Submission to the Financial System Inquiry

28 March 2014

Tyro Payments Limited (Tyro) welcomes the opportunity to submit to the Financial System Inquiry and contributes to the debate about the long term future of the Australian financial system and economy the perspective and experience of an innovative, fast growth new entrant into the banking space.

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.

If the financial system encouraged innovative, start-up and growth companies through open access and a level playing field instead of locking them out, 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.

To address this issue Tyro recommends:

1. **An ACCC Inquiry into the anti-competitive structure 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**
3. **An engaged regulator to open up access of the payment system to new technology players, while maintaining supervision and a level playing field**
4. **A review of the overcharging and cross-subsidies that currently disadvantage the small to medium business community**

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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 10,000 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 Financial System Inquiry has an opportunity to address the access and expansion barriers that stifle innovation and deprive Australian consumers of the benefits such innovation will bring.

1st Recommendation:

Tyro recommends an ACCC Inquiry into anti-competitive culture, structures and behaviours in the Australian payment space dominated by the four major retail banks.

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.

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."*

Switching inertia

Despite plummeting satisfaction levels amongst SMEs across several relationship and product attributes, banking relationships remain 'stickier' than ever according to business banking research specialists East & Partners' Australian SME Banking Markets report.

In April 2008, 34.5 percent of SMEs said they would definitely, or be highly likely, to make a move within the next six months. In 2011, less than 18 percent of businesses in this segment were looking to move.

"Actual conversion rates in outlook SME switching have also plummeted with a reduction from a pre-GFC average of 50 percent of customers changing all or part of their relationships to now less than 20 percent", Mr Dowling noted.[1]

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.

[1] http://www.tyro.com/files/news/document/279/East___Partners_-_SME_bank_bind_2011-05-09.pdf

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.

Interchange cross-subsidy

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[2] shows that banks charge small businesses as much as 2.0% in interchange fees[3] 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.

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 in 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

[2] http://www.rba.gov.au/publications/annual-reports/psb/2013/pdf/2013-psb-ann-report.pdf
3 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.

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.

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 refused to pay Tyro for the delivery of transactions as they do for the dominant retail banks.
- The rule that only allows the use of the term "bank" for an authorised deposit-taking institution (ADI) with a minimum capital of $50 million has prevented Tyro, although being an APRA supervised ADI, to use the term bank. This has caused significant complexity and confusion in their marketing to the SME community.
- The schemes, particularly MasterCard, require significant collateral for a non-rated acquirer despite the fact that such an acquirer is an APRA supervised ADI satisfying prudential capital requirements and is actually financially exposed to MasterCard whereas MasterCard has no financial exposure to such an acquirer.
- 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 private health funds, cab, fuel, and other dominant card issuers.
- Heightened regulatory capital requirements imposed on the sole acquirer.
- To allow next day settlement for its merchants, Tyro has to prefund MasterCard receivables, because those are settled with an up to three day delay. The major retail banks have refused up to now to fund Tyro's MasterCard receivables.

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.

An ACCC Inquiry into anti-competitive culture, structures and behaviours in the Australian payment space dominated by the four major retail banks 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.
- Mandating EFTPOS network access for all debit cards at zero cost interchange fee (like in New Zealand and Canada).
- Explicitly working to open access to government payment markets for new entrants.
- Ensuring proper access to oligopolistic and monopolistic markets such dominant card issuers, private health funds 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 payment services.

The Australian Government can use its purchasing power to open up markets and encourage competition and innovation.

Most importantly for the payment space, the Department of Human Services (DHS) could use innovative ways to deliver citizen-centred payment cost by efficiently leveraging existing industry infrastructure and working in partnership with private enterprise.

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 would support the RBA'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.

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.

3rd Recommendation:

Tyro recommends an engaged regulator to open up the access of the payment system to new technology players, while maintaining supervision and a level playing field.

With the increasing preponderance of smartphones and broadband access as well as innovative customer engagement strategies, new players ranging from start-up technology companies to trusted global consumer brands are entering, or thinking about entering, the payment space in one way or another.

Apple Inc. has become a giant in taking money on deposit. PayPal potentially disintermediates banking by connecting PayPal merchants with PayPal card holders. Commonwealth Bank of Australia potentially further bundles its payment product offerings and aggressively locks out further competition.

The new data rich digital economy will allow big retailers to expand their domination and further squeeze the remaining retail community. The two dominant retailers have upgraded their tens of thousands of EFTPOS terminals through their supermarkets, general merchandise, liquor, electronics, hardware stores, petrol stations and pubs to accept contactless payment devices using a new technology called Near Field Communication.

Australian consumers will benefit from large retailers' rewards, discounts and coupons by simply hovering the phone at the point of payment. What if consumers could use credit from a large retailer or their own money deposited into a retailer account and use their phone like an electronic wallet?

And further, what if the big retailer could, in real time, take a consumer's personal profile and purchase patterns and marry this information to their physical location? What if this data could then be used to expeditiously craft a message including a discount, coupon or reward that motivates the consumer away from the nearby owner-operated store and into a large retailer's outlet three blocks further on?

We have seen large retailers already increasingly promoting and discounting across a broad range of retail categories through loyalty and coupon programs. The digital revolution will bring this to an entirely new and threatening level.

For the small to medium retail community to survive in this new media-rich and interconnected digital world, a vigilant regulator and competition authority is required so big banks and big retailers will refrain from discriminatory behaviours and anti-competitive bundling opportunities made possible by the new digital environment.

The survival of small to medium retailers requires the business software industry, innovative payment partners and the retail community to work together and use the abundance of new ideas and products, such as convergent payment, marketing and promotion technology, to deliver the shopping experience that the new generation of digital-savvy consumers expect.

The potential of new players can only be harvested and the threat of the dominant players mitigated with an engaged regulator.

Regulator enforced access to the payment system

Tyro's participation in the Australian payment system became possible through the engaged support of the RBA who forced an access regime in 2004 and 2005 on the global card system and in 2005 and 2006 on the domestic debit card system (EFTPOS) and the clearing and settlement streams BECS and CECS.

Tyro's success is also owed to the Australian Prudential Regulation Authority (APRA) making the new license regime Specialist Credit Card Institution (SCCI) workable within the requirements of banking regulatory oversight and the needs and resources of a start-up innovative banking institution.

Despite Tyro's progress being slowed by many persistent entry and expansion barriers such as the broken EFTPOS access regime, the interchange fee regimes and the settling and bundling behavior of the major retail banks, it has built a business that caters for the small and medium business community. Tyro has raised the bar for Australian merchant acquiring in terms of speed, security, reliability and ease of use.

Regulator needs to enforce access to the Cabcharge system

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.

This is the only way to get lower fares in taxis and competition between all cards.

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

The advent of new technology players

We have seen mostly global players like Apple, Google, PayPal, VeriFone, Visa and MasterCard announce their ambitions in the mobile payment space. There is also much hype around start-ups like Square and other international and local start-ups innovating around the new mobile devices.

There will be heightened competition between four-party and three-party schemes leading to a proliferation of payment instruments and channels. These schemes are all predominantly driven by issuer interests translating into merchant service fees, interchange fees and financial float.

Schemes and issuers are on the consumers' side, not the merchants'. Without an engaged regulator as arbiter, players that provide services to the merchant may be barred access or suffer a competitive disadvantage.

Before the regulator's intervention, schemes only accepted as members those acquirers who were also issuers. This meant interchange fees increased at the expense of the acquirer and the merchant, and merchants were prohibited from recovering their reasonable cost of card acceptance.

While the schemes have privatized and pursue shareholder interests, the card payment market is malfunctioning.

Looking forward, the digital economy favours global players. The problem with this is that global players pursue their own interests, not necessarily Australian ones.

The significant further growth and proliferation in IP based electronic payments instruments and business models will put stress on the Australian back-end banking systems and on the regulatory and competitive oversight and consumer protection.

For example Apple iTunes and Skype have become huge deposit takers of Australian consumers' funds and are beyond any reach of Australian regulatory or prudential supervision.

Square has global ambitions with exponential growth rate. If they were to establish their business model successfully in the Australian retail and hospitality industry, Australian retailers and consumers would be potentially exposed to significant operational and financial risk.

Stability and trust into the Payment System

For domestic card transactions, each issuer is responsible for providing the funds to settle. In day to day operations, if an issuer has a settlement issue for some technical reason, the scheme acquirers then decide whether to settle the merchant prior to receipt of the funds or await the receipt of the funds.

Thus, technical settlement failures can cause disruption in the flow of funds to merchants.

If any issuer were unable to settle due to, for example, a credit occurrence, the scheme rules provide that the scheme would make the payment for the issuer. The scheme rules provide that an assessment would then be made of the still solvent members of the scheme to cover this payment. Thus, ultimately, all of the domestic members of the scheme are taking each other's credit risk.

Currently, all members of the schemes are regulated by APRA, so there is a very minimal credit premium priced into the scheme settlements. If certain participants were not APRA regulated, it would necessitate an evaluation of the increased credit risk by the other members of the scheme. It is possible that this would lead to a situation where frictional credit costs (due to uncertainty) where included in the cost of transactions. This effect could occur even without any realized losses.

If there were to be a failure of a counterparty (arguably more likely if the entities were not APRA regulated), the frictional credit costs in the transaction system could be greatly increased to the detriment of the real economy.

Thus, all these new players warrant and their customers would benefit from access to the payment system but through a suitable regulatory framework.

Tyro has supported the - in our view - established and proven SCCI banking license and prudential supervision model. Tyro did not consider the regime an inadequate burden.

An open and competitive payment environment requires the engaged regulator

Tyro has always advocated for an open and competitive payment environment AND for an engaged regulator ensuring consumer protection, stability, access and a level playing field.

For instance, we are encouraged by and supportive of the more proactive approach announced by the RBA 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.

We are concerned with the RBA's recent decision to confide the access and membership rules in the two dominant global card systems to them alone, trusting that they will ensure 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.

An efficient and frictionless payment system – an essential prerequisite for a safe, healthy and growing economy - requires the regulator and the prudential supervisor to eliminate the credit risk between participants. The direct participants that are in the settlement as members of the schemes and the clearing systems need to be regulated and trusted.

An innovative and competitive payment system – an essential component of productivity and growth – requires the regulator and competition authority to ensure open and fair access. Without regulatory oversight, concurrent payment systems will develop on their own, and will bring with them a whole host of risks and failures. It is in the public interest to have an open but regulated payment system where innovation can happen inside the system with but where trust and security are maintained.

Despite all the hype around technology and new players, the reality is that the payment space is dominated by the four major retail banks and the two global schemes.

New entrants and scheme participants will only have a chance to thrive and survive, if there is on the one hand a level playing field and on the other hand a suitable regulatory framework.

Membership (access) and risk management (oversight) cannot be left to global schemes alone. If it is, new players may never scale up because of the persistent scheme entry and expansion barriers, or, if they do scale up, they might introduce significant systematic risk to the entire payment system.

The result will be massive payments flows and deposits that are beyond the regulator's reach. Apple and PayPal rank high with their deposits measured against the league of global banks. Any player, large or small, should be brought under adequate regulatory oversight.

Given that payments are of the lifeblood of every economy, there needs to be an elaborate regulatory risk framework to mitigate the increased risks arising from the growing number and diversity of new global and local entities, their interdependence, their systemic risk and the impact a failure would have on public confidence in the core payment systems.

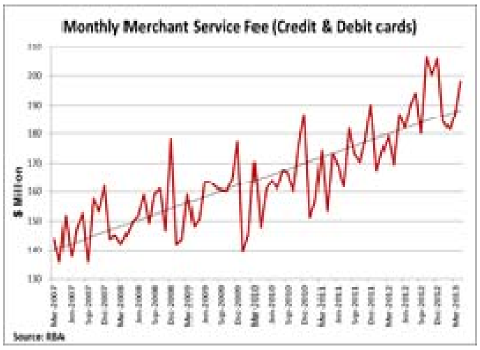
The regulator has the obligation, skills and credibility to understand the risks and intervene in increasingly complex and interdependent payment systems and to ensure that system wide exposures are appropriately identified and managed.

4th Recommendation:

Tyro recommends a review of the overcharging and cross-subsidies currently disadvantaging the small and medium business community.

An Australian Bureau of Statistics analysis shows that “small businesses are an important source of innovation in the economy.” Small to medium sized businesses employ more than seven million Australians[4], the majority of the private sector work force.

While Australia’s big banks are generating less income from fees from personal banking (savings, cheque and debit accounts), they are making up the shortfall by significant increases in revenue from their business customers, particularly the small to medium enterprises.



The banks' fee income from businesses increased 2012 by 7 percent to $7.3 billion[5] worth of fees. The compound annual growth rate in the prior five years was 7.9 per cent per annum as compared to fee income from households declining by 0.6 per cent per year.

The increase of fees for credit and debit cards has accelerated from 3.9% in the prior year to 8.2% in 2012.

The problem is compounded by the growing reluctance of banks to finance the debt of Australia’s small businesses, with 44 percent of applications being declined or not proceeding in the first quarter of 2013[6].

The small to medium businesses mostly absorb the fees imposed on them and not passing them on to the consumer. This is because SMEs need to remain competitive on price, especially with a record number of consumers purchasing online or overseas in the last twelve months. Thus, this vital segment of the economy is starved of earnings or capital to support their own innovation and job creation.

The increasing level and complexity of interchange fees introduced in the past decade is harming the country’s ‘jobs creators’. Bank fee inequality is increasingly making it harder for small business to survive as the country moves towards a ‘cashless society’.

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4 Australian Government, Department of Innovation Industry , Science and Research, Key Statistics Australian Small Business, page 7
5 http://www.rba.gov.au/publications/bulletin/2013/jun/5.html
6 East & Partners Business Banking Index (BBI) - January 2013 - National, structured sample of 538 SMEs interviewed - SME Segment : A$1-20m turnover enterprises

Conclusion

There are many obstacles that Tyro and other new entrants to the payments industry face in their effort to bring innovative, less expensive financial and banking services to Australian consumers and small business market.

If the Australian community wants to benefit from innovation and competition, the banking industry and card issuers must introduce self-regulated access, standards and rules. If this doesn't happen, then it is up to the Government and the Regulator to exercise the oversight, drive the agenda and maintain 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. Rules may need to be differentiated to reflect the differences between broad-line and mono-line ADIs, rated and non-rated ADIs, new entrant and incumbent providers.

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.

We encourage this issue to become an ongoing topic of debate.

Jost Stollmann, CEO