient (RBA 2021c, p 1). These four objectives are also relevant when considering the Proposed Transaction.

The conclusions of the Review largely focused on areas where the Reserve Bank has a direct relationship with the industry, particularly through the arrangements it has with the BDA Participant banks for purchasing and returning banknotes and maintaining the quality of banknotes in circulation (RBA 2022c, pp 13–14). The proposed changes to banknote distribution arrangements are intended to help the industry to adapt as cash use by the public evolves, but will not fundamentally reshape the economics of the industry.

Analysis undertaken as part of the Review concluded that the lower volumes of banknotes being transported and processed has contributed to significant excess capacity within the wholesale distribution network that is placing financial pressure on participants in the system, including the Applicants. The industry has high fixed costs and declining volumes. Pricing is often based on marginal cost, which is likely to be significantly below long-run average costs in this industry. Given these dynamics, the incumbent firms report they are losing money and will not be able to continue with current operations. It therefore seems unlikely that the current CIT industry structure can be sustained in the short to medium term.

The Reserve Bank's assessment is that some form of change is required to reduce the excess capacity within the system to ensure it is both viable and able to withstand further expected structural declines in cash usage. The Reserve Bank notes that the Proposed Transaction is one option that may achieve a more viable industry structure and the appropriate path forward will depend on a range of factors, including how various concerns arising from increased concentration can be addressed. It is also important to avoid any significant, abrupt and/or prolonged reduction in the timely availability of good-quality banknotes across the country. In the Reserve Bank's view, it is in the national interest that the industry be put on a more sustainable footing. If this is not done, access and availability to cash will decline, damaging the efficiency of the economy, particularly in regional Australia. Relatedly, it is desirable that any change is managed in an orderly way to ensure the stability of the wholesale distribution system and the retail distribution system that relies upon it.

General considerations (Q1 and 2)

The use of cash for retail transactions in Australia has been declining for at least the past two decades, a trend that was accelerated by the COVID-19 pandemic. This has reduced the volume of banknotes being transported and processed, contributing to an underutilisation of cash distribution infrastructure and an increase in the average cost of transporting and processing wholesale quantities of banknotes. The Reserve Bank estimates wholesale cash distribution infrastructure capacity utilisation has declined substantially over the past decade, to be around 65 per cent. This environment of declining volumes of banknotes being transported and processed is placing significant financial pressure on industry participants.

In November 2021 the Reserve Bank launched its Review, which sought to identify what changes could make the banknote distribution system more effective, efficient, sustainable and resilient. The considerations outlined in this Submission are therefore informed by the material prepared and analysed for this Review, including submissions made to the Review by industry participants. In its Conclusions to the Review, which were announced in August 2022, the Reserve Bank committed to implementing a number of specific changes. Those changes are largely focused on areas where it has a direct relationship with the industry – in particular, the arrangements with the BDA Participant banks for the purchase and return of wholesale banknotes from/to the Reserve Bank and those for managing the quality of banknotes in circulation. As noted earlier, those changes are designed to help the industry to adapt as cash usage by the public evolves, although the Conclusions to the Review noted that the changes are unlikely to fundamentally reshape the economics of the industry. The Conclusions to the Review also recognised that reducing capacity is necessarily a business decision for the private participants themselves.

Reserve Bank's interest in the Proposed Transaction: CIT services

The considerations outlined in this Submission relating to CIT services reflect the Reserve Bank's role as the sole issuer of banknotes in Australia, which involves the design, production, issuance, withdrawal and destruction of banknotes. The Reserve Bank participates directly in the wholesale banknote distribution system to issue new banknotes to meet increased demand or replace worn banknotes; at the end of their life, banknotes are returned to the Reserve Bank for destruction.

The BDA does not prescribe that the BDA Participant banks outsource their wholesale banknote distribution and processing activities to CIT service providers, although each of them currently do, to varying degrees. Where this occurs, the BDA requires that the relevant CIT be approved by the Reserve Bank for the purpose of accessing the Reserve Bank's distribution sites. There are currently four approved CITs, including the Applicants. To reiterate, the Reserve Bank's contractual relationship under the BDAs is directly and only with the BDA Participant banks; the Reserve Bank does not have a contractual relationship for wholesale distribution of banknotes with the four approved CITs.[2] That said, some of the terms and conditions within the BDAs would necessarily be reflected in the arrangements

2 [redacted]

that the BDA Participant banks have with their outsourced CIT companies to enable the BDA Participant banks to meet their respective obligations to the Reserve Bank.

An important implication of the nature of the BDAs and the Reserve Bank's responsibilities for the issuance and ultimate destruction of banknotes is that the Reserve Bank's direct experience of the services provided by CITs to their retail customers is limited. Accordingly, while the Reserve Bank has a good understanding of the issues related to wholesale distribution of banknotes, it has a more general understanding of the CIT services supplied to retail customers as it is not an active participant in retail distribution. Specific comments on CIT services in this Submission should therefore be understood from this perspective.

That said, the Reserve Bank has a broader public policy interest in ensuring that the Australian public has access to good quality banknotes for as long as they want and that confidence in the quality of banknotes is high. At present, most Australians have convenient access to cash and acceptance is widespread, however this could change. This was noted in the Review and, as such, the Reserve Bank intends to continue to monitor trends in the ability of consumers to access and pay with cash, as well as distances to cash access points and the cash acceptance practices of businesses, with a particular focus on regional communities (RBA 2022c, p 18). The Review also noted that any significant changes to cash access in the future could necessitate greater public sector involvement in this area.

Reserve Bank's interest in the Proposed Transaction: non-CIT services

In relation to the non-CIT services performed by Armaguard and Prosegur, the Reserve Bank has had a long-standing interest in the provision of ATM services from the perspective of its mandate under the PSRA to promote competition and efficiency in the payments system. The Reserve Bank designated the Australian ATM system in 2008 and imposed an ATM Access Regime in 2009 under the PSRA, which remains in place today.[3] The ATM Access Regime, which was introduced in combination with an industry administered ATM Access Code, was designed to increase competition in the ATM industry by making it easier for new deployers to establish the bilateral connections required at the time to become a direct participant in the ATM network. The ATM Access Regime also increased transparency of the price of ATM transactions by eliminating bilateral interchange fees (except in limited circumstances) and permitting ATM owners to set their own fees and compete directly for transaction volumes. Since the Access Regime was put in place, the Reserve Bank has continued to monitor developments in the ATM industry, including to understand how the reforms and other developments are impacting competition and efficiency in the provision of ATM services and the implications for how Australians can access cash withdrawal services.[4]

The Reserve Bank reviewed the ATM Access Regime in 2019 in consultation with industry participants. At the time, the Payments System Board determined that the ATM Access Regime should be retained in the near term, but noted that the policy basis for doing so was not as strong as when the Regime was introduced (RBA 2019). The Reserve Bank anticipates undertaking a further review of the ATM Access Regime in the next year.

The Reserve Bank notes a number of recent developments in the provision of ATM services, which may be of relevance to the ACCC's consideration of the Application:

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3 See Designation No 1 of 2008 and Access Regime for the ATM System. The Reserve Bank has also issued a number of exemptions in relation to aspects of the ATM Access Regime (see: Regulations | RBA).

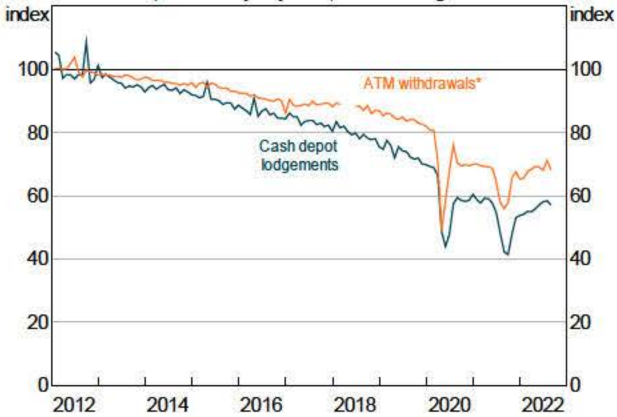
4 Examples of the Reserve Bank's analysis of developments in the ATM industry include: Filipovski and Flood (2010); Flood and Mitchell (2016); Mitchell and Thompson (2017).

- The use of ATMs has been declining since 2008, with the COVID-19 pandemic resulting in a further downward shift in ATM use in the past few years (Graph 3).[5] Overall, the number of ATM withdrawals has fallen by about 60 per cent compared to its 2008 peak, while the value of withdrawals is about 40 per cent lower over the same period. This reduction in the use of ATMs is in part a reflection of the declining use of cash for transactions, as many Australians have shifted towards digital payment methods.

Graph 3

Indicators of Cash System Activity

Value, seasonally adjusted, 2012 average = 100



* Series break between February 2018 and May 2018 due to changes in collection and reporting methodology.

Source: RBA

- While the use of cash for retail transactions has been continuing to decline, cash still remains an important payment method for certain types of transactions and for some members of the community, and overall demand for cash remains strong. To monitor trends in access to cash services, the Bank has periodically undertaken analysis of the average distance that Australians have to travel to reach their nearest cash access point – that is, locations where people can withdraw and/or deposit cash. The latest analysis using data for June 2021 indicated that the vast majority of Australians still had good access (i.e. live relatively close) to cash withdrawal and deposit services.[6]

- The declining use of ATMs appears to have prompted many banks and other deployers to rationalise their ATM fleets in recent years. Data published by AusPayNet show that the total number of ATMs in Australia peaked around 33,000 in late 2016 and has since declined to about 25,000 (AusPayNet 2022a). It is worth noting that, by international standards, Australia had a relatively high number of ATMs on a per capita basis in 2016.[7] The decisions by many bank deployers in 2017 to remove any remaining direct charges for using their ATMs, which reduced the revenue they earn from ATMs, may have further contributed to deployers reducing their ATM fleets.

- While banks have generally been reducing their ATM fleets over recent years, some independent deployers have been increasing their ATM fleets, including to take over sites where banks might have provided ATMs in the past. One way banks have been reducing their fleets is to sell some (or all) of their off-branch ATM fleets to third-party operators, including the Applicants, and

5 Monthly data on ATM cash withdrawals are published by the Reserve Bank in Table C4 (seasonally adjusted) and Table C4.1 (non-seasonally adjusted).

6 See Caddy and Zhang (2021) for methodology.

7 See Graph 2 in Mitchell and Thompson (2017).

negotiating access so that their customers can continue to use them on a fee-free basis. In an environment of declining cash and ATM use and where the costs of ATM deployment have been rising, such arrangements can be a more efficient way to sustain broad coverage of ATMs (RBA 2021b, p 39). This can be particularly important for regional and remote areas that often have fewer options for accessing cash.

- As noted above, the ATM Access Regime places certain restrictions on the ability of financial institutions (card issuers) to pay interchange fees to access other participants' ATM fleets.[8] Recognising that these restrictions could make it difficult for card issuers to join multiple ATM networks as a way to increase fee-free ATM coverage for their customers, the Bank granted an exemption from certain aspects of the ATM Access Regime in October 2021 (RBA 2021a). The exemption allows card issuers to pay interchange fees to access more than one third-party operated ATM network. The exemption was designed to support consolidation in the ATM industry and competition between ATM operators, which could assist in sustaining broad coverage of ATMs in an environment of declining cash and ATM use.

CIT services

The wholesale CIT market (Q3, 4)

The Reserve Bank's considerations relevant to the Applicants' shares and positions is limited to addressing the market as defined by the wholesale distribution component of Question 3(a); that is, the services provided by CIT companies transporting banknotes to and from the Reserve Bank's National Banknote Site and around the depot network, as well as the associated services provided by those CIT companies (such as sorting and processing).

As stated above, the BDA Participant banks are required (under the BDAs) to have their CIT company/ies approved by the Reserve Bank. The conditions of this approval are related to a small number of operational matters, including auditing, quality control, security and work, health and safety requirements. Once approved, these CIT companies are given Approved Cash Centre Operator (ACCO) status and individual depot sites are also approved to have VCH available for sampling by the Reserve Bank. Most approved sites have some degree of on-site quality-sorting capabilities in order to process and fitness-sort banknotes into VCH, although the sophistication of their machines varies. The ACCOs and their approved sites have to meet other requirements set by the BDA Participant banks, which are audited by external auditors. It is possible for other CIT companies to gain ACCO status. To do so, a CIT company would need to be nominated by a BDA Participant bank and meet the requirements.

There are currently four ACCOs: Armaguard; Brink's Australia Pty Limited; Prosegur; and Streamcorp Armoured (Streamcorp). [redacted]

8 Specifically, the Access Regime prohibits interchange fees being paid by a card issuer to an ATM acquirer, except in the case of a 'sub-network' of ATMs (a shared network of ATMs with a common and transparent interchange fee) and to access one other provider's ATM network via a 'one-way arrangement'.

[redacted]

The needs of CIT customers (Q5)

The ultimate user of banknotes is the Australian public. As outlined above, the Reserve Bank's direct participation in banknote distribution is limited to wholesale distribution. Its objectives for the wholesale banknote distribution system, as outlined in the Review (RBA 2021c), are one that is:

- **effective** – the distribution system enables demand for banknotes across the country to be met and supports the maintenance of good quality banknotes in circulation
- **efficient** – the distribution system is cost-effective and enables the community's cash needs to be met without prices being unreasonably high
- **sustainable** – the distribution system is able to continue operating in the face of declining and/or comparatively low levels of transactional cash use
- **resilient** – the distribution system is able to withstand disruptions and shocks to cash demand.

The BDA Participant banks purchase and return wholesale quantities of banknotes from/to the Reserve Bank to distribute around the country to meet their customers' demand for banknotes. Some BDA Participant banks also provide cash access facilities to meet the needs of other banks and larger retailers.

The key characteristics of wholesale CIT services that may help to achieve an effective, efficient, sustainable and resilient wholesale distribution system are:

- **National presence**: commercial banks (and their major retail customers) tend to require a national presence for the bulk movement of cash, given that these customers often have a national presence themselves. They need to maintain depots and transport routes across Australia so that fluctuations in cash demand can be met in a timely and efficient way. An important aspect of a national presence is the distribution of cash to regional areas, which requires CIT services that can accommodate the distances inherent in Australia's geography.
- **Frequency of service**: an effective distribution system is able to meet customers' needs by maintaining adequate frequency of cash collections and disbursements.

- **Fitness-sorting capability**: in order to effectively maintain the quality of banknotes in circulation, fitness-sorting capability, including the necessary equipment and labour, that can process banknotes adequately and efficiently is required.
- **Technology, infrastructure and systems:** in addition to fitness sorting, the CIT provider needs to have the technology and systems in place to accurately count and balance large volumes of banknotes and settle the customer's account, while operating in a high-security environment.
- **Innovation:** the sustainability of the distribution system in the face of declining and/or comparatively low levels of transactional cash use requires innovation, continuous improvement and, potentially, new capital investment.
- **Banknote trading**: providers of end-to-end CIT services need to maintain a system to trade banknotes between various customers. This is an important aspect of the efficiency of cash distribution, as it reduces the need to transact directly with the Reserve Bank for new banknotes or to return excess good-quality banknotes. It also facilitates intra- and inter-depot trading.

Barriers to entry (Q7)

There are likely to be a number of barriers to entry to undertaking wholesale processing and distribution activities. For example, there are physical infrastructure needs, such as security vaulting and warehousing requirements, banknote processing machines and, because of the large values involved, armoured vehicles. There is also the need to fulfil staffing requirements of qualified armed security officers. In addition, broad geographic coverage is demanded by customers with national operations.

Table 1: Stylised Models of the CIT Industry

	Model 1 Traditional CIT model	Model 2 CIT as a handler model	Model 3 CIT as an agent model	Model 4 CIT as an owner model
CITs' cash services	Transportation only	Transportation and processing	Transportation and processing	Transportation and processing
Ownership of cash depots	Owned by commercial banks	Owned by CIT operators	Owned by CIT operators	Owned by CIT operators
Relationship with retailers	Acts as courier only	Acts as courier only	Acts as courier; CITs deposit cash with commercial banks on behalf of retailer	Acts as courier; CITs deposit cash with commercial banks on behalf of retailer
Ownership of cash during handling	Owned by commercial banks	Owned by commercial banks	Owned by commercial banks	Temporarily owned by CITs

Source: Adapted from Scholten (2017)

There may be economies of scale benefits related to wholesale CIT services, such as bulk cash transport, processing and storage, but there are also other industry models and examples in other countries where different firms undertake different elements of cash-related services. Examples include: a separate company doing cash processing to the one that does transport, or sharing and sub-contracting routes or infrastructure (Table 1) (see Box A in RBA (2021c), pp 16–17). The Australian wholesale CIT industry exhibits elements of Models 2 and 3. However, it should be noted that the viability of other models has not been tested in the current Australian context.

Constraints on the combined Applicants (Q8)

The Reserve Bank notes the Applicants' claim in Section 12.2, that if they were to increase prices significantly for CIT services, the Reserve Bank could exercise powers to regulate the cash distribution system and that the threat of such regulatory intervention would constrain them.

The Reserve Bank has the power, under the PSRA, to designate 'payment systems' if it is in the 'public interest', as being subject to its regulation. The Reserve Bank may then impose standards and/or access regimes on 'participants' in those designated payment systems. A 'payment system' is defined under the PSRA to mean 'a funds transfer system that facilitates the circulation of money, and includes any instruments and procedures that relate to the system'.

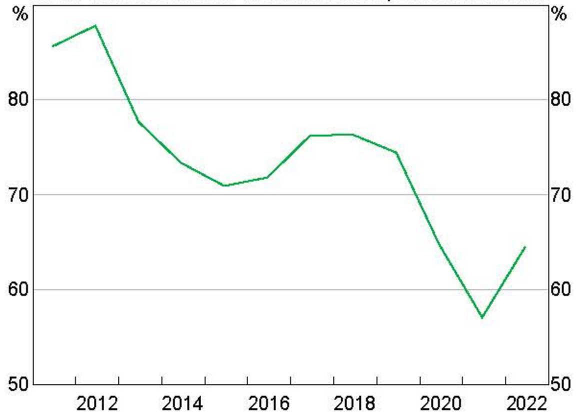
It is not clear what the Applicants mean by the 'cash distribution system'. To the extent that the term is referring to, or intended to cover, CIT services – that is, the physical transportation of banknotes on behalf of the owner of those banknotes between different locations in Australia and associated cash processing and quality sorting processes – the Reserve Bank does not consider these activities to be within the scope of the PSRA, as currently drafted (see further details in Appendix: Matters for Clarification).

Demand for cash (Q9)

Despite the stock of banknotes in circulation being around record highs, the use of cash for transactions is in structural decline. This means banknotes are moving around the economy less, as indicated by the decline in ATM cash withdrawals and cash lodged at CIT depots over many years (Graph 3). These indicators suggest cash system activity will continue to fall in line with declining transactional cash use.

The Reserve Bank estimates that lower volumes of banknotes lodged at ACCOs has led to underutilisation of the depot networks of the Applicants (Graph 5). Recent estimates indicate that current depot utilisation may be around 65 per cent. Low and falling capacity utilisation for banknote processing implies that for some regions and in some time periods, total demand for banknote processing services could have been met by significantly fewer CIT depots. Accordingly, there are likely to be efficiency gains from, for example, a reduced number of CIT depots; in this regard the Applicants (Paragraph 322) state that the closure of a substantial number of duplicative sites is envisaged in order to generate the synergies from the Proposed Transaction.

Graph 5
Annual Capacity Utilisation*
Based on banknote flows between cash depots and customers



* A depot's capacity is estimated as the highest level of banknotes it has processed in the four years prior to a particular month; 2022 estimate based on partial data.
Source: RBA

It is the Reserve Bank's understanding from liaison conducted during its recent Review, that segments of the banknote distribution system are characterised by relatively high fixed costs, such that those activities tend to be more efficient and cost-effective with higher volumes (RBA 2022c, pp 13–16). Australia's geographic size and relatively low population density will also contribute to the costs associated with meeting demand for cash services, such as picking up and delivering cash from/to banks and retailers and the servicing of ATMs in regional and remote locations.

Public benefits

Section 11 of the Application identifies nine types of public benefits claimed to arise from the Proposed Transaction. As noted in the 'Matters for Clarification' section in the Appendix, the Reserve Bank does not consider the benefit outlined in Section 11.7 (Avoiding uncertainty and transition costs associated with moving to a new regulatory model) to be a benefit that would accrue from the Proposed Transaction, as the Reserve Bank is not, at this stage, proposing 'moving to a new regulatory model for cash distribution'. The release in August 2022 of the Conclusions to the Review lessened the uncertainty of the Reserve Bank moving to a 'new regulatory model' and confirmed that the core terms and conditions for banknote distribution are expected to largely remain in place.

The following considerations are provided in respect of those other public benefits claimed in Section 11 that are most pertinent to the public policy objective of the Reserve Bank of providing access to good quality banknotes for as long as the Australian public want to use banknotes.

Avoids costs, uncertainty and customer impacts of a disorderly exit (Q15, 16)

In relation to the benefit in Section 11.1 ('Avoid likely dislocation costs, uncertainty and customer impacts associated with a disorderly exit'), as stated in its November 2021 Issues Paper, the Reserve Bank continues to believe that the exit of one of the major CIT companies could disrupt cash distribution and with it access to cash, at least in the short term (RBA 2021c, p 19). This stems from the fact that the CIT industry in Australia is highly concentrated: Armaguard and Prosegur together comprise between 70 and 90 per cent of the CIT industry's market share (Road Safety Remuneration Tribunal 2015; The Senate Rural and Regional Affairs and Transport References Committee 2021).

Against this backdrop, if either of the Applicants were to stop supplying CIT services, there would be a reduction in industry capacity and the customers of the exiting CIT company would need to transition to another provider. Given the Applicants' importance in the cash cycle, it is highly likely that this would impede the distribution of cash within the economy, at least until some form of service could be restored. It could lead to ATMs and businesses being without cash in certain areas which, by extension, could leave people in those areas without access to cash. Given the Reserve Bank places a high priority on the community having good access to cash withdrawal and deposit services, it considers avoiding a prolonged and/or widespread disruption of this nature as important.

The extent and duration of a disruption to CIT services – and so the likelihood of avoiding the impact of a disorderly exit – is difficult to predict. It would depend on factors such as:

- the length of the notice period provided by the exiting CIT company to its customers
- the nature of any relevant contractual terms between the exiting CIT company and its customers
- the wind-up process that is put in place to manage the exit by the CIT company and its outcomes
- the ability of other CIT providers to provide services to the customers of the exited CIT company, both immediately and following the wind-up of the exited CIT company
- the business continuity plans/arrangements of the CIT company's customers, how quickly they can be mobilised and how effective they are in this particular context in transitioning to a new supplier.

[redacted] AusPayNet's procedures for the Australian Cash Distribution and Exchange System (ACDES) include protocols in the event that a participant organisation (or their CIT) is unable to move or deliver cash (AusPayNet 2022b). In addition, for the BDA Participant banks, APRA Prudential Standard 231: Outsourcing could also be relevant. That Standard requires all outsourcing arrangements involving material business activities entered into by an APRA-regulated institution to be subject to appropriate due diligence, approval and ongoing monitoring, and that all risks arising from outsourcing material business activities must be appropriately managed to ensure that the APRA-regulated institution is able to meet its financial and service obligations to its depositors and/or policyholders.

In considering these types of issues, it can be illustrative to consider relevant examples internationally, or from other industries; however, Australia's banknote distribution context is likely to differ in important ways, particularly in relation to population size and density. The Netherlands provides one such example of how the exit of the second largest CIT company was managed to minimise the disruption to cash distribution and associated costs. The Reserve Bank's knowledge of the incident is based on [redacted] newspaper reports (Algemeen Dagblad 2019; de Volkskrant 2019; Business Insider 2019). [redacted]

- [redacted]

- [redacted]
- [redacted]

It is possible that a disruption could have a longer-term impact on cash use, although this may be a function of the duration of the disruption and the responsiveness of customer behaviour. For example, those people who depend on or have a strong preference for using cash may be less inclined to shift away from this position quickly (Delaney, McClure and Finlay 2020). Similarly, while banks and businesses may move away from offering cash services or accepting cash over time, this is unlikely to be spurred by a temporary disruption in CIT services, but rather part of a longer term strategy. Unpublished surveys commissioned by [redacted] the Reserve Bank suggest merchant cash acceptance rates [redacted] The Reserve Bank sees the other costs cited by the Applicants, including in Section 11.2, – such as an increased risk of counterfeiting, or a retail run – as being less likely to arise.

Efficiency in the provision of CIT services (Q17)

The Application states at Paragraph 320 that 'the Proposed Transaction will allow for the Applicants to combine CIT operations, which will mean greater utilisation and the de-duplication of costs to increase productive efficiency' and at Paragraph 322 'Such synergies … are based on, among other things, the closure of a substantial number of duplicative sites, and the disposal of trucks'.[9] At face value, reducing the number of depots from 55 to 29, as proposed by the Applicants, would likely support improved productive efficiency. Conditional on these actions occurring in a timely and effective manner, excess capacity should, other things equal, reduce, which in turn should enable resources to be used more efficiently.

Entity better placed to invest in existing infrastructure and innovations

Section 11.4 notes that the Proposed Transaction would create 'a sustainable combined entity that is better placed to invest in both the existing cash infrastructure as well as new products and technological innovations.' The Application states at Paragraph 74, 'the Applicants will be required (as a condition precedent) to clear all existing pre-completion debts to enable the merged entity to operate on a debt free basis post-completion. Furthermore, the Applicants will also be required to invest a significant amount of capital post-completion to ensure that the merged entity can continue to be sustainable on an ongoing basis'. In addition, at Paragraph 326, the Application states that 'the Proposed Transaction will enable the Applicants to continue to invest in wholesale cash infrastructure … This includes investment in equipment required to comply with the NQRS under the BDA'.

9 Paragraph 75 notes that '… the merged entity will operate: 29 ACCs (one of which will be a cash processing hub only); and two transport hubs (where no cash processing activities are undertaken)'. This compares to 55 sites combined currently (see Figure 30 of the Application).

If the Application is approved, it will be important that the terms of the approval are such that the investment and the high customer service levels referred to in Section 11.4 and Section 11.5, respectively, of the Application are achieved.

In addition, the generation of efficiencies at a point in time is unlikely to be sufficient; it is likely that there will also need to be ongoing efficiencies (that is, dynamic efficiencies), given the longer run challenges facing the CIT industry from the ongoing structural decline in the use of cash. Innovation, process improvements and new investment will continue to be required to contain average costs in the event transactional cash usage declines further.

Ensure high customer service levels (Q17)

The extent to which customer service levels are affected by actions to improve the efficiency of operations (such as, the closure of depots or the reduction in the number of trucks, both of which are implied by the Applicants, including in Paragraphs 75 and 322), would depend on a range of factors, as outlined below.

Distribution of wholesale and retail cash

While the closing of depots or reducing the number of trucks will likely improve efficiency of the relevant businesses conducted by the Applicants, the impact on customer service levels – such as the frequency of cash collection and deliveries – is unclear. On the one hand, if the Applicants are able to better optimise transport routes, cash collections and deliveries could be more frequent and service levels would improve. If, however, fewer depots or trucks meant that greater distances needed to be travelled to service some businesses or locations, the frequency of collections and deliveries could fall; this could result in either an increased frequency of 'cashed-out' ATMs, retail outlets, etc., or the need for businesses or banks to hold higher working inventories of cash. Consequently, key considerations for customer service levels include the location of the sites to be closed and whether a reduced frequency of transport collections or deliveries results. Further, the extent to which customers in regional and/or remote locations could be more affected by any such changes than those in metropolitan areas is also relevant.

Quality of banknotes in circulation

The Applicants also provide banknote quality-sorting services. Some customers (such as banks and ATM providers) require quality-sorted banknotes to minimise problems in banknote processing equipment. For example, banknotes with folded corners or tears can cause issues in ATMs and ticketing and vending machines. In addition to these defects, the Reserve Bank also seeks to remove from circulation banknotes with worn or damaged security features so the public can easily determine the banknotes they receive are genuine and not counterfeit. To quality-sort banknotes, the Applicants need to have sufficient banknote sorting equipment and labour; this requires ongoing investment (see further details in Appendix: Matters for Clarification).

There are some factors which may work to limit a degradation in quality-sorting services. To an extent, the Applicants will have an incentive to continue to provide a base-level of banknote sorting services as the Applicants require these services themselves for their ATM businesses. In terms of the Reserve Bank's quality-sorting arrangements, [redacted]

[redacted]

The Reserve Bank also intends to implement revised NQRS standards, in part to enable banknotes from its new series with worn or damaged security features to be removed from circulation. The Applicants have noted in Paragraph 132 that 'the RBA has proposed changes to the NQRS, which would significantly impact the investment required from the Applicants in order to ensure that banknotes are kept to standard'. As part of the Conclusions to its Review, the Reserve Bank announced that it intends to make a modest increase to the maximum annual payment pool available to BDA Participant banks for quality sorting under the NQRS to assist the industry to invest in new or upgraded equipment that is capable of quality sorting the new series. This change will occur when the Reserve Bank puts in place the revised NQRS quality standards and payment framework that was agreed with industry participants in 2021; a date for this change will be determined in consultation with the industry.

Additional Public Benefits

One additional public benefit, which could be achieved, though not identified in the Application relates to the enhanced potential for banknote trading. As noted above, the existence of a system whereby banknotes can be traded between various customers is an important aspect of the efficiency of cash distribution. Where trading operates efficiently, it reduces the need for BDA Participant banks to transact directly with the Reserve Bank for new banknotes or to return excess good quality banknotes, thus reducing unnecessary transport activities. In the event there was a single provider of CIT services to the BDA Participant banks, the potential for banknote trading should be increased, other things equal.

Public detriments (Q21)

In terms of the CIT services provided by the Applicants for wholesale distribution, the Proposed Transaction could result in additional public detriments from there being a single national provider of wholesale CIT services. These include less resilience in the wholesale cash distribution system and potential negative impacts on customer service levels around ease of access to cash (particularly in regional areas) and the quality sorting undertaken.

Resilience

It is important for there to be enough capacity in the (wholesale and retail) distribution system to meet unexpected changes in demand. For example, the COVID-19 pandemic led to strong demand for banknotes, which combined with logistical challenges associated with flight cancellations arising from lockdowns, resulted in the CIT companies having difficulties distributing banknotes around the country. The Reserve Bank opened its contingency distribution site in Sydney to assist the industry to meet demand. It would be important to avoid a situation where the merged entity reduced capacity such that it would be unable to deal with an unexpected, and potentially sudden, increase in demand.

It is also possible that having a single CIT company responsible for wholesale cash distribution could increase the risk associated with other disruptions, such as natural disasters, employee strikes or disruptions to IT services, which may impact its ability to provide timely cash distribution and processing services. It would be important to ensure that the CIT firm had robust risk management and contingency arrangements in place to respond to and minimise the impact of such events. However, there are other smaller CIT companies that could provide resilience in the event of a localised incident such as a natural disaster or strike. The ability of BDA Participant banks to utilise these services would depend on their internal business continuity arrangements.[10] The ACDES contingency arrangements referred to earlier provide guidelines for a coordinated industry response to such disruptive events.

One final consideration is the ongoing financial viability of a single CIT firm responsible for wholesale cash distribution in an environment of ongoing decline in the transactional use of cash. In the event the Proposed Transaction is approved, consideration would need to be given to whether the reduced resiliency associated with there being only one national provider of CIT services might be able to be mitigated. In addition to the business continuity plans of the BDA participant banks, there may also be relevant examples internationally, or from other industries, that could be drawn on, such as requirements for ongoing monitoring and resolution planning for approved providers of wholesale CIT services, which might also help in cases where the disruption proved to be more than temporary.

Access to good quality banknotes

In the event the Proposed Transaction is approved, there is potential for further cost-cutting efforts by the merged entity, or an increase in prices, to negatively impact ongoing cash access. This is of particular concern for regional areas, where cash access is already more limited than in metro areas (Caddy and Zhang 2021). Similarly, if prices for CIT services – such as those in regional areas – were to increase substantially, this could lead banks and retailers to reconsider offering cash services in those areas. As noted above, providers of CIT services also carry out quality sorting of banknotes on behalf of the BDA Participant banks and their other customers, which relies on banknotes periodically moving through the CIT depot network. If the Proposed Transaction sees the closure of less-utilised CIT depots in regional areas, it could lead to banknotes in those regions recirculating for longer without being processed and assessed for fitness in a CIT depot, resulting in a decline in the quality of banknotes in those regions. The approaches taken by other countries in helping to mitigate these risks has included legislating minimum requirements for cash access and opening additional publicly owned cash distribution sites. There may also be relevant examples from other industries where community service obligations have been established.

Reserve Bank of Australia
28 October 2022

10 [redacted]

Appendix

Matters of clarification

The Reserve Bank wishes to highlight three areas in the Application, relating to the Reserve Bank, that warrant clarification:

1. **The ability of the Reserve Bank to regulate CIT service providers.** The Applicants submit that a factor that would constrain the merged entity in its provision of CIT services is the 'credible threat of regulatory intervention by the Reserve Bank.'[11] The Application states that 'if the merged entity were to significantly increase its pricing levels for CIT services post-Transaction, the RBA could exercise its broad powers to intervene and regulate the cash distribution system in Australia' (paragraph 389). In particular, the Application states that 'if the RBA considers it in the public interest to do so, it could first designate the cash distribution system as a payment system under Section 11 of the *Payment Systems (Regulation) Act 1998 (Cth)'* and then 'intervene and introduce specific regulation for participants in the cash distribution system, including the post-merger entity and any other providers of CIT services' (paragraph 389).

   Under the PSRA, the Reserve Bank has the power, if it is in the 'public interest', to designate 'payment systems' as being subject to its regulation and then to impose standards and/or access regimes on 'participants' in those designated payment systems. 'Payment system' is defined under the PSRA to mean 'a funds transfer system that facilitates the circulation of money, and includes any instruments and procedures that relate to the system'.

   It is not clear what the Applicants mean by the 'cash distribution system'. To the extent that the term is referring to, or intended to cover, CIT services – namely, the physical transportation of banknotes on behalf of the owner of those banknotes between different locations in Australia and associated cash processing and quality sorting processes – the Reserve Bank does not consider these activities to be within the scope of its powers under the PSRA.

   The Reserve Bank notes that the Treasury is currently undertaking a review of the PSRA to ensure the Reserve Bank can respond appropriately to financial stability, efficiency or competition risks posed by new innovations in the payments ecosystem (see The Australian Government the Treasury (2021) Recommendation 6, p 8). The Government has also recently considered regional communities' access to cash and banking services more broadly in its Regional Banking Taskforce Final Report (The Australian Government the Treasury 2022). There may be an opportunity for the government to consider regulatory reforms or interventions to ensure the Australian public has good access to cash for as long as they want it, including a potential regulatory role for the Reserve Bank in this area.

2. **Avoidance of new regulation by the Reserve Bank as a potential public benefit of the Proposed Transaction.** One of the public benefits identified by the Applicants is that the Proposed Transaction avoids 'the cost, delay and uncertainty associated with the RBA moving to any new regulatory model for cash distribution, which would replace the current commercial arrangements in place between the RBA, the Major Banks and CIT providers'.[12] This potential public benefit, which is identified in the Application and the related report by RBB Economics, suggested that the Reserve Bank was looking to implement 'a new regulatory model' as part of its Review of Banknote

11 See Executive Summary and Section 12.2 of the Application.
12 See page 14 and Section 11.7 of the Application.

Distribution Arrangements. The release of the Conclusions of that Review – which were publicly announced on 24 August 2022, before the Application was submitted – did not, however, propose a 'new regulatory model' (RBA 2022c, pp 20–21).

Instead, the Conclusions to the Review indicated that the Reserve Bank will replace the existing bilateral contractual BDAs with a transparent, standard set of terms and conditions for the wholesale distribution of banknotes. It is the Reserve Bank's intention that, at least initially, the new standard terms and conditions will be little changed from those in the existing BDAs, apart from increases to the incentive payments related to quality sorting and the payments for transport of unfit banknotes to the Reserve Bank and the potential incorporation of some industry-led efficiency gains where there is broad industry support. The announcement of the Conclusions to the Review, therefore, lessened the uncertainty of the Reserve Bank moving to a 'new regulatory model' and confirmed that the core terms and conditions for banknote distribution will largely remain in place.[13]

Also, as part of its Conclusions to the Review, the Reserve Bank committed to creating a new Industry Forum to provide an avenue for the dissemination of information relating to the translation of the current bilateral arrangements into the new standard terms and conditions. It will also enable further consultation on the feasibility of, and industry support for, future efficiency gains. Membership of the forum will, at a minimum, comprise participants in wholesale banknote distribution, which currently includes the four major commercial banks who have signed BDAs with the Reserve Bank (the BDA Participant banks) and those CIT companies (including the Applicants) that have been approved by the Reserve Bank to participate in BDA-related activities.[14]

3. **Reserve Bank requirements for quality sorting**: There are references to the quality standards for circulating banknotes that are set by the Reserve Bank, which could be taken to mean there is a certain standard that it requires. For example, at Paragraph 132, the Applicants state that 'Recently, the RBA has proposed changes to the NQRS, which would significantly impact the investment required from the Applicants in order to ensure that banknotes are kept to standard'.[15] The BDA incorporates the arrangements under which the quality of banknotes in circulation is managed, achieved by way of incentive mechanisms that reward quality-sorting outcomes rather than prescribing specific standards to be met or sorting equipment to be used (see Box A in RBA (2022c)). It is a matter for each of the BDA Participant banks to individually determine its approach to quality sorting in response to the financial incentives provided by the Reserve Bank. If a BDA Participant bank outsources its quality sorting services, for example to CIT service providers, any requirements are commercially negotiated between each BDA Participant bank and its CIT service provider. Further, one of the conclusions from the Review was that the Reserve Bank would make a modest increase to the maximum annual payment pool available to BDA Participant banks for quality sorting under the NQRS to assist the industry to invest in new or upgraded equipment that is capable of sorting the Next Generation Banknote series, and this change will occur at the same time as the revised NQRS framework is implemented. The implications of this increase to the

13 Although the release of the Conclusions to the Review has been acknowledged in the Executive Summary to the Application, it does not appear to have been recognised in other areas of the Application, particularly Section 11.7.1. See page 13 and page 15 of Application.

14 Parties other than banks can enter into a BDA with the Reserve Bank, however in practice only the four major commercial banks have done so since 2001, when this model for the purchase/return of banknotes was introduced. This is primarily a feature of the large monetary values involved and the corresponding need to have sufficient capital to fund the purchase of the banknotes from the Reserve Bank.

15 See also paragraph 179 and 282.

payment pool, and thus potential payment to a CIT company for quality sorting, is not acknowledged in the Application.

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