

# Strategic Review of Innovation

## Consultation and Review

In June 2012, the Reserve Bank published the *Strategic Review of Innovation in the Payments System: Conclusions* (Conclusions Document).<sup>26</sup> The document sets out the Payments System Board's conclusions and recommendations, following an extensive period of review and consultation examining innovation in the Australian payments system. First announced in May 2010, the objective of the Strategic Review has been to identify areas in which innovation in the Australian payments system could be fostered through more effective cooperation between stakeholders and regulators. The focus of the Review has been medium term, looking at possible gaps in the Australian payments system that might need to be filled through innovation over a time horizon of five to ten years.

Over the two years during which the Board conducted the Strategic Review, a number of documents were published and two sets of consultations took place. The first period of consultation was initiated in July 2010 when the Board called for initial submissions and informally consulted with interested parties. These initial consultations suggested that while innovation in the Australian payments system was occurring in some areas, deficiencies remained in others.

In June 2011, *Strategic Review of Innovation in the Payments System: Issues for Consultation* was released.<sup>27</sup> This document drew on feedback from the initial consultation phase, as well as a study on the use of retail payments and the work of the Bank for International Settlements Committee on Payment and Settlement Systems (CPSS) Retail Working Group on Innovation in Retail Payments, in which the Reserve Bank participated (see 'CPSS Retail Working Group on Innovation in Retail Payments', below).<sup>28</sup> It provided the basis for a second round of consultation by setting out 51 specific questions for industry to comment on, covering issues such as whether there is the need to manage the decline of certain payment methods; whether the current industry governance arrangements promote innovation; the role of the Board and the Reserve Bank in setting an agenda for payment systems innovation; what functions a central hub could provide the Australian payments system; and how strong the demand is for payment options that will provide availability of funds 24 hours a day, seven days a week. A summary of the submissions was published in February 2012.<sup>29</sup>

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26 RBA (2012), *Strategic Review of Innovation in the Payments System: Conclusions*, June. Available at <<http://www.rba.gov.au/payments-system/reforms/strategic-review-innovation/conclusions/index.html>>.

27 RBA (2011), *Strategic Review of Innovation in the Payments System: Issues for Consultation*, June. Available at <<http://www.rba.gov.au/publications/consultations/201106-strategic-review-innovation/issues/index.html>>.

28 Bagnall J, S Chong and K Smith (2011), *Strategic Review of Innovation in the Payments System: Results of the Reserve Bank of Australia's 2010 Consumer Payments Use Study*, RBA, June. Available at <<http://www.rba.gov.au/publications/consultations/201106-strategic-review-innovation/results/index.html>>.

29 RBA (2012), *Strategic Review of Innovation in the Payments System: Summary of Consultation*, February. Available at <<http://www.rba.gov.au/payments-system/reforms/strategic-review-innovation/summary-consultation/index.html>>.

As well as the two consultations, the Reserve Bank hosted a roundtable for stakeholders to discuss the issues raised in the Strategic Review. The roundtable took place on 16 February 2012 and was attended by 34 industry participants; members of the Payments System Board also attended. The discussion was centred around the three main topics raised in the consultation process, namely industry governance, the potential innovation gaps and payments system architecture.

## Conclusions of the Strategic Review

Following this extensive period of consultation and research, the Board concluded that the removal of some of the barriers to cooperative innovation in the Australian payments system has the potential to deliver significant public benefits over time. The Board proposed two means by which it would seek to improve cooperative outcomes.

First, the Board intends to be more proactive in setting out strategic objectives for the payments system. These will identify services or attributes that the Board believes the payments system should be able to provide by a specified time and will take into account the interests of all stakeholders, including end users of the payments system. In general, the industry would be expected to determine how those objectives could be met most efficiently. A review of the strategic objectives will be conducted every three years, at which time the Board will establish new or revised strategic objectives, or confirm existing ones. The initial set of strategic objectives is outlined below.

Second, the Board proposes that there be more direct dialogue on a regular and ongoing basis between itself and the industry. As part of this effort, the Reserve Bank will work with the industry to constitute an enhanced industry coordination body that is suited to engaging in this dialogue.

The Reserve Bank sought input by end August 2012 from the industry on the strategic objectives and timelines identified in the Conclusions Document, as well as on the approach to the provision of real-time retail payments. The Bank is currently engaged in an ongoing dialogue with stakeholders on these issues and has also started to work with industry on an enhanced industry coordination body.

### Initial strategic objectives

Having concluded that it should set high-level strategic objectives for the payments system, based on its assessment of the public interest, the Board has proposed an initial set of five strategic objectives. These objectives reflect deficiencies identified over the course of the consultation period. In summary, the Board is of the view that the payments system should be able to provide:

- *Same-day settlement of all direct entry (DE) payments*

In the Board's view, the industry should move to same-day settlement of all five DE file exchanges to reduce risk and allow end users to access funds in a timely manner. The industry recently indicated that it is intending to amend industry policy – it had previously proposed settlement of the first three exchanges – to implement this.

- *The ability to make real-time retail payments*

The ability of individuals, government agencies and businesses to make retail payments, with the recipient having visibility and use of those funds in near to real time, is an objective that seems likely to become more pressing. Indeed, one of the key trends identified by the CPSS Working Group on Innovations in Retail Payments was an increased focus globally on speeding up payment processing through faster settlement or payment initiation. The capacity for real-time retail payments could be used by government agencies to make

emergency payments, by individuals to make personal payments and potentially by businesses to make better use of cash balances. Some financial institutions have recently been promoting various elements of real-time payments, including the capacity to make real-time mobile payments to customers of the same bank. To the extent that this is valued by customers, it makes sense that this type of functionality should be available across financial institutions.

- *The ability to make and receive low-value payments (DE, real-time payments and crediting of card payment receipts) outside normal banking hours*

It is desirable that the payments system be available when and where needed by users. In the Board's view, the one area of accessibility that is clearly lagging is the availability of low-value payment systems out of hours, particularly during weekends and public holidays. Elements of some systems continue to operate during these times, for instance the clearing of card payments continues to operate, consumers can initiate 'pay anyone' or BPAY payments via online or phone banking, and ATMs continue to operate. However, the systems used for the exchange of non-card payment instructions between institutions do not generally operate on weekends, meaning that no DE files are exchanged between banks and no interbank settlement occurs. Banks' accounting systems also do not generally recognise weekends for account-posting purposes. Together, these factors mean that the recipient of a DE payment initiated after a bank's cut-off time on a Friday night might not receive those funds until Tuesday. The same might be true for a merchant accepting a payment via eftpos on a Friday night. These delays are of course longer during long weekends.

- *The ability to send more complete remittance information with payments*

The Board considers that providing the capacity to carry additional remittance information with payments could result in a significant improvement to business efficiency. Currently, the DE system, which is the principal business payment system, can carry a maximum of 18 characters of additional remittance data with the payment message. This is insufficient for many business purposes, and can also be a constraint for personal use. Businesses might, for instance, wish to incorporate detailed information about an invoice, for example an indication of which items on the invoice are being paid.

- *The ability to address payments in a relatively simple way*

A key element determining the ease of use of a payment system is the process by which the payee's details are provided by the payer. Currently, in order for a payment to be made into a bank account, the payee's BSB number and account number must be provided. In many cases, individuals will not remember these details themselves and in other cases individuals are reluctant to provide them because they are concerned that they might somehow be used fraudulently. The need to enter up to 15 digits correctly is a further problem. Errors are easily made and the consequences can be uncertain. The Board believes that an easier means of addressing payments could improve the efficiency of the payments system. It may also have a by-product of increasing competition in the provision of financial services to the extent that it makes it easier for customers to switch accounts between financial institutions.

## **Enhanced industry self-governance**

The Board considers the constitution of an enhanced industry-level governance body as important for two key reasons. First, engagement between the industry and the Board will be crucial in helping to both identify and achieve strategic objectives. Second, there will also be many issues not covered by the Board's strategic objectives, but which nevertheless require industry coordination.

Currently, the main body for industry coordination is the Australian Payments Clearing Association (APCA). APCA's genesis was in governing the cooperative clearing arrangements between member institutions; however, in recent years APCA has sought to play a greater role in industry-wide cooperation, for instance through the Australian Payments Forum. APCA has also recently proposed its own new governance arrangements. The Board welcomes these efforts, but considers they should be built upon to encourage the broadest possible participation in, and coverage of, industry coordination arrangements.

The Board has proposed that the Reserve Bank convene discussions with stakeholders on constituting an enhanced industry body. The body would have broad industry coverage and would be responsible for industry coordination, as well as being the principal industry voice in liaison with the Bank and the Payments System Board.

As a starting point, the Board has outlined some desirable features of an enhanced industry body. The body should have a clearly stated obligation to consider both the interests of the industry and the public. The peak level of the body should also be small enough to be effective, with sufficiently senior representatives to be able to promote a strategic approach and commit resources where appropriate. Membership of the body should also be representative of those that have a genuine stake in the outcomes and should not be dominated by any class of participant. End users' views should be represented either explicitly or through independent directors.

## **Payments system architecture**

Payments system architecture is the set of physical and logical structures that allow institutions to exchange payment instructions, initiate settlement and perform any additional functions associated with a payment. Payments system architecture is an important part of the Review as it is relevant to how well and how easily the types of gaps identified can be addressed. Also, some forms of architecture appear to be more conducive to innovation than others.

As outlined in the Conclusions Document, payment systems can be arranged in two ways. Traditionally, Australian payment systems have often been bilateral systems, with physical connections, and logical and business arrangements, between pairs of participants. By contrast, many systems around the world (and some operating in Australia) operate via a central hub, with messages passing via the hub to recipients. Recently, the implementation of internet protocol technology, such as in the Community of Interest Network (COIN) in Australia, has blurred the lines between the two architectures. The COIN rationalises the physical links – participants need only one link to the COIN to establish physical connectivity with all other participants – but participants must still have bilateral logical and business relationships with each other.

The Board notes three roles for centralised architecture such as a hub: simplifying connections; enabling additional processing functions (e.g. holding a database of account identifiers and potentially accommodating remittance data) to provide more sophisticated payment products or greater interoperability; and facilitating real-time, or near real-time, settlement of retail transactions. The Board believes that there should be a general presumption in favour of establishing more centralised systems, particularly in the establishment of new systems.

## **Real-time payments hub**

As noted above, the Board has indicated there should be the capacity for businesses and consumers to make payments in real time, with near-immediate availability of funds to the recipient, by the end of 2016. The

Board believes that the critical element of real-time messaging should logically be provided via a payments messaging hub ('payments hub').

A payments hub could be linked to a settlement system providing real-time settlement of retail transactions. While the settlement system would most likely be provided by the Reserve Bank as a separate module of Reserve Bank Information and Transfer System (RITS), the Board has an open mind about how the payments hub could be provided. The payments hub could potentially be provided by the industry, either on a commercial basis or operating as a utility, or by the Bank. If provided by the Reserve Bank it could either be owned and operated by the Bank, or potentially be transferred to a private entity once it reached sufficient scale.

Regardless of the ownership structure of the payments hub, the Board has outlined some desired characteristics of a real-time retail payments hub. These include:

- initially providing credit transfers, with future capability for debits, future-dated payments and other payment types. It would also provide for future capability to use customer identifiers (e.g. mobile phone number) for ease of addressing payments and to assist in account switching
- payment messages based on ISO 20022 standards capable of carrying additional remittance information
- open access for financial institutions and payment service providers; that is, potentially accessible to consumer and business customers of all authorised deposit-taking institutions (ADIs) offering retail transaction banking
- resilient connectivity to all ADIs, and 24 x 7 resilient operation with high levels of security
- the receiving bank to provide real-time funds availability – required by the end of the first year of operation
- the sender (payer) to have confirmation of the funds destination before committing a payment, and confirmation that the payment has been made into a valid recipient account
- settlement of each payment in central bank funds (through an enhanced 'fast' settlement service in RITS)
- support for a range of secure payment channels, including the use of mobile devices.

## **CPSS Retail Working Group on Innovation in Retail Payments**

As noted above, the Board's review of innovation drew upon the work of the CPSS Retail Working Group on Innovation in Retail Payments, in which the Reserve Bank participated.<sup>30</sup> The Working Group's mandate was to provide an overview of innovative retail payment activity in CPSS countries. The work involved a fact-finding exercise in which participating central banks identified influential innovations in their respective jurisdictions, with the outcomes of this exercise documented and analysed in the Working Group's report, which was published in May 2012. All up, the Working Group considered 122 retail payment innovations from 30 countries. The Report identified a number of key innovation themes across countries including an increasing desire to speed up retail payments, either through faster settlement or faster payment initiation; an increasing focus on innovations that improve the reach of payment products, either by facilitating financial inclusion for unbanked populations or by meeting urgent payment needs (e.g. through mobile networks or prepaid cards); and the changing role of non-bank entities in retail payments. The Report identified security, standardisation and interoperability as some of the key challenges faced by central banks in relation to payments innovation.

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<sup>30</sup> CPSS (2012), *Innovations in Retail Payments, Report of the Working Group on Innovations in Retail Payments*, May. Available at <<http://www.bis.org/publ/cpss102.pdf>>.

