

Banking Department
Reserve Bank of Australia

Response to questions in
Australian Payments Clearing Association
Low Value Payments:
Challenges of Evolution
Consultation Document

29 August 2008



Introduction

The Reserve Bank of Australia (RBA) is pleased to submit its response to APCA's *Low Value Payments: Challenges of Evolution* consultation document. The process of planning the future shape of Australia's low value payments systems is very important and we believe the consultation document provides a good foundation for developing an agreed way forward.

The RBA agrees that existing cheque and direct entry clearing systems are reliable and efficient and that they have served the banking industry well over many years. However, as noted in the consultation document, it is becoming increasingly clear that these systems (and the infrastructure that supports them) need to be refreshed. In particular, existing direct entry arrangements lack the flexibility to meet emerging customer needs. Payments services providers have also recognised the need to update network infrastructure and inter-FI settlement arrangements, as there has been little industry change in these areas for many years. We are also witnessing payment systems in other countries undergoing significant reform. The overseas trend towards a new payments framework using international message standards appears to be compelling.

As a participant in the Low Value Payments Industry Direction Working Group, the RBA is aware that each of the component item options identified in the consultation document were themselves the subject of considerable scrutiny during Working Group discussions. In respect to network and settlement risk issues, our submission indicates our willingness to work further with participants on trying to reach an agreed solution which has the necessary buy-in from participants. We also support the case for moving towards using the ISO20022 payments framework and argue that this work should commence as soon as possible, in parallel with the network and settlement risk tasks.

We believe the industry needs to demonstrate a strong commitment to the delivery of new low value payment solutions. Decisions on the proposed way forward will need to be made in a structured, constructive and considered manner with key dates and milestones formally agreed. For reputational reasons, it will be important for the industry to focus on ensuring that all deliverables and timeframes are met.

The RBA confirms its commitment to participating in the planning, development and implementation of new low value payments solutions in Australia. The development of an agreed roadmap is the next step and we look forward to working with APCA and industry representatives on this important task.

The remainder of this paper provides the RBA's views on the various questions raised in the consultation document. Our submission also includes feedback from our government agency client base.

For the information of APCA and representatives of the Low Value Payments Industry Direction Working Group, this submission was prepared by the RBA's banking area which is mainly responsible for the provision of banking services to the Australian Government. Input was also provided by our payments settlements area – this area provides inter-FI settlement services to Exchange Settlement account holders. The use of the term "RBA" in this document refers to these two operational areas.

Usage and Trends

Q

3-1 How do you anticipate your usage of cheques in (say) 5 years time will compare to your usage today? What factors would influence this?

A

Many of the RBA's government agency banking customers have traditionally used cheques as a primary means of payment. In many cases, legislation has been the main contributor to the large number of cheques issued. Legacy payment systems are another reason for the extensive use of cheques by government. Despite these factors, the use of cheques by RBA customers has declined in line with industry trends and this decline is expected to continue into the next five years and beyond.

Factors which will influence the rate of decline may include:

- changes to government legislation for particular agencies;
- the ability of agencies to make systems changes to introduce other payment alternatives;
- the introduction of a commonly used alternative for the delivery of associated remittance information;
- the widening of pricing differentials between cheque payment costs and other electronic payment options; and
- industry development and customer take-up of suitable alternative payment option(s).

Q

3-2 What is your view of the merits and shortcomings of direct credit as it is today in meeting your payments needs? Similarly for direct debit and BPAY if you are a user of these services, what merits and shortcomings do you see?

A

The majority of outward payments processed by the RBA are recurring direct entry credit payments (pension/salary, bill payment, etc) and these are well suited to existing systems which provide low cost and proven reliability.

For outward direct entry payments, the main issues raised by our customers are the inability to validate BSB and account details prior to the sending of the transactions and the timeliness of access to funds by recipients.

For inward direct entry payments, which are mostly *ad hoc*, our agency customers have expressed a strong desire for cleaner reference information to be made available. More accurate payment information can result in significant cost savings as payments can be applied in back end systems without manual intervention. The in-built validation of the BPAY reference number is an example of what can be done in this regard.

Our customers have also expressed a desire to see changes made to the existing low value clearing arrangements to enable payment recipients to have within day access to funds. For this to occur, we would expect that changes to the current inter-FI settlement arrangements would need to take place.

Q

3-3 What facilities associated with these electronic payment types would make them more attractive for you?

A

The vast bulk of Australian Government payments made via direct credit/debit systems are efficiently delivered without the need for any system enhancements. However, a proportion of these payments would benefit if there were capabilities to:

- validate payee information ahead of the payments being sent - this would greatly reduce the number of incorrect payments and the need for subsequent correction processes;
- send improved and standardised remittance information with the payment; and
- select, at the senders discretion, the option of a faster “intra-day” payment transfer. This would be in addition to the existing direct entry payment exchanges, potentially carrying enhanced remittance information.

Q

3-4 What is your view as to why cheques are used in preference to electronic alternatives? Do you anticipate these factors changing over time?

A

As detailed in the consultation document, cheques do have certain advantages over other payment instruments. These include payer control, the ability to provide unlimited supporting remittance information, dual authorisation capability, dishonour facilities, and the use of the “float” until the cheque is presented.

The impact of changes to consumer and business behaviour on their cheque usage is difficult to predict. We expect that the cheque will continue to be commonly used until a suitable alternative is introduced. We also believe that it will be easier to steer business users away from issuing cheques in the shorter term.

Q

3-5 What additional aspects of the current situation would you wish to see considered in support of any case for change?

A

Generally speaking, we believe there should be more emphasis within the industry on the need to maintain a leading payments system in Australia. At present, our view is that commercial considerations have a higher weighting in discussions and there needs to be a bit more balance between these two objectives.

We note that the international trend in low-value payments systems is to facilitate greater access to payment streams (such as through mobile technologies, etc), more timely exchanges of value and enhanced remittance information capabilities.

A number of participants in the Australian system have requested that the RBA provide a means to settle low-value payments intra-day in RITS. The RBA's Payments Settlements Department is responding by developing a low-value feeder. We believe that the industry should actively plan to implement a modern means of timely and efficient settlement of low-value payments as it designs new clearing, network and processing systems.

Q

3-6 What additional commentary would you like to provide?

A

We believe the Industry Direction Project needs to improve its governance. The project group should develop and publish a timetable that sets out achievable milestones for achieving industry reform. The current process that seeks open-ended commentary on issues may be a necessary part of the consultation process. However, the project is at risk of undue delay if firm deadlines for the completion of necessary steps are not established and met.

The implementation approach for any new solution must be a serious consideration in these early evaluation stages. Any new solution must cater for the fact that not all participants will be ready to go live at exactly the same time.

Network Arrangements

Q

4-A1 What factors do you consider most important to the selection of a network architecture for inter-FI payments traffic?

A

In the short term, legacy communication links using Telstra X25 or DDN services will need to be replaced. Most financial institution bilateral links rely on these services. The RBA uses Telstra DDN services and will require an alternative communication link solution to be put in place before end 2009.

We believe the current situation represents a good opportunity for the industry to attempt to find a common solution. Given the fact that network changes must happen, we believe that technical experts and relevant business representatives from the various financial institutions should attempt to find a suitable proposed way forward on the basis of agreed business requirements.

In the absence of a HUB (or ACH), it appears that a good case exists for the development of COIN or VPN based solution. Such a solution(s) might be industry based or collectively agreed amongst participants. These shared networks could co-exist with existing bilateral arrangements but they would only become cost effective when participants are able to significantly reduce the number of bilateral links they support. It may even be the case that multiple networks complement each other and a business case exists to keep these functional well into the future.

The new network architecture will need to have the following characteristics, all of which are well known:

- IP based;
- robust and highly secure;
- cost effective;
- scalable;
- capable of real time messaging as well as batch based file transfers;
- readily accessible to a wide range of participants; and
- have strong redundancy and backup arrangements.

Given the relatively short time-frame involved, we believe the industry should move as quickly as possible to see if a common solution can be found. The way forward will need to be agreed (or known) by early 2009.

An important consideration of any network change is the impact it has on participants' business applications. Business applications and the supporting exchange network are inherently linked. We note that some large financial

institutions have recently committed large expenditures on the redevelopment of their internal core banking systems – these large projects may impact on their ability to implement complementary network changes at the same time.

Q 4-A2 What additional high level requirements would be important to assess between alternatives?

A An important factor from our point of view is the file transfer application product(s) that will need to be supported on any new network infrastructure. Participants usually have to bilaterally discuss and agree on the product they will use as part of the file transfer process (eg XCOM, CONNECT:Direct, FTP, etc). This can often cause some contention as each participant usually wishes to limit the number of file transfer application products they are prepared to support.

Q 4-A3 Apart from transition, what other implications would there be if a change was made from bi-lateral network arrangements to COIN or VPN?

A We have seen already two participants build and implement a COIN based solution for their message based CECS traffic. These participants have canvassed others to see if they would like to join the COIN. Appropriate governance arrangements will need to be agreed amongst participants for a wider industry based COIN to be able to operate effectively. Another important consideration will be the range of file transfer application software supported over the COIN. Whilst the RBA hasn't looked closely into VPN options, we expect that similar issues will apply.

Q 4-A5 What further suggestions or variations would you add for this component?

A The RBA's operational areas believe that there is merit in further exploring the case for an industry hub for the exchange of low value payments. As a stimulant for discussion, an industry hub could provide the following possible advantages (or "value adds") into the long term:

- central message translation from old to new payment formats;
- a central validation point for formats or industry standards;
- connection to multiple network solutions – these could be old bilateral links, the new COIN, or SWIFT FileAct;
- allowance for different file transfer protocols and security arrangements (rather than financial institutions having to separately agree on Connect:Direct, or XCOM or FTP, etc);
- allow financial institutions to have a "one" connectivity solution for their low value payments;

- collation of intraday settlement data on a batched or file by file basis;
- provision of common applications for use by the industry eg. AML, account switching, account validations, etc;
- direct access to clearing arrangements for smaller participants;
- the provision of a central database for statistical purposes;
- common bridging to other international networks in the future; and
- real-time capability to monitor inbound and outbound files – both current and previous.

The RBA operational areas are mindful that a significant transition period would be required to move from the current bilateral network to entirely exchanging files over an industry hub. Costs will also be a very significant consideration.

Settlement Process

Q

4-B1 What proportion of your inwards payments would benefit from faster access to the funds received? Similarly, what proportion of your outwards payments would benefit from being recognised faster by the payee? Why? What specific timing issues or problems affect you?

A

A small percentage of the RBA's inward payments would benefit from faster access by customers to the funds received. From our point of view a greater benefit would be the surety of clear and irrevocable funds if frequent inter-FI settlements also occurred.

On the outward payment side, the majority of the RBA's government direct entry payments are recurring benefit based payments which are well suited to existing processes. We believe that current arrangements do facilitate timely access to funds on the morning of due date.

In recent times we have seen an increased demand from government for new solutions which would allow funds to be made available to recipients as soon as possible on the date of exchange. Some examples include the payment of emergency funds to those in need and disaster relief payments.

Q

4-B2 Do you believe intra-day settlement would reduce your concerns over settlement risk satisfactorily?

A

Intra-day settlement would significantly reduce settlement risk for the RBA. Under current arrangements, the RBA pays funds on a near real time basis for its outward government direct entry payments whilst we are a large receiver of funds at 9am (for obligations generated by the previous day's exchanges).

We believe that a move to multiple intra-day settlements should occur and that industry rules should be structured to ensure all participants make a genuine effort to clear and settle their payments as soon as possible. In the absence of rules (or incentives) we believe some participants could hold back their exchange of payments. This would withhold liquidity and possibly create intra-day and overnight distortions in ESA balances.

A move to same day settlement (preferably multiple intra-day settlements) would also potentially allow financial institutions to wait until settlement has occurred before they posted credit funds to their customers' accounts.

Q

4-B3 What respective merits do you see in being able to support real time file by file settlement versus adoption of (less frequent) intra-day settlement windows? What other dependencies do these alternatives introduce?

A

Ideally participants should have a range of options to settle the payments they have exchanged. This may include file by file gross settlement, intra-day multi-lateral settlement and overnight net deferred settlement. However, on balance, we feel that an agreed and uniform settlement process should be adopted across the industry for each clearing arrangement.

In the past, participants have indicated that if BECS inter-FI settlements were moved to a same day basis, these settlements would have to be multilaterally netted basis because of liquidity concerns. Such a process would require central collator-like functionality to be developed to record the bilateral and resulting multilateral obligations as files are exchanged.

The RBA banking and payments operational areas believe that file by file settlement (facilitated by a SWIFT or VPN message to RITS) would be the most straightforward option to implement. The confirmation message generated once settlement has occurred could be then used to trigger, where possible, postings to customers' accounts. In our view reconciliation issues seem more easily overcome with file by file settlement when compared to any net settlement alternative. Nevertheless, the RBA payments operational area will consider the provision of a facility to calculate periodic multilateral settlement amounts for within day settlement.

Q

4-B4 What further suggestions or variations would you add for this component?

A

We believe the settlement risk issue needs to be more actively and seriously addressed by the industry. This issue affects a number of different stakeholders within each financial institution and it will be important to keep all interested parties informed of ongoing developments in this area.

The RBA banking operational area has a willingness to fully explore each of the suggested same day settlement options. This would be subject to the chosen settlement method being uniformly agreed by all participants.

As stated above our preference is to move to one of the same day settlement options. An alternative option to reduce settlement risk is to introduce a lower cap on the value of individual transactions travelling over the low value payment systems. This would require financial institutions to remove transactions above the cap amount from their direct entry files and separately send them via an alternate system such as RTGS.

Transaction Reference Information

Q 4-C1 To what extent would extended transaction information improve operational efficiency for your business? Is STP (straight through processing) on your agenda?

A Many of the RBA's government banking customers have indicated that they would benefit if extended transaction reference information was made available for their inward and outward payments. At this stage, the expected benefits are hard to quantify and we would need to undertake further consultation with our customers in this regard.

Q 4-C2 Would initiatives such as these encourage greater use of electronic payments in lieu of cheques?

A It is now common for cheques to be electronically issued by business customers with detailed remittance information attached. We believe that the number of cheques issued would decline if existing paper-based reference information was able to be carried with the payment. For this to occur, standardised message structures would need to be developed.

Q 4-C3 What is your view of the potential offered by ISO20022 as a payments framework both for inter-FI and FI-customer services? What alternatives should be considered?

A The advantages offered by ISO20022 as a payments framework appear to be very significant. This framework seems to be quite flexible and capable of meeting all current and emerging requirements, both for inter-FI and FI-customer data exchanges.

We see the move to the ISO20022 framework as being inevitable. As such, we would like to see APCA commission a project with the objective of investigating, and then implementing a more flexible message format in Australia. We believe this project should begin relatively quickly as the status quo in the longer term is not acceptable.

A commitment to move in this direction would be seen as a significant and positive step by the industry to modernise Australia's existing low value payment systems. Our view is that there will be considerable long term benefits by moving ahead in this manner.

Q

4-C4 Do you perceive benefit in introducing an interim capability on existing BECS messages before adoption of (eg) ISO20022? Is this realistic for you?

A

The RBA does not see any benefit in making changes to the existing BECS message format. We believe that any proposal to add additional fields would be a large project in itself and that such a solution would only provide a short term fix to some of the problems and issues that have been identified.

We would prefer to focus on a longer term solution that is flexible and in line with international developments. We do however see the need to retain the existing BECS format into the medium term, especially for customers.

Q

4-C5 What are your views regarding the adoption of international standards vs the development of local standards for payments and payments integration?

A

The RBA strongly believes that international messaging standards should be used where possible. Our general understanding is that the ISO20022 framework can be adapted to meet local needs as necessary. For this reason, our view is that the default position should be to work from this international standard.

Q

4-C6 What other commentary would you provide on this component?

A

The adoption of any new low value payments messaging standard in Australia will be a significant undertaking for all stakeholders. The project will necessarily involve detailed discussions on how such standards might be developed, agreed and implemented. This process should also focus on identifying opportunities to improve the way payments are processed from beginning to end. The introduction of certain validations and flexibility in the exchange of remittance data are some obvious examples.

Clearing Processes

Q

4-D1 What advantages would real time or faster authorisation / notification processes provide you?

A

The RBA is seeing increasing demand for some of its low value credit payments to be cleared in near real time and for funds to be made available to recipients as soon as possible. The ability for the clearing process to provide an optional positive or negative acknowledgement to the originating (sending) financial institution would also be quite useful.

We have less demand for a near real time direct debit payment option. In saying this, we would still be supportive of such an offering if the industry saw a business need to provide this capability.

The option to receive a positive or negative acknowledgement in respect to a direct debit payment request would also be a very attractive feature from our perspective. This would provide greater surety to direct debit initiators that good funds have been provided.

Q

4-D2 Are there other clearing related requirements you would suggest?

A

We believe the design of the road map will need to include greater flexibility in the clearing of low value payments between financial institutions. As an initial step, we believe the various options should be placed on the table with each carefully assessed. At the broader level, we believe improvements in clearing and low value payments processing can be obtained by having:

- more frequent exchanges in either message based or batch based file formats;
- including cheque images as embedded files in cheque clearing exchanges;
- additional payment options and improved systems which facilitate faster funds availability for customers;
- enhanced payment message structures being used under a common payments framework;
- additional value add capabilities such as positive or negative acknowledgements; and
- other forms of non-value messages being available, such as account validation requests.

Q

4-D3 What additional impacts would these concepts present?

A

One of the main considerations will be the expected take-up by customers of any new payment system offerings. It is likely that significant IT development will be required by financial institutions and other main stakeholders involved in the payments process. As such, the business case for each option will need to be carefully assessed against the perceived benefits.

Q

4-D4 What further suggestions or variations would you add?

A

Our view is that the roadmap should provide broad direction of where the industry should head and the framework that should be used to get there. There are a large number of possible initiatives and it will be important for the industry to discuss, agree and prioritise these.

Our preference will be to move forward with specific initial focus on developing enhanced direct credit and direct debit functionality using the ISO20022 payments framework.

Transactions Facilitation

Q 4-E1 To what extent is electronic support for invoicing on your business horizon?

A Transaction facilitation initiatives such as e-invoicing are not on our immediate business horizon. We therefore agree with the relative priority given to this component in the consultation paper. Although some customers have expressed an interest in this area, it is clear that this type of development has less priority than other specific payment system improvements.

Q 4-E2 To what extent would a service such as described attract you to adjust your business processes to take advantage of it? Would it influence take-up of electronic payments for commercial transactions for you? Why

A We would need more detail on the type of solution envisaged before any assessment could be made on whether or not we would adjust our business processes. We would also need to have discussions with our customers on the merits of offering any transaction facilitation services. Our initial thoughts are that proposed additional capability to carry structured remittance information with the payment instruction will meet the needs of most of our customers. We also note that electronic payments for commercial transactions are still common despite the lack of an e-invoicing solution.

Q 4-E3 How familiar are you with the Finvoice model or equivalents elsewhere? What additional lessons do you believe we could derive from these?

A The RBA banking operational area is not familiar with the Finvoice model.

Q 4-E4 What is your view of wider services such as these being provided to customers through payment services providers?

A At the conceptual level we would not be opposed to one or more transaction facilitation services being provided by payment service provider(s). We would be prepared to consider any specific ideas or proposals on their merits.

Q 4-E5 What other segment based solutions could take advantage of a transaction facilitation service coupled to payments? What would drive the case for action for these segments?

A Our understanding of ISO20022 as a payments framework is that the standard allows for flexible segment based solutions to be adopted,

especially in respect to the carrying of structured remittance information for particular market segments (eg superannuation). The introduction of any segment based standard would most likely need to have a strong business case which demonstrated improved processes and/or cost reductions.

Q

4-E6 What other comments would you like to make regarding this proposition or variations?

A

As mentioned earlier, and in terms of transaction facilitation, we believe there are opportunities to introduce new features in the low value payments process flow. These include the ability to validate details such as BSB/account number prior to the sending of payments and the delivery of positive or negative acknowledgements to the originator of the transaction.

Customer Interface

Q 4-F1 What are your views on the importance of the “standardised” integration of payments with customer software?

A The common use of known standards is a very important consideration going forward. Customer systems producing payment transactions are generally provided by software vendors and these vendors and other payment service providers will need plenty of advance notice of any new payment formats and message structures.

As software vendors provide systems to multiple clients with different banking relationships, we believe it is very important, in terms of cost, for the industry to use standardised and known payments messaging standards.

Q 4-F2 What proportion of your payments would you see being enacted in real time as opposed to being batched for bulk submission?

A We are seeing an increasing demand for the banking industry to be able to provide a faster payments service. In recent times, government policy makers have placed a significant focus on improving service delivery to clients. Improving the timing of payment delivery is one of the major items that government is seeking to address. We would therefore expect that, over time, an increasing portion of payments would be exchanged on a more frequent basis for settlement the same day with funds then being made available to customers on a more timely basis.

The nature of our banking business does not generally require faster (i.e. intraday) processing of inward payments to our customers accounts.

Q 4-F3 What other commentary would you provide regarding this component?

A We have no further comments.

Direction and Priorities

Q

5-1 What is your view of the respective priority of initiatives?

A

The RBA banking and settlement operational areas agree with the proposed order of priority set out in the APCA LVP consultation paper. The most immediate priority relates to network modernisation. The RBA would support industry initiatives to either develop some form of centralised industry switching network or move to a simpler “cloud” configuration for the exchange of low value payments. In principle, we would be prepared to participate in a secure VPN and/or COIN type IP network, provided it offered savings over the medium term and its governance, access, security and back-up capabilities were acceptable. The proposed approach with respect to the various file transfer applications used by participants would also need to be considered. The RBA would support the formation of a payments industry group made up of business and technical experts to move this item forward. The RBA would be happy to nominate people to participate in this group.

The RBA also strongly supports moves to introduce intraday settlement arrangements for some or all low value payments. Industry efforts to date in this area have not been successful, even though it seems that there should be a natural incentive for financial institutions to insist on receiving settlement funds prior to making funds available to customers. Recent indications seem to suggest that there is greater consensus among industry participants on the need to address the settlement risk issue. We believe this is a good starting point for more detailed discussions on “how?”.

The “Next” initiatives outlined in the consultation document are also strongly supported. We believe that the development of a new internationally compatible message standard capable of carrying extended and structured reference information is required. Work should commence on thinking how this can best be achieved as soon as possible. This is potentially a very large industry project which will need to be undertaken in stages. The first stage is likely to involve further research as to the ISO20022 framework itself and investigation on this framework can be productively used in Australia. This will help determine how the future roadmap might be structured. It will also assist in the development of a supporting business case.

Q

5-2 What is your view of the “case for action”? Where would you look for benefits?

A

The RBA believes there is a strong case for action and that work should proceed as quickly as possible on each of the priority components identified in the consultation document.

Our view is that the benefits are long term in nature and that any “return on investment” considerations need to have at least a 10 to 15 year time horizon. Over time we believe there will be efficiencies in terms of cost savings (integrated systems, less link infrastructure, standardisation) and new revenue opportunities created by improved payment capabilities (faster access to funds, extended remittance capabilities).

Q

5-3 What is your view of the “emergence of convergence” in electronic payments?

A

The recent trend in electronic payments convergence appears to be logical and sensible. It is hard to argue against the concept of using a single framework for the processing of all low value payments, both domestically and internationally.

The emergence of a uniform and flexible international standard provides the practical capability for moving forward in this area. The likely adoption of this new framework will also allow financial institutions to work towards consolidating their existing disparate systems over time.

Q

5-4 What is your view of the future of the cheque as a payment type?

A

As mentioned earlier, we see the cheque continuing as a payment instrument for the foreseeable future. Our view is that many customers still require the convenience of being able to issue a cheque and that this is unlikely to change unless a viable substitute becomes available.

We note that there may be further opportunities to improve cheque clearing arrangements in Australia (eg further investigation on enclosing embedded cheque images with any future implementation of ISO20022-based cheque exchanges). Such opportunities should be explored as part of the development of the roadmap.

Q

5-5 What final comments would you like to make on the future of low value payments in Australia?

A

The RBA’s comments have been incorporated throughout this response. We look forward to our continued participation in this important initiative.