26 August 2014

Mr David Murray AO
Chair, Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Via email: fsi@fsi.gov.au

Dear Mr Murray AO

Tyro Submission to Financial System Inquiry

Tyro Payments welcomes the renewed opportunity to submit to the Financial System Inquiry after the Interim Report.

While the banking sector has been seen by the Inquiry as competitive, albeit concentrated, the experience for new entrants is otherwise. 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.

That stifles 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 integrity and stability as well as access of the system. 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.

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.

Tyro would welcome the opportunity to provide a further briefing to both yourself and the FSI Panel during the consultation process.

Yours sincerely,

Jost Stollmann, CEO

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Submission to the Financial System Inquiry

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Tyro Payments Limited (Tyro) welcomes the renewed opportunity to submit to the Financial System Inquiry after the Interim Report.

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 startups and fast growth companies building the technologies and business models of the future and that for 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. Until today, no one followed and that despite the enormous and growing profits that the Australian banking industry declares year after year.

When Tyro battled for access, market entry and scaling up, it could first hand observe 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.

The FSI is a great opportunity to reverse the community's prevailing skepticism and cynicism in that regard. The task for an Inquiry 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 FSI observation that "the banking sector is competitive, albeit concentrated" is not at all shared by non-bank startups 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.

Tyro would welcome a Final Report of the Inquiry that is encouraging for entrepreneurs, technologists and non-banks to dare competing with the highly concentrated Australian banking market (oligopoly).

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Regulatory Oversight of Payment Systems

Tyro concurs with the FSI observation that credit an debit card payment schemes and payments in general need regulation for innovation and “competition to lead to efficient outcomes”.

We always argued for the engaged regulator, who maintains skills in the complex payment space and offers a graduated regulatory regime that accommodates the increasing diversity of payment players and solutions.

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 the 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.

Systems that perform similar functions need to be regulated in the same way.

Systems that functionally differ still require regulation, but in a way that reflects the degree of risk exposure for the banking system and the consumer. Such a graduated approach would establish light, but early oversight of emerging and fast growing new systems like stored-value, loyalty or cryptographic currency payment solutions.

Interchange Fee Regime

The FSI 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.

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[1].

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.

   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[2] 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.

Choice for merchants and consumers

The FSI Interim Report highlights the issue of choices, for instance the choice for the merchants as to "which scheme to route transactions through". Or there is the suggestion to "provide merchants and consumers with real-time pricing information regarding interchange fees and merchant service fees". There is also

[1] Exclusive GST

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

the choice for foreign consumers in which currency they wish to pay at the point of sale (Dynamic Currency conversion).

All these choices are being effectively removed as the card schemes deploy contactless payments and account level processing solutions.

1. Contactless cards remove the need and option for cardholders to interact with the terminal for transactions under a certain limit. For cardholders of multi-function cards and for accepting merchants, this removes the opportunity to choose the payment type and network at the EFTPOS terminal for contactless payments.

   As the issuer pre-determines the payment type and network default, cards essentially become single scheme cards when operating contactless. The technology is designed in a way that requires the transaction amount to be determined by the terminal before knowing which type of card is in the wallet to be tapped on the terminal. The card creates a cryptogram that includes the amount in the algorithm used and sends it to the issuer. This is done to prevent changes being made to the amount after the card's approval, as there is no other proof of the amount accepted such as a signed paper authorisation.

   This one step process also prevents the merchant surcharging the card, other than using a blended surcharge. A blended surcharge amount penalises the less well off in the community to the benefit of the well off. i.e. A credit "black" card costs a merchant significantly more, up to 2% in interchange, and a "consumer" card around 0.4%. But a blended surcharge will be higher than cost for the consumer card holder, and a discount for a black card holder.

   The technology also eliminates the possibility for the merchant to offer Dynamic Currency Conversion (DCC) for contactless transactions because the card's Bank Identification Number (BIN) is not available until after the transaction is completed. This excludes the possibility of issuing a DCC lookup (from terminal to acquirer) and calculation, before the actual transaction is submitted to the issuer bank for authorisation.

2. Visa has announced it will implement changes to support Account Level Processing (ALP) in Australia. This change will fundamentally shift the way transactions are processed in Australia, enabling issuers to customise consumer credit products at the account number level (instead of using a six-digit BIN), and allowing product identification to be sent to participating acquirers with every transaction. As a result, consumers can be upgraded or downgraded to a new card product without requiring a new card number.

   In our view, Visa could have chosen to maintain the card type that allows determining the applicable interchange fee on the card's chip, a feature inherent in the EMV specification. This would have left acquirers and merchants with the option of surcharging the cost of the specific card transaction.

   The Wall Street Journal Business dated 14 June 2011 reports that "*the Retail Industry Leaders Association expressed concern that merchants can't distinguish which cards carry higher interchange fees on sight. The Justice Department said that it has worked with Visa and MasterCard and that they "will soon offer such an electronic means to differentiate among card types.""*

These technology choices, and today's practice of calculating a surcharge through mental arithmetic or through the point-of-sale system, compromise or eliminate the potential of fair and transparent surcharging, stymieing informed and efficient choices. The challenge increases with card proliferation, interchange fee differentiation and contactless and mobile payment technologies. If the merchant and cardholder cannot identify the card type and its associated costs, economic pricing and market mechanisms fail.

It is time for the industry schemes, issuers and acquirers to embrace the surcharging concept and to create a transparent and cost-based surcharging process. Tyro would be happy to provide its merchants with the required technology, should the industry move towards differential surcharging. The disarmingly simple alternative would be to eliminate, or significantly reduce, the interchange fee and consequently the surcharging requirement.

Tyro believes it is critical to retain choices at both the cardholder and merchant level to maintain competitive tension and efficient pricing. To this end we recommend:

- The Reserve Bank of Australia require schemes to refrain from mandating contactless terminals and to not discriminate against chip & dip alternatives.
- The Bank requires the EMV specifications for future mobile payments to re-establish the network and currency choices and surcharging capabilities.
- The Bank requires schemes to implement their system, operation and business enhancements in a way that maintains choices for issuers, acquirers, merchants and card holders.

Only recently has there been some questioning in the media for instance, about the surcharging of a contactless payment surprising the consumer (ASIC vs ALDI). While this was firstmost a failure in signage, the press coverage showed the unawareness of consumer with regard to surcharges on transactions and particularly contactless transactions through tap and go.

Prevalent Anti–Competitive Structures and Culture

Despite a lot of recent hype around new technologies and new technology players, startups 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 Australians' deposit.

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 and inertia.

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 FSI Interim Report invites"views on the level and exercise of market power across the various markets in which the major banks operate."

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.

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 cross-subsidising, product bundling, packaging and cluster-pricing for banking services.

Tyro re-iterates its recommendation from its first submission for an ACCC Inquiry into anti-competitive culture, structures and behaviours in the Australian payment space.

The 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" stifles effectively innovation and competition, leaving the affected competitors without recourse. For a startup 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.

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.

Other Opportunities - Public Procurement

The FSI Interim Report has emphasised as the first priority issue competition and contestability.

Tyro wants to reiterate the thought that 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 startups, 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 and its would be very keen to compete under a panel arrangement 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.

It is a big opportunity for Government. And it is timely. Australians want more competition.

Recommendations from the first Tyro Submission

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

Conclusion

While the banking sector has been seen by the Inquiry as competitive, albeit concentrated, the experience for new entrants is otherwise. 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.

That stifles 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 integrity and stability as well as access of the system. 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..

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.

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.

Jost Stollmann, CEO

APPENDIX:

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.