Submission to the Review of Competition Policy

17 November 2014

Tyro Payments Limited (Tyro) welcomes the opportunity to submit to the Review of Competition Policy.

As the Competition Review seeks to examine not only the current laws, but the broader competition framework, to increase productivity and efficiency in markets, we are pleased to contribute the perspective and experience of an innovative, fast growth new entrant into the banking space and an advocate for the Australian small-to-medium business community.

Tyro is supportive of the thrust of the draft recommendations' emphasis on ensuring a competitive economy and recognition that a number of the current legal structures and frameworks are no longer adequate to support healthy competition.

Tyro's submission seeks to provide some detailed support from actual experiences for a number of the Review's existing recommendations and suggest additional avenues for exploration in the Review's aims. In an environment where technology is driving and accelerating change, the oligopolistic structure and behaviour of today's banking system - dominated by the four retail banks - is stifling Australian businesses and especially the ability of small-to-medium businesses to compete.

Most of Australia's two million trading businesses are small-to-medium businesses (SME) and they are the engines of employment, innovation and growth. They employ almost 70 per cent of the workforce. The Australian banking system has found it difficult to support the SME community with efficient transactional banking and funding solutions.

Prosperity in the new digital century will come to a large extent from start-ups and fast growth companies building the technologies and business models of the future and ones that enable Australia to compete in the global markets. Thus, it is critical that Australia's small-to-medium business people as well as its start-up and fast growth entrepreneurs believe in fairness and accessibility. The scorecard is not good.

When the Reserve Bank of Australia invited non-banks to compete with the dominant retail banks in the payment space, only Tyro Payments, not an established player but a start-up, dared to pick-up this challenge. To date, no one has followed despite the clear profit pool given the enormous and growing profits that the Australian banking industry declares year after year.

As Tyro battled for access, market entry and criticl mass, it observed first hand a culture among the major retail banks that is guided by "what can one get away with" -- i.e. hindering access to new entrants, stifling investment into the inter-bank infrastructure, discriminating settlement, practicing bundling and cross-subsidising.

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The Review of Competition Policy is a great opportunity to reverse the community's prevailing skepticism and cynicism in regard to the inordinate power and anti-competitive behaviour of the four major banks. The task for such a Review is challenging, because the predominant voices raised in such inquiries are those of the establishment and their consultants and lobbyist.

Despite the establishment's appeasing narrative, most Australians and including us at Tyro, we believe that markets in Australia are too concentrated and we are desperate with the lack of competition and innovation.

The observation in the recent Financial System Inquiry Intermediate Report that "the banking sector is competitive, albeit concentrated" is not at all shared by non-bank start-ups or companies seeking access to the banking system or trying to compete with new and innovative banking solutions. Neither would it be shared by small-to-medium businesses seeking competitive banking fees and access to funding. Perhaps the comment of a NAB executive captures the feeling better:

AAP - 7 June 2011: *NAB head of customer experience design Mark Appleford said: "The big four have had a very cosy time for quite a long time and there really isn't a sense of competition."*

Tyro would hope for the Australian Competition Policy to enable and encourage entrepreneurs, technologists and non-banks to dare competing within the highly concentrated Australian banking market (oligopoly).

If that was achieved more companies such as Tyro would start and scale up in Australia instead of Silicon Valley.

Importantly, as a flow-on effect, new fast growth companies would contribute to higher productivity and growth of Australian businesses, especially in the small-to-medium business community.

Today the prevailing anti-competitive structure and behaviour of Australia's oligopolistic banking sector stifles innovation, reduces productivity, eliminates choice, taxes the small to medium business community and ultimately increases costs for the consumer.

To address this issue Tyro recommends:

1. A strengthening of the Competition Law, including as put forward in Recommendations 25 and 28, which would hopefully create an impetus for an ACCC Inquiry into anti-competitive structures and behaviours in the Australian payment space dominated by the four major retail banks.
2. A review of Australian public procurement policies and procedures with a view to promote competition and innovation through open panel tendering of payment services.

Further, given the network nature of the payment system and its crucial importance as a foundational piece of national infrastructure, Tyro also believes that an engaged regulator will always be necessary to ensure the payment system is best serving the broader community. In particular, an engaged regulator is required to open up access to the payment system for new technology players, while maintaining supervision and a level playing field.

1st Recommendation:

Tyro recommends a strengthening of the Competition Law, including as put forward in Recommendations 25 and 28, which would hopefully create an impetus for an ACCC Inquiry into anti-competitive structures and behaviours in the Australian payment space dominated by the four major retail banks.

Despite a lot of recent hype around new technologies and new technology players, start-ups and major brands, providing new consumer experiences at the periphery of banking, the contestability of core banking services has been and continues to be weak. The competition stops, when it is about reaching the payments system.

That is due to the dominance of four industry players in a highly concentrated market, the required and legitimate regulatory oversight, the network effects of clearing and settlement and the switching complexity created by product bundling.

The Australian credit and debit card acquiring market is dominated by the four major retail banks and the two major retailers. New market entrants face significant barriers to entry and expansion. Consequently, Australian consumers do not benefit from the outcomes that a competitive market would provide.

Given these characteristics of the banking and payments market, the Government is that much more called upon to improve access and restrain anti-competitive behaviour.

The Financial Service Industry Interim Report concurs that the “major banks have market power across a range of markets.” The report continues to say: “However, it is not clear they are abusing this power. The ACCC has taken relatively little action against the major banks in recent years”.

A culture of “what one can get away with” effectively stifles innovation and competition, leaving the affected competitors without recourse. For a start-up or fast growth company, today’s paths to seek protection or redress by litigation are not realistic – a start-up or new challenger lacks the resources for this legal challenge. For the major banks, the legal cost is easily funded. (And while this imbalance may be addressed by draft recommendation 49 which could provide small businesses with some alternatives, the drain on a start-up will still be, practically speaking, unbearable.)

Since the pattern of anti-competitive behaviour seems to be below the level of severity that allows the ACCC to intervene, Tyro recommends to heighten the threat of penalty significantly by introducing the concept of triple damages. This would increase the risk perception and improve the competitive behaviour all across the large bank organisations. In concert with draft recommendations 25 and 28, the behaviour of oligopolistic businesses in the financial services industry could actually begin to change. Some of the behaviours Tyro would hope to see change are detailed below.

Product bundling offers

Tyro is a specialised competitor challenging the dominant banks with their broad product lines. As soon as a merchant is of a size that results in the major bank providing a relationship manager, Tyro's closure rate drops off dramatically. Tyro's perception is that the dominant banks deploy the following strategies to lessen and eliminate competition:

- the insinuation of reduced access to debt unless all transactional banking is bundled with the dominant bank;
- the bundling of products, particularly debt facilities, into a working capital package;
- earlier settlement when the merchant services account and the transactional account are bundled with the same dominant bank.

The Tyro experience on the sales front is that often, even after successful pilot installation, merchants withdraw from rolling out the Tyro EFTPOS solution. We suspect this typically happens when the final decision is tabled at the management or board level.

At this point the company's overall banking policy and risk appraisal seems to prevail over the initial openness to innovation and competition. The coding is then that it is not the right time to change.

Tyro has experienced the following examples of anti-competitive behaviour:

- A major merchant terminated an existing acquiring solution, because a dominant bank had undercut Tyro's fees dramatically, waived all development expenses and promised other reciprocal business in return.
- A merchant maintained the relationship with Tyro although the major retail bank said that "Tyro is too expensive, and we give the same service for a quarter of the cost". This major retail bank explicitly stated that "we are trying to get Tyro out of the market".
- Another longstanding Tyro merchant terminated unexpectedly, because his funding requirements were in the millions. "Given strict review points and mile stones" he felt he needed to avoid any opportunity for strained relationships with the bank in case this negatively impacted one of his assessments.
- A longstanding car dealer terminated with Tyro, explaining that the bank had given them a package deal which would save them in excess of $15,000 and this offer was "too good to refuse". This offer was only available if their acquiring was switched back to the bank.
- A retail chain terminated because as part of their funding overdraft facility the bank "held a gun to their heads and insisted on having all acquiring".
- A retail chain did not sign up, because they thought that "If we take this off them the relationship will fall off in all the other banking services we need from a trading bank that Tyro don't offer."
- A hospitality chain withdrew with the comments that "one of the Directors had discussed the option with the Manager [of a major bank] and they

have made it clear they would disapprove of using the Tyro terminals, so I am stuck…"

- A hospitality outlet said that they "can't" leave the bank, because it gets a cheaper rate on the business loans if EFTPOS is with the bank as well.
- A major chemist chain was advised by a major bank that the bank would absorb the significant EFTPOS interchange fee increase, whereas Tyro as a sole-acquirer will have to pass it on.

These few extracted cases are based on conversations and email comments, but they all point to a situation where the major retail banks are able to use their privileged position in the deposit and thus loan market to inhibit competition in the acquiring business – actions which lead to less productive economy over time.

Tyro is largely locked out of competing for businesses that have a bank relationship manager, because the dominant retail banks engage in competition stifling tactics such as bundling, packaging and cluster-pricing.

Discriminatory structure

Tyro is a sole-acquirer and as such has to compete within dominant issuer-acquirer banks. As soon as issuers see an opportunity to improve their margins at the expense of the acquiring and merchant side, they do so. The strategies, structures, and behaviours to lessen or eliminate competition include:

- The increase of the fee components that are not exposed to merchant and acquirer competition i.e. the interchange and scheme fees. The dominant banks can net off as far as on-us transactions of issuer-acquirers are concerned.
- The charge card systems, or three party systems, have to date refused to pay Tyro for the delivery of transactions as they do for the dominant retail banks.
- The access regime to the domestic debit card system (EFTPOS) remains unworkable and at the discretion of the dominant banks. Tyro is charged with substantial switching fees.
- Major Banks offering new acquirers different settlement timing into transaction accounts than they do to their own acquiring business.
- The bundling of acquiring services as working capital packages or support for debt facilities.
- Card scheme and EFTPOS interchange fees cross-subsidising the issuer side at the detriment of sole-acquirers.
- Complex and costly tendering processes awarding single providers effectively eliminate access to public procurements for smaller competitors.
- New entrants are barred from access to oligopolistic and monopolistic markets such as cab, fuel, and other dominant card issuers.

If the Australian community wants to foster innovation and competition, the banking industry and the card issuer organisations must introduce self-regulated access, standards and rules. Government and regulators must be involved in driving industry initiatives and maintaining competitive access.

Due to its network nature, the payment industry requires a strong set of standards and rules to protect the integrity and stability of the system. However, the standards and rules must also enable innovation and competition. Stronger competition laws will help drive a more open and ultimately economic set of standards and rules.

Tyro also believes that with strengthened competition laws, an ACCC Inquiry could be and should be launched into anti-competitive culture, structures and behaviours in the Australian payment space dominated by the four major retail banks which could result in initiatives that encourage innovation and competition such as:

- Creating a level playing field between the acquirer and issuer by imposing reciprocal compliance, choices and business rules
- Recommending to the Reserve Bank of Australia to mandate EFTPOS network access for all debit cards at zero cost interchange fee (like in New Zealand and Canada) (See Appendix 2)
- Explicitly working to open access to government markets for new entrants, as discussed more in the following section (See Appendix 3)
- Ensuring proper access to oligopolistic and monopolistic markets such dominant card issuers, and the Cabcharge proprietary card system.
- Requesting information about and monitoring anti-competitive behaviour by the major retail banks relating to price transparency, cross-subsidizing, settlement timing, product bundling and cluster pricing for bank services.

The fact that Australia has seen such strong consolidation without new entrants challenging the oligopolistic structures highlights the need to continue and intensify the payment space reforms and competitive oversight.

2nd Recommendation:

Tyro recommends a review of Australian public procurement policies and procedures with a view to promote competition and innovation through open panel tendering of available government services, including payment services.

The Government itself has the key to promote innovation and competition through its procurement. It is the largest purchaser of products and services in Australia. With a panel tendering process it has a low risk approach at its disposal to open up markets and give start-ups, fast growth companies and small-to medium enterprises also a chance to provide innovative products and services.

Currently there is an active example of how concerted government action could increase financial innovation.

On 8 August 2014, the Australian Government – Department of Health – invited industry to submit dynamic and innovative commercial solutions to provide Australians with convenient, efficient and secure ways to claim $32 billion of their medical and pharmaceutical benefits a year.

Imagine the Department of Health structured the procurement in a way that multiple providers, big and small, are invited to continuously compete for the most innovative and efficient way to deliver the requested public services. Giant players like Australia Post or Telstra could compete as well as Tyros, new competitors entering the market with disruptive solutions.

Tyro Payments has submitted to the Department of Health this approach which has been successfully implemented with Medicare Easyclaim, a real-time rebating solution that successfully marries security, stability and low risk with efficiency, innovation and competition. Tyro, ANZ, CBA, NAB and Suncorp provide this service. Tyro, the market leader in this space, credits the Medicare rebate in 11 seconds to the patient’s bank account and that immediately at the end of the practice visit.

This successful approach relies on three basic ideas:

- The architecture of the service delivery is “as a scheme” with set rules which allow private enterprise to develop their own solutions to meet the Department’s requirements. This architecture is vitally important since it allows for and creates competitive tension among private solution providers (innovation).
- The business requirement definition reflects a deep understanding of the user needs and perceptions which has created rapid acceptance and thus the benefits the Department was seeking flow quickly (acceptance).
- The EasyClaim-type solution fits into existing systems and procedures so that it could be developed as a discrete module without the need to modify the entire system (modularisation).

The Australian financial payments industry provides an infrastructure that is ideally suited to satisfy the payment side of the benefit claims and payment requirements in terms of security, privacy, access and ease of use.

The Department of Health has an opportunity to re-invent the payments side of its benefit claims and payment service delivery by establishing an “Australia Government Scheme”, analogue to the established business models, policies and procedures of the international schemes like Visa and MasterCard or the domestic scheme eftpos Payment Australia Limited.

The goal would be to sign-up Australian banks to deliver real-time payment and information services on behalf of the Department of Health processed through the existing Australian clearing and settlement systems and though the EFTPOS network. This proven and low cost infrastructure exists today and connects the providers’ points of business to providers, patients and consumers.

The government would benefit from the immediate coverage of Australian citizens through the issuing banks and the coverage of Australian health providers and their software providers through the acquiring banks. The banks provide as a standard business practice card holder and provider authentication and information.

Tyro would be very keen to compete under panel arrangements with level playing field accreditation and commercial terms providing the payment and related information services under a scheme-type arrangement. Its acquiring and integration technology is ideally suited to deliver solutions in partnership with the software industry with minimum time to market.

Tyro Payments and our ancillary and primary health practice management system as well as pharmacy point of sales software providers, all small-to-medium businesses, would be very keen to be able to provide medical and pharmaceutical benefits claims process and payment services as part of our solutions to the health industry.

(See Appendix 3 for more detail.)

Medicare Easyclaim – A Successful Best Practice

By introducing a new real-time Medicare claiming and rebating service (Medicare Easyclaim), the Department of Human Services (DHS) used successfully the innovative scheme approach to deliver a citizen-centred service by efficiently leveraging existing industry infrastructure and working in partnership with private enterprise. Thus the Government already has a working model of using procurement to foster innovation, competition and a direct benefit to the Australian public.

The three key ideas that were successfully used in the Medicare Easyclaim project and that can be expanded to other payment areas are:

- Use the existing domestic debit card system (eftpos) as a secure and ubiquitously available payment infrastructure (reach)
- Architect the service delivery as a scheme maintaining competitive tension among private solution providers (innovation)
- Business requirement definitions should reflect a deep understanding of user needs and perceptions (acceptance)

Such a use of the eftpos system supports the Reserve Bank of Australia’s goal to see a domestic payment network coexist so as to maintain contestability around payment choices for Australian consumers and merchants in view of the dominance of the international card payment duopoly, Visa and MasterCard.

An engaged regulator still required.

Tyro believes that the draft recommendations of the Competition Review will help improve the level of innovation and completion in the payment industry.

However, given the network nature of the payments system, an active and involved regulator is required to ensure that competition and innovation do in fact flow to the benefit of the Australian consumer. This engaged regulator will need to address issues related to a range of issues including access, interchange levels, choice for merchants and consumers on surcharging.

Two particular examples, discussed below, illustrate the need for strong competition policy and regulatory insight if the Australian consumer is to benefit from payment system improvements.

Regulator enforces access to the Cabcharge system

The benefits of increased competition in the taxi industry are not only dependent upon the number of taxi licences allowed or the licensing framework.

Australia's 65,000 taxi drivers and their 372 million passengers would benefit dramatically from an end to Cabcharge's cosy monopoly in the Australian taxi market, with better services at lower costs.

Tyro and Tyro business partner Cabfare consider it up to the RBA to open up the Cabcharge system to competition. It is one of Australia's longest lasting monopolies and has held for 38 years.

Last year Australians spent an estimated $4.8 billion on taxis from 213 million separate journeys. Nationally, taxi service fees contributed $91 million in revenue to Cabcharge in the 2013 financial year, charged on $1.06 billion in taxi payment turnover. Cabcharge operates its payment terminals in 97 per cent of Australian cabs.

The current situation of having multiple terminals in taxis in order to process all cards is unproductive and highly inefficient. Both CabFare and Tyro have campaigned actively for the reduction of service fees in taxis for the past two years and believe that if they were able to process Cabcharge cards on their taxi payment systems, passengers in Australia could benefit from lower fares.

CabFare has approached Cabcharge to become a Cabcharge merchant in order to process Cabcharge transactions in taxis, adding much needed competition to the market and allowing all passengers wishing to pay by cards the protection of Tyro/CabFare's secure taxi payment system.

Cabcharge repeatedly refused CabFare and Tyro access to Cabcharge cards.

Having been frustrated by Cabcharge's non-commercial merchant approval process, CabFare asked the RBA in November 2012 to intervene and set the access fees and arrangements; bringing Cabcharge into line with other card issuers like MasterCard and Visa Card.

A decision by the RBA is still pending on whether to regulate the Cabcharge system and open it up to competition.

The Development of the New Payments Platform

The New Payments Platform (NPP) is being developed by the RBA and the payment industry to enable full scale real time payments. Everyone's memory of the last effort is still fresh: after years of effort, the major retail banks abandoned the committed $500 million real-time payments project, MAMBO (for "Me and my bank online").

Mr Glenn Stevens recently described the NPP as a piece of national infrastructure. While he recognised the banks' legitimate pursuit of shareholder interests, he singled this project out as serving public interest. He urged the banks not to block new players and innovation and to take account of the interests of players who had not yet emerged.

Given that currently the major bank driven new rules for NPP commit the banks to settle among themselves in real-time, but left open the possibility for them to delay the availability of funds for the user, this urging may need to have some regulatory force if the Australian consumer is to benefit from the NPP.

Apart from a minor reduction in systemic intra-bank risk, if the NPP does not provide small businesses and consumers with real time settlement, the Australian economy will not benefit. Indeed, if the NPP further entrenches the established major banks, it may, perversely, slow down the pace of innovation in financial services.

Conclusion

In financial services, there is a lot of innovation at the banking periphery, but access to the core banking space is barred by anti-competitive structures and behaviours. There are many obstacles that stifle Tyro's and other new entrants' efforts to bring innovative, less expensive financial and banking services to Australian consumers and small business market.

Due to its network nature, the payment industry requires a strong set of standards and rules to protect the integrity and stability of the system. However, the standards and rules must also enable innovation and competition. The fact that Australia has seen such strong consolidation of the banking industry without new entrants challenging the oligopolistic structures highlights the need to intensify reforms in the payments space.

It is ultimately in the best interest of the major retail banks, government bodies, card issuers and merchants to encourage, fund and support the best and brightest Australians to try it on their own and compete with innovative technologies and implement bold business models.

The banks will benefit from seeing innovative ideas validated under their eyes, spill over and energise their own organizations. Over time the new companies might be acquired at a more mature stage, become significant companies in their own right or even create a base for international competitive advantage.

The Australian community expects fair and transparent pricing as well as fair and transparent dealings with new entrants. It is important that innovation and competition embracing behaviour visibly permeates the culture of the major banks' organisation.

Significant innovations come from mono-line players. If a new entrant and innovator cannot access larger merchants because the major retail banks block access by bundling, potential new entrants will be discouraged and the ones daring to enter will fail to build sufficient scale. This leads to switching inertia and stagnation in the banking and payments industry.

For the Government, public tendering should be constructed in a way to maintain access for new entrants. The success of the Medicare Australia Easyclaim project validates the approach of allowing an innovator to compete.

Tyro is the new entrant challenging the banking establishment. We are proud that there is one Tyro innovating and competing successfully in a core banking process. But where are the others? The country needs more of these high growth companies.

If the Review of Competition Policy encouraged innovative, start-up and growth companies through open access and a level playing field, there would be more companies such as Tyro starting and scaling up in Australia instead of Silicon Valley.

Importantly, as a flow-on effect new fast growth companies would contribute to higher productivity and growth of Australian businesses, especially in the small-to-medium business community.

In reality, the prevailing anti-competitive structure and behaviour of Australia's oligopolistic banking sector stifles innovation, reduces productivity, eliminates choice, taxes the small to medium business community and ultimately increases costs for the consumer.

Jost Stollmann, CEO

APPENDIX 1:

Tyro Payments background

Tyro Payments Limited is Australia's one and only new entrant into the EFTPOS business in over 18 years.

Since its foundation in 2003, Tyro has faced significant access and expansion barriers that stifle the growth of a new entrant company competing in the banking and payments space.

Tyro would not have gained access to the banking system were it not for the significant support of the then Governor of the Reserve Bank of Australia (RBA), Ian John Macfarlane AC and the Chairman of the Australian Prudential Regulation Authority (APRA), Dr John Lakers AO.

Tyro would not have been able to enter the market were it not for the then Minister of the Department of Human Services, the Hon. Joe Hockey MP and now Treasurer insisting on sourcing Medicare rebating services through the existing domestic debit card system and tendering the service through an open panel accreditation structure allowing the innovator Tyro to compete.

Tyro holds an authority under the Banking Act to carry on a banking business as a Specialist Credit Card Institution (SCCI) and operates under the supervision of the Australian Prudential Regulation Authority (APRA).

Under the SCCI authority, Tyro operates as a specialist banking institution and supplies EFTPOS terminals and provides card acquiring services to 11,000 companies who are mainly small to medium businesses.

Tyro authorises, clears and settles Visa, MasterCard, American Express, Diners, JCB and EFTPOS card payments on behalf of medical practices, pharmacies, newsagents, book and duty free stores, car dealers, restaurants and general retailers.

Tyro does not take money on deposit.

Tyro and the public interest

With an investment of only $33 million, Tyro has developed and operates an end-to-end transaction acquiring solution using state-of-the-art server hardware, (open source) software, IP networks, development tools and agile methods, as opposed to the legacy solutions offered by the major retail banks.

Generally, in terms of speed, security, reliability, integration and mobility of the retail payment system, Tyro has dramatically raised the bar.

While the big banks battle with glitches, failures and outages, Tyro delivered and delivers 100% acquiring system availability.

The industry has been battling with series of data breaches, while Tyro's architecture eliminates the exposure of sensitive cardholder and financial transaction data. No Tyro merchant was featured in any of the card thefts that have happened to merchants with alternate legacy solutions.

In terms of merchant service fees, we are the only banking institution siding with merchants and fighting bank fee increases.

It was Tyro that launched the first real-time electronic Medicare rebating solution for medical practices, and seamlessly integrated this solution into practice management systems. With one mouse click, staff can process patient payments and reimbursements. It only takes eleven seconds until the money is back in the patient's bank account and eliminates the need to queue at Medicare offices.

Tyro is now the Medicare Easyclaim market leader, processing more than half of all Medicare rebates through the domestic EFTPOS system. The savings for Medicare from decreasing the number of paper based transactions are substantial.

Two years ago, Tyro worked closely with key software providers to develop Australia's first, all IP based, integrated "pay at table" solution. The solution allows customers to use the EFTPOS terminal at their table to securely pay and split the bill, as well as tip, by entering their four-digit PIN. Security is increased because the customer never loses sight of their card.

With the Tyro solution, restaurants can turn tables faster and reconciliation is made easier. There's no need to punch numbers into terminals to process tips and there's no time wasted investigating keying errors.

Tyro creates a secure and convenient payment experience and provides Australian SMEs with significant productivity improvements.

Tyro has dramatically improved the economics of the acquiring business. Its low cost, in-house developed payment platform allowed Tyro to become profitable with only one percent share of the Australian credit and debit card transaction volume.

Such innovation and competition should be of prime interest to Australian consumers and the SME community. They are underserved and overcharged by the dominant retail banks. And it is the SMEs who create the jobs and will secure Australia's future in the new digital economy.

The Competition Policy Review has an opportunity to address the access and expansion barriers that stifle innovation and deprive Australian consumers of the benefits such innovation will bring.

APPENDIX 2:

Interchange Fee Cross-Subsidy

The recent Financial System Inquiry Interim Report highlights the issue of interchange fees, merchant service fees and customer surcharging. That is above all an SME and consumer problem.

The solution is disarmingly easy, when one thinks of surcharging being nothing else but the reversal of the discriminatory high interchange fee levied on small-to-medium businesses. A ban of or a low cap on interchange fee is an easy and elegant solution to all the complexities and the unfairness of the current system.

The acceptance of credit and debit card payments at the point of sale has become an efficient and ubiquitous method. The displacement of cash is accelerating with the increased convenience of contactless and mobile payment solutions. It is a public utility.

According to statistics of the Reserve Bank of Australia, the average merchant service fee for credit card transactions in Australia is 80 basis points. The interchange fee regulation caps the average interchange fee for domestic credit card transactions at 50 basis points with a tolerance of ten percent. The actual interchange fee across the Tyro merchant portfolio is 71 basis points for MasterCard and Visa domestic credit card transactions.

Both the issuer and acquirer side pay around 7 basis points in scheme fees. If then the interchange fee in Australia is indeed hovering at or above the 55 basis points, and if the average merchant service fee is at 80 basis points, then the issuing margin is 2.7 times higher at 48 basis points than the 18 basis points on the acquiring side. The interchange fee is not exposed to competition. Thus, if not capped by the Reserve Bank of Australia as the regulator, the interchange fees rise continuously.

According to Reserve Bank of Australia (RBA) data, small business owners are paying up to 10 times more in interchange fees than big business. The RBA's Payment Systems Board Annual Report[1] shows that banks charge small businesses as much as 2.0% in interchange fees[2] to process certain credit and debit card transactions, but as little as 0.20% for large businesses.

The RBA report states: "The cost of these higher interchange rates tends to fall on medium-sized and smaller merchants and other merchants that do not benefit from strategic rates; the same card when presented to a merchant with lowest strategic risk will carry an interchange fee of 0.20 or 0.23 per cent, but will have a fee of 2.0 per cent for a merchant that doesn't benefit from preferential arrangements".

Recently the Payment System Board gave EFTPOS Australia Payments Limited, (the governance body created to promote and oversee the domestic debit card system) the liberty to set interchange fees. The organisation is dominated by the four dominant retail banks and the two dominant retailers.

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[1] http://www.rba.gov.au/publications/annual-reports/psb/2013/pdf/2013-psb-ann-report.pdf
2 Interchange fee is charged by the card holder's bank to the business' bank and then passed on to the business as part of the merchant service fee.

The flexibility was then used by the banks and the two retailers to raise the interchange and scheme fee on standard EFTPOS transactions by 11 cents. This increases the issuer margin and stifles acquirers' and merchants' investment capacity into the urgently needed upgrade of domestic EFTPOS into EMV, contactless and online. (This is in direct contrast to New Zealand and Canada, where there is mandated EFTPOS network access for all debit cards at a zero cost interchange fee.)

The two major retailers sheltered themselves from the cost increase by exempting themselves first and then obtaining preferential terms – the so called differential POS rate range.

The result is that the big banks, all dominant issuer and acquirers, benefit from an increased issuer margin and can cross-subsidise the acquiring side. The small business community sees its costs of payment acceptance dramatically increased, whereas the two dominant retailers are exempted or secured for themselves substantially better terms.

Since the RBA has only capped the average interchange fee, the fee concessions to the big retailers are being recouped by overcharging small to medium businesses.

The end result is that the SME community is being burdened with the costs of Australia's move into the cashless society and new acquirer entrants face the threat of being squeezed out of the market.

The time where interchange fees might have been required to have retailers fund the promotion of credit card penetration in consumer wallets or to have banks promote the deployment of EFTPOS terminals in retail outlets are long gone.

With transactions from PCI compliant secure terminals now being handled across the internet, the cost to banks of accepting small merchant card payments are no longer significantly higher than accepting payments from large merchants.

In fact, looking at breaches, would suggest that large merchants are just as vulnerable as SME merchants, and affect far more cardholders when they fail. While Australia does not provide mandatory reporting, the USA does and companies such as Target and UPS are amongst those that have been compromised.

So why does an interchange differential persist? SMEs are effectively subsidizing their large competitors.

The Australian card payment system could be dramatically simplified by banning or lowering the current interchange fees. The leading card scheme charges its strategic merchants, we assume the major retailers, an interchange fee as low as 0.2% on credit cards and 2 cents on debit cards[3].

With a ban or such a lower interchange fee cap two major problems with the practice of today's card payments in Australia would disappear:

1. The Reserve Bank of Australia (RBA) has capped the interchange fee. The card schemes have granted their strategic merchants dramatically lower interchange fees and recouped the shortfall by charging dramatically higher fees to the small-to-medium business community.

[3] Exclusive GST

According to RBA data, small business owners are paying up to 10 times more in interchange fees than big business. The RBA's Payment Systems Board Annual Report[4] shows that banks charge small businesses as much as 2.0% in interchange fees to process certain credit and debit card transactions, but as little as 0.20% for large businesses.

The RBA report states: "The cost of these higher interchange rates tends to fall on medium-sized and smaller merchants and other merchants that do not benefit from strategic rates; the same card when presented to a merchant with lowest strategic risk will carry an interchange fee of 0.20 or 0.23 per cent, but will have a fee of 2.0 per cent for a merchant that doesn't benefit from preferential arrangements".

2. The RBA has given merchants the ability to pass on the acceptance costs. Surely enough, dominant merchants, exposed to little competitive pressure, used the right to charge what consumers perceived excessive surcharges.

   In a new regulatory intervention, the RBA attempted to reign in the abuse and gave the card schemes the right to limit surcharging to the recovery of reasonable costs.

   An elimination or low cap on interchange rates would eliminate the need for a right to surcharge. After all, surcharging is essentially nothing else but the reversal of the interchange fee.

There are successful precedents. New Zealand and Canada have mandated EFTPOS network access for all debit cards and set the debit card interchange fee at zero. The European Commission set MasterCard Europe's cross-border interchange fees at 20 bps for debit transactions and at 30 bps for credit transactions. Visa Europe has followed offering the same caps.

[4] http://www.rba.gov.au/publications/annual-reports/psb/2013/pdf/2013-psb-ann-report.pdf

APPENDIX 3:

Australian Government Scheme Infrastructure

The DHS has an opportunity to re-invent its stand-alone payment solutions by establishing an "Australian Government Scheme", analogous to the established business models, policies and procedures of international schemes.

The goal of an Australian Government Scheme would be to sign-up Australian issuers and acquirers to deliver payment and information services on behalf of DHS through the EFTPOS network from their merchants' point of sales to their card holders.

The Government would benefit from the immediate coverage of Australian citizens through the issuing banks and the coverage of Australian merchants through the acquiring banks.

Cardholders would authenticate themselves at an EFTPOS point of payment with their EFTPOS card (including multi-functional cards) and PIN. Multiple factor identification could be realised with a driver's license and a Medicare card. The merchant provides an additional role as a third-party witness.

The merchants' EFTPOS terminals would provide a highly secure ubiquitous data entry and dialogue device. The merchant would be a point of explanation and support for technologically less attuned or disadvantaged people. Merchants would be interested in the traffic building.

Australian financial institutions are under pressure to keep their acquiring and issuing solutions up-to-date in terms of security, availability and convenience. Thus the DHS would automatically benefit from the periodical upgrades like 3DES, EMV, mobility and contactless.

Australian Government Scheme Transactions

The Australian Government Scheme would design and launch transaction types that are targeted at certain constituencies, conditioned on certain user or usage attributes and differentiated by transaction type, always using the same accreditation framework, standards, infrastructure, procedures and policies (as Visa and MasterCard do).

- Medicare bulk-bill or patient paid transactions
- PBS gap payments
- Centrelink welfare payments, income management
- Child Support Agency payments
- Specific programs like disabled taxi fare, student computer, and house improvement subsidies
- Government bill payment

The complexity of the transactions can vary significantly. The varying costs for providers would be reflected in the transaction and interchange fee structures, very similar to how Visa and MasterCard manage their portfolio of transaction and program types. Fees could reflect the respective costs of

- A stand-alone, purely financial transaction
- Such a transaction excluding certain Merchant Category Codes (MCC)
- Fraud control through multiple identity and/or age verification, co-payment and card identity information
- Usage control through integration with the Point of Sale (POS), Practice Management System (PMS) or Dispensary System. The integration provides DHS with service or stock numbers as well as beneficiary and provider details.
- And other value added features such as claim assignments, bill payments, change confirmations, etc.

Leveraging the Payment Systems Reform

The significant volume of Government transactions would support the RBA agenda and the EFTPOS Payment Australia project in a significant way.

EFTPOS Payment Australia Limited would need to be the player that promotes the required message standards in the EFTPOS network with the participant issuers and acquirers. For them, the Australian Government Scheme would be the lifeline that would allow them to compete with the international debit card scheme through domestic features and functions.