

31 July 2012

VIA EMAIL : pysubmissions@rba.gov.au

Payments Policy Department
Tony Richards
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001



Dear Tony

**Submission to the Review of the Regulatory Framework for the EFTPOS System:
Consultation on Options for Reform – June 2012**

Tyro Payments Limited is a Specialist Credit Card Institution authorised by the Australian Prudential Regulation Authority. Tyro is Australia's independent provider of acquiring services for credit, scheme debit and EFTPOS cards and electronic Medicare processing services for patient paid and bulk-bill claims.

Tyro Payments is responding to the Reserve Bank of Australia's consultation from the perspective of the only new entrant into the payment space competing with the incumbent banks as a technology innovator and a sole-acquirer i.e. an ADI that does not issue cards and does not take money on deposit.

Tyro has only been operating as a sole-acquirer in the payments market for somewhat less than 6 years. Nonetheless through its focus on new technology and merchant deliverables Tyro has achieved significant results. Such results have, however, been hard fought and Tyro's progress and broader involvement has been resisted by some of the more traditional banking participants. Further necessary advancements in crucial payments developments have failed to be implemented by the industry itself, however, and Australia is lagging to the detriment of Australian consumers and merchants.

Thus, Tyro welcomes the more proactive approach announced by the Reserve Bank of Australia in terms of setting goals and timelines for system-wide payment innovation to overcome the coordination challenges and investment disincentives of the major retail banks.

However, Tyro is very concerned with the foreshadowed new regulation of the EFTPOS access and interchange fee regime discussed in the recent paper published by the RBA on 12 June 2012.

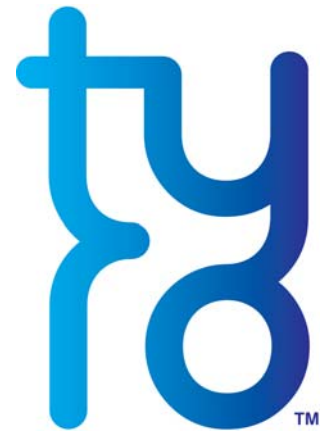
The New Designation

The RBA announced on 12 June 2012 that it has elected to change the current designation for EFTPOS by adopting a narrow definition using the EPAL scheme rules.

The RBA has stated in its paper that *"the practical effect of this designation is that any regulation imposed by the Bank in relation the new designated EFTPOS system will directly affect only EPAL and its members. This does not mean that debit card transactions cannot occur outside EPAL; rather, that the interchange fee and access arrangements imposed by the Bank on the designated EFTPOS system will not apply to those transactions."*

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In Tyro's submission the other practical effects of this designation are:

- Tyro and other new entrants and smaller participants are de facto forced to become ePAL Members and thus subjected to ePAL obligations and costs, as they will otherwise be unable to negotiate access and or commercially viable arrangements for the switching of electronic payments with the other banking institutions; and
- Those current EFTPOS participants with sufficient market power will be in a position to elect to leave ePAL as they will have the necessary volume and or market presence that will allow them to negotiate whatever commercial deals they seek beyond any parameter set by the RBA standards on access or interchange fees.

This situation has the potential to create a real distortion in the market.

Significantly, if an EFTPOS participant with sufficient market status elected to operate outside of the designated ePAL environment then effectively they will be competing with ePAL. This exposes the industry to potentially destructive competitive pressures and creates a two tier market in terms of regulatory exposure and conduct.

Importantly this situation is relevant consideration to the explanations provided in the RBA's paper as to problems with bilateral negotiations. For example the RBA points to weaknesses in options retaining bilateral arrangements and refers to a drawback that *"participants with bargaining power may be able to retain or negotiate bilateral interchange fee agreements more favourable to them than the multilateral interchange fee set by EPAL."*

If the participants with sufficient market power believe they can retain or negotiate better arrangements outside of ePAL then the risks identified could eventuate because of this designation.

Such risks can be addressed by the RBA if the interests of all participants, not just the powerful financial institutions and dominant retailers are considered and balanced. A thriving EFTPOS that can successfully compete with scheme debit systems depends on creating an environment that encourages and incentivises all participants, in particular the new entrants and the innovators such as the sole-acquirers like Tyro.

The RBA and APRA created the Specialist Credit Card Institution (SCCI) regime with the intention to induce innovation and competition by attracting new entrants into the payment space. The question now then is how fair access and equal playing field terms and conditions can be ensured to a new or small participant like an SCCI under EPAL, an organization controlled by the dominant payment card issuer quartet.



Tyro's Position as to access, interchange fees and other terms

In order for EPAL to satisfy the uniqueness of a new entrant SCCI and sole-acquirer, there would need to be a

- functional access regime,
- commercial membership terms for a small participant,
- debit card interchange fee terms analogous to the current regulated bilateral (which is a cost based fee flowing to the acquirer)

1. Functional Access Regime

In respect of the EPAL environment the RBA has stated that the EPAL scheme rules set out the requirements for membership and place an obligation on EPAL to admit applicants that meet such requirements. However, there is no mandated time frame in those rules as to when such applications will be considered and allowed.

A new EFTPOS participant needs a fair i.e. commercially viable access to the credit, debit and charge card schemes and the clearing and settlement systems.

The access has to be comprehensive, since a new entrant on the acquiring side can only compete, if it can offer all credit, debit and charge cards. The current EFTPOS access regime is impractical and broken.

By this Tyro means that the RBAs' new standard needs to ensure that "access" is not merely a technical right to establish a communication line with one or two participants of the EFTPOS system.

Rather access must mandate the timely establishment of full connections on request and to reach agreement to actually perform the functions of interchange of all card transactions with that new participant.

Importantly the RBA should mandate that current "Members" (adopting the language used by RBA in its draft proposed regime) as well as new Members have the right to request access (direct connection and interchange agreement) with others and that such access must be granted within 12 months at a regulated capped access charge.

The standard also has to mandate that the dominant EFTPOS participants have the obligation to switch and settle EFTPOS transactions on behalf of Members for a regulated capped switching and settlement fee.

That is, the RBA must ensure in its standard that new or small participants who can not establish a direct connection with every other EFTPOS participant will have guaranteed switching services provided (at reasonable cost) for all card transactions, whether on-us or off-us transactions.

EFTPOS participants that have not granted access (that is a direct connection) within one year of a request from a Member should in the Standard be required to reimburse the latter's switching and settlement cost.

The EPAL scheme rules also set out other requirements such as the right EPAL to require an applicant to provide security in an amount determined by the Company.



For entities that are already directly switching and settling transactions such as Tyro, an entity already a member of APCA, and an SCCI regulated by APRA, this self-imposed right of EPAL to require security and otherwise assess an application pursuant to its own determination is unsatisfactory.

The RBA access regime must prohibit EPAL's ability to unilaterally impose those types of conditions or requirements on current participants of the EFTPOS system.

Costs of Connection

This should be addressed immediately. The COIN infrastructure has simplified the connection effort and lowered access costs significantly. The industry should voluntarily collect the relevant data ahead of the imposition of a new access regime and be required to provide this to RBA for prompt regulation of this issue.

Enough time has been lost in the past. The system has to be opened to new entrants. Given the current speed of technology change, it would be irresponsible to stall access for new entrants for another one and a half year.

2. Commercial membership terms for a small participant

A new EFTPOS participant needs fair i.e. commercially viable membership terms and guarantees in respect of its rights to participate and grow in the EFTPOS market.

Tyro understands that currently the yearly fixed EPAL membership fee is \$10,000 and scheme fees are \$0.01 cent paid by each of the acquirer and for the issuer are charged. In Tyro's view, if a Member of EPAL, payment of such fees is reasonable.

However, if such fees can be changed at the decision of those larger members who have greater voting power then there is a clear risk that smaller and new participants will be effectively priced out of participation.

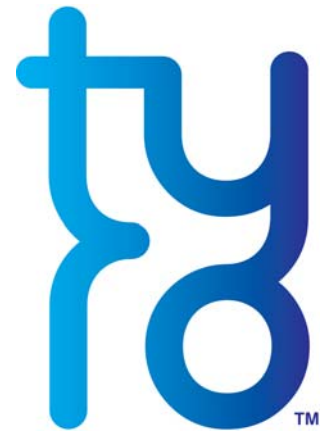
3. Cost-based Interchange Fee for Participants sole-acquirers

Interchange fees in EFTPOS are not set under effective competition. Neither an SCCI sole-acquirer, nor merchants (except the very large ones), nor consumers have an ability to impact the interchange fee.

New entrants lack the bargaining power to negotiate any fair fees in any non-regulated bilateral or otherwise space.

The dominant issuer-acquirers enjoy the receipt of greater interchange fee revenue that now flows to them under the new multilateral fee regime (as income now received on the issuing side is greater than the fees once paid to the acquiring side and so more than offsets the higher costs). However a sole-acquirer is fully exposed to the loss of interchange fees and consequent cost increase unless it is able to retain or negotiate bilateral agreements with interchange fees flowing to it.

For the sole-acquirer model to be sustainable, the interchange fee model needs to be cost-based and acknowledge that sole-acquirers should have such costs paid by the users of the payment system not all consumers.



The RBA states that it is not clear what impact the switch in direction of interchange fees will have on the long-run viability of different business models such as the sole-acquirer (that received interchange fees under the bilateral standards.)

The RBA goes on to say *“the effects will depend on the way that the change in interchange fees flow through to pricing to merchants and bank customers, with evidence to date suggesting that pricing adjustments are still underway.”*

Tyro is not aware of what evidence the RBA has or is referring to in respect of such price adjustments.

Tyro acknowledges that the RBA's recent decision in respect of designation is not part of this consultation. However given the flow of EFTPOS interchange fees is still a matter of consideration it is relevant to note that the question of payment of EFTPOS Interchange Fees to acquirers has previously been considered by the Australian Competition Tribunal.¹

In that matter the tribunal considered the likely impact of a proposal to have zero interchange fees for EFTPOS rather than the fees paid to acquirers.

The Tribunal found that there was an absence of any satisfactory evidence that issuers would promote the use of debit cards to cardholders particularly ahead of credit cards and a lack of any evidence that such cost shifting would otherwise change cardholders' behavior. The Tribunal also accepted that merchants in the large part would pass on such higher costs to all consumers generally through higher prices of goods and services.

At that time the costs to acquirers of a zero interchange fee was around \$170 million. The Tribunal found there was a real public detriment in having such costs passed on to consumers generally.

The increased costs to acquirers of having to pay a multilateral interchange fee to issuers and foregoing the bilateral interchange fee income, should there be a switch in the interchange fee, will be substantially greater than that amount.

Tyro does not understand on what basis it could be said that passing on such costs is in the public interest. Further, if these cost increases will not or only partially be passed on to merchants through merchant service fee increases, the sole-acquirer would suffer a significant disadvantage.

Over years as acquiring contacts renew and as costs are passed on by the issuer-acquirers, a sole-acquirer would possibly be able to re-establish some of its lost acquiring margin. However, the sole-acquirer remains at a persistent cost disadvantage and exposed to issuer-acquirers using their increased issuer interchange fee revenue to cross-subsidise pricing bidding situation thus lessening or eliminating competition from sole-acquirers.

¹ Australian Competition Tribunal in Re EFTPOS Interchange Fees Agreement [2004] ACompT 7 (25 May 2004)



EPAL and the Differential Rates for Certain Merchants

The new multilateral interchange fee regime set by EPAL currently distinguishes between different transaction types and merchant types.

As the RBA noted recently EPAL announced a differential interchange rate range to take effect from 1 October 2012.

Unfortunately, repeated requests by Tyro to obtain clarity as to what all of EPAL's criteria and application rules involve have not been satisfied.

This confirms our concerns that the setting of rules and fees by EPAL is

- not transparent,
- not subject to consultation with all participants,
- not set in the interests of all participants; or
- not open for comment or change by all EFTPOS participants.

What New Standard for Interchange Fees

It is Tyro's submission that the RBA should regulate that EPAL provides for the one-sided sole-acquirer Member an acquirer cost-based interchange fee.

Of the five options posed by the RBA only option 1, leaving the current regulation unchanged, expressly provides for sole-acquirer participants to be paid interchange fees. However the RBA has stated that this approach does not address the potential for bilateral interchange fees to constrain EPAL's ability to set interchange fees in the best interests of the system.

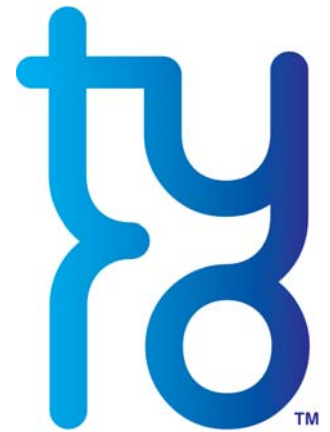
However Tyro has found no explanation or evidence to suggest or prove that the multilateral fees set by EPAL are in the best interests of the system.

The RBA also notes that "*Bilateral interchange fees within the range set before the establishment of EPAL are significantly different from current multilateral fees for most transactions and provide an incentive for acquirers to seek to access these fees rather than the multilateral fees set by EPAL.*"

This situation is not surprising and in Tyro's submission does not cause any detriment to the payment system or the public. The scenario of only issuers being paid an interchange fee risks the following disincentives/or outcomes:

- That no new sole-acquirer participants will seek to enter and/or will succeed in entering the Australian EFTPOS payment system;
- That there will be a detrimental impact on the incentive of sole-acquirers and in turn merchants to invest in new technologies and innovations;
- That there will be a detrimental impact on such participants and merchants to promote EFTPOS at their point of sale ahead of competing credit and scheme debit products.

The institutions who are both acquirers and issuers do not face such a dilemma. The interchange fee revenue flows to them in any case. They are in a substantially improved position.



Tyro has not located any material from any party to explain and prove how this switch in financial benefit actually benefits the EFTPOS system.

If in its reference quoted above the RBA was referring to the difficulty of all acquirers (not just sole-acquirers) opting for the bilateral arrangement rather than the multilateral fees then such could be easily remedied. The RBA could amend its interchange fee standard to stipulate that for any transaction acquired by a sole-acquirer (that is any participant who does not also issue debit cards) the interchange fee must flow to the acquirer. For all other transactions the fee would flow to the issuer.

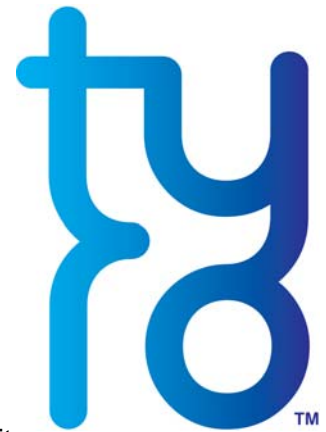
It is Tyro's submission that the RBA, acting in the best interests of the EFTPOS system should issue a standard that requires EPAL to implement an interchange fees regime that also provides for the fees to flow to sole-acquirers for transactions acquired by those participants.

This could be arrived at in different ways.

1. The RBA could pass a new or revised Standard that requires bilateral interchange fees flow to sole-acquirers (who are members of EPAL). EPAL could use the methodology the Reserve Bank of Australia has used in the past to determine the bilateral interchange fee standard. Past benchmark exercises have determined the costs of acquiring result in an interchange fee of 4 to 5 cents flowing from the issuer to the acquirer.
2. Alternatively, the new RBA Standard could provide for both positive and negative multilateral interchange fees to be implemented by EPAL. Tyro notes that the current RBA Interchange Fee Standard provides for both positive and negative multilateral interchange fees.

The revised RBA Standard could require EPAL to set multilateral interchange fee regime that provided:

- For transaction acquired by a member that is a sole-acquirer then the multilateral interchange fee for such transactions is paid to the acquirer at the level EPAL has set for that period;
- For transactions not acquired by a sole-acquirer the multilateral interchange fee for such transactions is paid to the issuer at the same level as EPAL set for that period;
- The regime could still maintain the different fees for cash-out, low value transactions etc;
- The cap set by the RBA standard would remain at 12 cents in both directions to align such with the Visa Debit Standard;
- The notion of bilateral agreements between EPAL members could otherwise be removed; and
- Every prospective new member would know what their position was in respect of interchange fees and not be required to negotiate on this matter.



The attraction of such a dual direction multilateral interchange fee regime is that it satisfies the objectives in respect of a strong future for EFTPOS:

- It balances out the interchange fee based on costs of all participants;
- It is simple, transparent and removes the unknown factor of bilateral negotiations on the question of fees.
- It allows all participants fees to be set and reviewed at the same time.
- It incentivizes all of the direct participants to promote EFTPOS as a preferred method of payment particularly through merchant engagement;
- It will incentivize all direct participants to invest in innovations and technology so desperately needed by the EFTPOS system.

A strong EFTPOS system going forward will require the investment of issuers, acquirers and merchants. A great advantage of a dual direction multilateral interchange fee regime is that it will provide incentives to all of these participants.

Given the inherently uncertain nature of future innovation in the payment system, it would seem wise to allow a regime which allows numerous approaches to thrive.

EFTPOS grew from its inception because merchants found it beneficial (and paid for much of the investment) and issuers found it beneficial (for taking transactions out of the branches). More recently certain other innovations have used the EFTPOS system for government purposes (Easyclaim, as delivered by a sole-acquirer).

It is impossible to predict with any accuracy the eventual source of future innovation in the EFTPOS system. A dual direction multilateral interchange fee regime allows all players to continue to strive for innovation.

An issuer-acquirer would get less interchange with a dual direction scheme only to the extent that merchants decided that other acquirers offered them a better product. From a merchant's point of view the issue needn't only be price, since all the major banks already frequently discount their Visa and MasterCard fees in competitive situations for acquiring business. So, if they wanted to discount their EFTPOS fees to compete, they are certainly able to do that. The discounting on Visa and MasterCard interchange fees hasn't effected the banks investment in those networks. Why would it effect their investment in EFTPOS?

Non-Discrimination Clause

Should interchange fees not be regulated in a manner outlined above, then a non-discrimination clause should be included for sole-acquirers. Such a non-discrimination clause should not be restricted to just new entrants in the system but all sole-acquirers.

It is the very nature of the two-sided payments market that the interchange fee is a wholesale "issuer fee" (or transfer price) set pursuing issuer interests and not subjected to competitive pressures by the payers i.e. acquirers, retailers and consumers. To the contrary, the "acquiring fee" is subjected to strong competitive



pressures by the payers i.e. retailers and consumers negotiating the fee as a component of the merchant service fee.

The only payers-acquirers that have bargaining power and exercise acquiring interest are the two dominant Australian retailers, themselves Members of EPAL in their status as self-acquirers. They put competitive pressure on the interchange fee that otherwise is sheltered to serve issuer interests only.

Thus the differential rates now being provided for certain merchants are very likely to have the practical effect that self-acquirers will obtain more favorable interchange rates than other sole-acquirers and of course the issuers.

Fair access for the sole-acquirer would be protected, if the interchange fee would be aligned with the self-acquirers. Tyro submits such should be along the lines of:

The interchange fee charged on an EFTPOS sole-acquirer must not be less favorable than the most favorable one charged on any EFTPOS self-acquirer.

If new entrants, innovators and or non-banks, were to contribute their part to the efficiency, risk mitigation and competitive tension in the payment system, the fact that only one new entrant has dared to enter the market reflects poorly on the factual and perceived openness and fairness of the Australian payment space.

Unique Nature of EFTPOS

As noted above EFTPOS is a unique payment system that has evolved through the mutual involvement of merchants, financial institutions, the new breed of ADIs such as Tyro, and technology innovators. It is neither the property nor brand of a private company but rather a system that has been generated by recognizing the interests of all participants. Tyro agrees that the RBA and EPAL should focus on how EFTPOS can compete and continue to thrive against products such as scheme debits. However, it is not necessary to treat EFTPOS as analogous to the other schemes in order to achieve such objectives and the RBA should continue to regulate EFTPOS in a manner that supports and recognizes this unique nature.

Transition

It is difficult to identify the proper manner and period for appropriate transition period when the nature of the “new regulation” is unknown and there are such variables being discussed. Clearly if the option adopted was along the lines posed in Option 3 of the RBA paper then a significant transition time frame for sole-acquirers would be required to allow such entities to adjust to the dramatic upheaval in the regulated environment on which they had invested in and built their business.

Conclusion

The real challenge for EFPTOS is how it can thrive in an environment where new technologies are on the horizon and global schemes compete with function rich and globally accepted scheme debit products.



Innovation through new EFTPOS entrants will only happen, if innovators and investors can trust in an open access with mandated timelines, costs and paths to reach all EFTPOS participants. Also, the EFTPOS sole-acquirer must trust in a fair process of setting interchange fees on cost basis.

Tyro is one of the few participants in the EFTPOS system that singularly focuses on the merchants' role in payments, in particular the interests of the merchant and specifically small business community, who have no voice in the current payment industry structure.

The new regulation has to provide a mechanism that mandates a cost-based sole-acquirer multilateral interchange fee or alternatively a non-discrimination clause aligning the interchange fee charged to sole-acquirers on those charged to self-acquirers.

The RBA needs to complement any proposed new EFTPOS regulation by a standard that mandates a timeline for EFTPOS access and a switching and settlement obligation.

These additional rules are about making sure that the Australian payment infrastructure and framework becomes an open system, where all participants and new entrants can compete within fair rules and on a level playing field.

If that is not the case, parallel payment worlds will develop without regulatory oversight and thus with all the risks and failures that this engenders for the community. It is in the public interest to have an open but regulated payment system where innovation can happen inside the system with trust and security maintained.

The fact that so far there has been only one new EFTPOS system participant, since the RBA first regulated, combined with the fact that there is so much innovation enabling technology on the horizon underlines that a lot of work and conviction still has to be performed, before innovation and competition through smaller participants and new entrants can happen within the payment system.

Yours Sincerely

A handwritten signature in blue ink, appearing to read 'Jost Stollmann', with a stylized flourish at the end.

Jost Stollmann
CEO