

## **Access and Innovation in the Australian Payments System**

Thank you Ian for the opportunity to speak today on the subjects of access and innovation in the Australian Payments system. These are both subjects that are of significant importance to our organisation and where more work is still needed, particularly, if we aim to have a payments system that allows new entrants and promotes an environment that is progressive and open to change.

To put my comments into context, let me briefly explain who Indue is. We are an ADI who specialises in providing “own labeled” and co-branded payment solutions to smaller organisations who wish to provide payment functionality to their customers. Two important differentiators for us are flexibility and agility. These are also important competitive advantages for us and allow us to customise our solutions so that they integrate efficiently and seamlessly with our customer’s own environment. This empowers them to develop the type of customer experience they believe is important to them. For our organisation, we compromise flexibility and agility when we allow complexity to creep in to our solution. So at Indue keeping things simple is top of mind.

Equally, our customers want solutions fast. While we have made much improvement in this area over the last few years, there is still more work to be done. Going beyond the customer, agility for us is more than just getting a product in to the market quickly. It is also about the cost associated with delivering that product and the resource drain that product places on us. Clearly, the less agile we are as an organisation, the greater the cost of bringing a product to market.

I believe there are some parallels between what is our experience in providing our customers with payment functionality and the ease with which one can gain access to the payments system; and once in it, how creative and innovative one can practically be.

I am conscious that I only have a limited amount of time available today and will restrict my comments to three specific areas, namely physical access to the payments system, connectivity within the payments system and creating an environment that is conducive to encouraging organisations to be creative and innovative.

Improving access to the payments system has been a feature of reforms since the beginning. In the first instance the Reserve Bank considered how to improve access to the Visa and MasterCard schemes. This led to the creation of a special class of institution called Specialist Credit Card Institutions. Next we considered access within the EFTPoS system and as a result we now have the Access Code and the Access Regime which together have created a greater level of certainty for those seeking to become a direct connector, both in terms of the process and the cost. Now we have APCA looking at the issue of access to the ATM system and an ATM specific Access Code is expected by August 2008. By and large I believe the work undertaken on access through the reform process has moved us forward as an industry and therefore, been successful.

However, there is more work to be done in the area of access and we must widen our focus and consider access on a whole of system basis; particularly in the EFTPoS payments system. In the EFTPoS system, our bid to improve access has focused our attention on only one aspect of access, namely that of securing a direct connection. While this is important, particularly for a new entrant looking to enter the

market as an acquirer, establishing a connection is not the only piece in the puzzle required to have effective access to the system. While a direct connection will certainly enable them to exchange messages and where they introduce new technology realise the benefits of this, they also need to be able to exchange value with the issuers of cards whose transactions they acquire. In this case, securing access to direct settlement and clearing arrangements requires the same level of certainty as currently exists for direct connection. At present this not the case.

Of course this is not just an issue for acquirers but is also an issue for issuers who may wish to re-engineer their settlement and clearing arrangements in a bid to unlock important cost savings. In our organisation, re-engineering our remaining indirect settlement and clearing arrangements will unlock up to 66% of the cost of performing this function indirectly.

The need to allow a market participant to re-engineer their settlement and clearing arrangements was foreseen by APCA during the development of the Access Code. As a consequence, changes were made at that time to the CECS rules which allowed a market participant with at least 0.5% of the national throughput to request direct settlement and clearing arrangements with an existing direct settler and clearer. It also gave some certainty with respect to the change windows when such changes can be scheduled to occur. While these changes are welcomed, they are not enough in removing the barriers to entry for a market participant who wishes to enter the payments system as a direct settler and clearer.

Unlike the position for a direct connection where certainty exists with respect to the level of costs to be incurred by an access seeker, the same certainty does not exist for a seeker wishing to establish direct settlement and clearing arrangements. Instead the access provider gets to set their own price and in our experience the disparity between the price demanded by the various access providers varies significantly. In one encounter we have been quoted a price that is more than double that set in the Access Regime, namely \$78,000, for a direct connection and the work involved in establishing a direct connection is far more extensive and complex. While I can accept that some organisations may suffer from inefficient legacy systems, why should the access seeker have to pay for this in efficiency and lack of investment?

Furthermore, the split interchange rate for EFTPoS transactions, specifically the unregulated fee, also has the potential to frustrate access, as there is no obligation on the access provider to negotiate fairly.

These all combine to restrict the level of access that I believe was in the spirit of what was intended to be achieved when access was first raised as an issue in the payments system. We need to also understand that unless we correct this in the current review, then any restrictions that remain and favour the existing access providers, will only hurt the system as a whole. Particularly, the more innovative organisations who typically will be smaller organisations like Indue, will be handicapped in their endeavors to secure reasonable passage into the payments system, specifically when it comes to direct settling and clearing.

Being restricted in the level of access one can gain to the whole of the payments system will limit the degree of innovation one can reasonably expect to see within the payments system. Equally so, where a system, because of its inherent structure accommodates complexity, innovation will also suffer. I said earlier that for our organisation simplicity in how we develop our systems was paramount in giving us flexibility and enhancing our agility. Both of these combine to help us develop "out of the box" solutions for our customers which often are creative if not innovative

because of how we have adapted to meet the needs of our customers. It is no different in the payments system.

Complexity is usually an arch enemy of innovation and often we tend to innovate to remove the complexity that time allows to creep into the system. The inherent structure of our EFTPoS payment system at present has all 8 direct connectors bilaterally connected to each other. By its very nature in its current form, with every new connector that is added, the level of complexity in the system will increase. However, given the uncertainty that previously existed in the process for securing a direct connection, the potential for complexity, understandably, has not been a major concern. However, with the greater degree of certainty introduced by the Access Code and the Access Regime, the potential for new direct connectors increases and as such, we face the real risk that our web of 8 connectors can become potentially a far more complicated web.

But complexity is not just limited to the technical infrastructure that supports our current bilateral web of connections. Certainly as more organisations seek to become direct connectors, the number of connections required will increase. While we have capped these costs at \$78,000, we must not forget that with every new connection added, the cost for a new entrant increases by a multiple of \$78,000 each time. In a short space of time it is not difficult to see that if the number of connectors increases, then notwithstanding the cap imposed in the Access Regime, even with this, it may still prove to be price prohibitive and in effect become a barrier to access and innovation.

So how can we remove this potential for complexity from our current access arrangements? Well one way would be to remove the need for future new entrants to have to seek direct bilateral connections with every organisation they wish to establish a direct link with. This could be achieved by re-engineering the underlying communication infrastructure of bilateral links to achieve a central hub. This would mean that our potentially increasing web of connections would by and large remain relatively simply. Consequently, connection costs could be kept as low as just \$78,000 for any new entrant.

While moving to such an environment no doubt threatens the very fabric of what we hold dear today, let me ask you to think about why we remain locked into the current web of connections. Is it because we feel that the act of switching transaction messages between institutions gives us some form of competitive advantage and hence, to relinquish control makes us less competitive? It is hard to think that there could be any competitive advantage in sending and receiving a standard message format. At this level of switching, I would argue that it is a commodity and as such, the issue is all to do with the cost of switching these messages. I would expect that all of us at this level would want this done as cheaply as possible. While I can accept that perhaps some may feel some cost advantages may exist in the actual processing of these messages, this would still remain a function of each institution's host environment and hence, any competitive advantage an institution may have in this area is unaffected.

Some work I acknowledge has been done on exploring this idea of a central hub by APCA through its CECS Interchange Communications Facility Project. While I believe they made good progress in their efforts to try and simplify access and create the means for innovation and creativity to be allowed to flourish, I find it disappointing that this work did not receive funding in APCA's 2007/08 project plan and by implication did not receive priority. If as a community of financial organisations we believe ourselves to be progressive, how can we not see this work as important?

Lastly, let me explore briefly some of the things we should consider if we are to create an environment within the payments system that will facilitate access and promote and foster innovation and creativity. In this sense the challenge I believe is how to facilitate an effective governance structure that will work towards these goals.

At present in the payments system we have three ways of creating change. We have the RBA, who under the Payments Systems Act have the powers to designate a particular payments system which, among other things, they believe to be inefficient and where change to that system would be in the public interest. Next we have APCA who is an administering body and by and large oversees the efficient operation of the various payment streams in terms of their policy, standards and procedures, and then we have self regulation or voluntary reform from within the industry.

Over the last 5 years we have seen all three methods of change in action. The least intrusive method, namely self regulation, we have applied to ATM reforms. This process commenced in 2002 with the formation of the ATM Industry Steering Group and only in the last 12 months, after 5 years of discussions, do we have an agreed way forward. An important turning point in this process was when the RBA intervened in March 2007 by holding a series of meetings for industry participants. At the first of these meetings the RBA stated clearly that unless the industry could agree to a position, the RBA would exercise its powers and designate the ATM system. This single action crystallised years of debate.

APCA developed for us the Access Code for EFTPoS and generally this was a successful process. However, I think it is important for us to acknowledge that access to the EFTPoS system was flagged by the RBA in June 2004 and so we, the industry, knew that access was an important issue for the RBA and therefore, we would frustrate APCA in its work to our detriment. History will say that the Access Code was developed and accepted by the Industry and pretty much delivered an important element of the RBA's planned reforms for the EFTPoS payments system. However, I ask you the question, had the RBA not made access an important public issue, would APCA have been successful in driving the development of the Access Code?

The RBA, over the last 5 years has invoked its powers under the Payments Systems Act to designate a number of payments systems to drive reform. Clearly, in invoking these powers it must have reached the view that the path of self regulation, while ongoing, was not going to achieve a satisfactory outcome within a reasonable time frame. Now whether you agree with all that the RBA has done or not, one thing is certain, by their action they have brought focus to the payments system in totality and driven change. I think it would be hard to deny that the RBA's intervention has improved access, particularly with regards to direct connection. Certainly for our organisation we are all the better for the work of the RBA on access and have realised real benefits because of it.

However, the RBA's work has been intrusive and intensive and most likely I think we would all agree (including the RBA) that we would prefer to find a better way for future reforms of the payments system.

I believe from watching the proceeding of the last 5 years, one of the reasons we have found self regulation difficult to enact has been because we can only move forward once we have by and large a unanimous view. Even then, the four major Banks must agree to the change before the rest of the industry can then be

convinced of the benefits of change. This is fine if the change is good for the major banks and is something they want to do, or, if the regulator is making its intended desire painfully clear. But what if the change is not so welcome by the majors?

Under this scenario can APCA play a role in reconciling the views? Well yes it can, but lets not lose sight of the fact that the majors have 43% of the voting rights at APCA and hence, have a strong position of influence. To be perfectly clear, I am not suggesting that the majors behave badly. Like the rest of us, they are commercial businesses and in practical terms need to run their businesses in a manner that best suits them. Change for them, and us, is always best at a time when we are ready to receive it.

While it may sound as if I am about to make a strong case for leaving all future reforms to the RBA as our experience of the last 5 years shows that they have been the most effective means of driving change, in fact I am advocating quite the opposite. In order for change to be sustainable, change itself must be driven from within. When change is created from within the industry, there is normally a greater commitment to it and a stronger sense of urgency towards its implementation. But this does not mean that all want the change. Often not all want change for a variety of reasons, however, this is where good leadership and good stewardship needs to exist. In instances where doubt exists over change, the industry must be able to turn to an independent arbitrator who can exercise leadership and make a decision, after due consideration of all pertinent facts, that is in the best interest of all. This is true of an organisation, and I see no reason why this would also not be true of our payments system.

In summary, let me recap on the three points I have made. With respect to access, I believe we must create the same level of certainty in the payments system for those looking to become direct settlers and clearers, as we have created for those wishing to become direct connectors. Secondly, if we want to foster an environment within our payments system that will promote innovation and creativity, we must look towards ensuring that our communication infrastructure remains simple and adaptable. We must support APCA's work in exploring how to streamline the current web of bilateral connections to avoid the growth of these connections becoming an effective barrier to entry for those smaller and more innovative organisations. Lastly, we have tried the path of self regulation over the last 5 years and if we are honest with ourselves, we have failed to self regulate. While this should not be a reason to rule out self regulation in the future, the lessons from the last 5 years suggest that where we have failed is in our pursuit to secure unanimous consent to change. Therefore, we need help in breaking this pursuit for unanimous consent by putting in place strong leadership that will help us, as an industry, govern ourselves by making decisions that will, in the long term, be for the good of the whole payments system.