

20 July 2011

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Payments Policy Department
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Dear Chris

Submission - Review of Card Surcharging

Tyro Payments Limited is a Specialist Credit Card Institution authorised by the Australian Prudential Regulation Authority. It has launched 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 invitation for submissions to the *Review of Card Surcharging: A Consultation Document*. In Tyro's opinion, it is time for the banking industry, schemes, issuers and acquirers, to take ownership and embrace the surcharging concept. It is their responsibility to provide the merchant community with a transparent, auditable and cost based surcharging process.

I. Is there a case for modifying the Standards to allow schemes to limit surcharges?

Tyro supports the Reserve Bank of Australia's aim to promote the efficiency and competition in the Australian payment system by giving all participants choices on the basis of cost based price signals and as such believes that the merchants' right to surcharge should be retained. Tyro recommends the following changes:

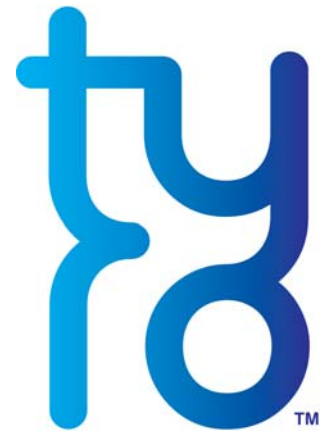
1. To eliminate the practice of Excessive Surcharging, Tyro recommends allowing schemes to re-instate the no-surcharge scheme rule for merchant point of sale transactions that do not offer an equivalent (in terms of convenience and security) surcharge-free payment alternative.
2. To reduce the practice of Blended Surcharging, which dulls price signaling, Tyro recommends allowing four party schemes to cap the amount of surcharging in function of interchange fees and three party schemes in function of the merchant service fees.

II. Is a surcharge cap best implemented by the Board setting a transparent and specific permissible cap that is specified in the Standards, and may then be imposed in scheme rules? Or, should the Standards allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance?

Today's surcharging uses predominantly blended rates. That minimizes investment into system and simplifies the cardholder dialogue at the point of sale. It does however dull the price signals, thus not delivering the cost transparency and

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interchange rate pressure that it could, if it was applied in a cost differentiated way. The crude method of just surcharging card payments, or just differentially surcharging four party and three party schemes does not reflect the increasing gap between low-cost and high-cost card products within the same scheme.

There is a path toward transparent, policeable and cost-based surcharging with limited complexity and investment. It uses the by now well established process of surcharging in the ATM space and reflects that interchange is the dominant cost factor and cost differentiator.

RBA statistics show merchant service fee for Visa and MasterCard at 80 basis points. Assuming currently interchange at 55 basis points and backing out scheme fees, the interchange fee is 3 times higher than the other costs reflected in the acquirer margin. The scheme interchange fees vary by a factor of 6.8 between 0.275% and 1.87% depending on the card payment type.

Analogous to the ATM process, the merchant would submit the surcharge amount with the authorization process and print on the receipt the actual merchant service fee of the transaction. With the full fee disclosure to schemes and card holders, the merchant would be allowed to surcharge if he offers an equivalent surcharge-free alternative.

The four party schemes would be allowed to cap the surcharge at twice the interchange rate and the three party schemes at 1.5 times the merchant service fee applicable to the specific transaction type.

The factor determine how closely the surcharge is related to direct transaction interchange and processing costs and annex costs like terminals, gateways, PCI-DSS compliance, risk premiums and other fees. The merchant has an incentive to use differentiated surcharging.

This policy re-establishes cost signals by eliminating the non-transparent significant cross-subsidies of

- expensive schemes to the detriment of less expensive ones,
- expensive card products to the detriment of the less expensive ones and
- largest merchants with preferential interchange fees to the detriment of the remaining merchant community.

There are segments in the market that face particular cost structures when delivering a card payment service. These Merchant Service Codes (MCC) would require specific, higher but cost based surcharge caps.

An example is the Tyro merchant National Billing Group, trading as Cabfare, who entered the cab and limousine card payment market that is dominated by Cabcharge. The 10 percent surcharge in the industry, independently of arguing the exact level, does reflect the higher costs of

- maintaining the additional EFTPOS terminal infrastructure in a moving vehicle fleet under taxing conditions of use,
- the complexity and costs of various additional participants like third party processor, fleet operators and churning cab drivers and
- the cost of fraud management, disbursements and reporting



Should there be some level of tolerance allowed around any surcharge cap?

Tyro's concept is based on real costs. It is automated, auditable and transparent. The only case where a level of tolerance is required concerns specific merchant segments facing significant cost particularities. In that case, a cost based review and exemption should lead to adjustments to the surcharging limits. That would be the case to the cab and limousine industry, whose surcharges have to reflect the heightened terminal, fraud and processing costs in this specific environment.

Is the merchant service fee an appropriate measure of the cost of card acceptance (that can be applied consistently across all merchants)?

No, the best measure for the cost of card acceptance is the interchange fee, since it is known by the four party schemes and set by them. It is the dominant and most variant cost element of merchant services fee and it is published by Visa and MasterCard on their web sites. Schemes can police interchange fees easily. They do not know merchant service fees.

From an industry policy point of view, the interchange fee is the cost component of the value added chain that is sheltered most against competition. No merchant, except the largest ones, can discuss and negotiate the interchange fee with their bank. However, by making it the base of the surcharge cap and by incentivizing differentiated surcharging, there is some competitive tension building around setting interchange fees. Higher interchange fee costs will be reflected in a heightened surcharge limits so as to transfer a correct price signal to the point of sale and the card holder.

Three party systems can use merchant service fees to measure the cost of card acceptance and use them to cap surcharging. These schemes do know the actual merchant service fee charged to the merchant.

Should merchant service fees be used to measure the cost of card acceptance, the four party schemes would not be able to police the surcharging, since they are no party to the setting of the merchant service fee. The use of MSF as benchmark would also be subject to "gaming". The acquirers would have to monitor the compliance, because of the technical limitations to transmit surcharge and charged amount in current message protocols.

In this case, the differentiated or blended merchant service fee or possibly a heightened merchant service fee to reflect annex costs would be basis for the cap. The blended surcharge would need to be matched with the merchant service fees for the weighted mix of the blend.

A surcharge cannot be applied to merchants using today's scheme contact-less transactions, because for surcharging to happen the amount of the transaction needs to be determined in advance of knowing the card used by the card holder.

III. Should the no-surcharge Standards clarify that, notwithstanding any surcharging cap, scheme rules cannot prohibit merchants from applying a surcharge that is either a blended rate for each card scheme or the cost of accepting each card within a card scheme? Are there alternative ways to allow for differential surcharging?



The no-surcharge Standards should clarify that their intention is to improve price signals facing consumers choosing between different payment methods offered by different schemes.

Thus schemes should be explicitly prohibited from disallowing or limiting differential surcharging and that includes differentiating between card products within the scheme as well as between schemes.

The way to enable differential surcharging is to use the ATM type automated and fully disclosed process.

IV. Should the no-surcharge Standards require acquirers to pass on information about the merchant's cost of acceptance for each different card type if it is requested by the merchant? And, for those on 'interchange-plus' pricing, should the no-surcharge Standards require acquirers to pass on information about the weighted average merchant service fee if it is requested by the merchant?

The acquirer invoices the merchant service fee to his merchant and thus the merchant has his cost of acceptance for each different card type. Since many acquirers charge a blended merchant service fee, the different card types have the same cost for him, while the acquirer suffers from significant cost differences due to the various interchange fees.

The "interchange-plus" merchant has also the information to calculate his weighted average merchant service fee on the basis of the invoicing. In his case, his costs or merchant service fee will be closer related to the acquirer's costs of which the dominant element in the form of the interchange fee has been passed on.

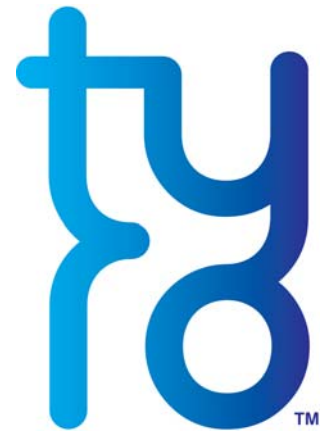
V. Is there a case for disclosure of the cost of card acceptance by merchants? Or, would it be sufficient for the Bank to collect and publish more detailed data on merchant service fees, such as the range and average of merchant service fees across merchant categories for each card scheme?

Tyro recommends that the acquirer should be required to print the merchant service fee of the transaction on the card holder receipt as to assure full disclosure. The receipt would show the cost to the merchant and his surcharge.

The merchant who surcharges actual costs would be able to legitimize the surcharged amount. The merchant who refrains from passing on the cost would be able to make this transparent as a service to his customer and the one who heightens the surcharge beyond his own merchant service fee would have given the card holder the chance to question and challenge his pricing.

The Reserve Bank of Australia should prohibit the schemes from disallowing acquirers to report to their merchants the scheme fee assessments. Tyro has introduced to the Australian market transparent interchange fee reporting. Adding scheme fee reporting would further the merchants ability to manage their costs.

The Reserve Bank of Australia should publish average scheme debit and EFTPOS debit card merchant service fees, as it does for credit and charge card merchant service fees.



The Tyro proposal to cap surcharging at a multiple of interchange fee or merchant service fee and the full disclosure requirement on the receipt create the transparency at the moment and place when and where it matters, when choices are made i.e. the place and time of the actual payment transaction.

Contactless card technology eliminates any surcharging differentiation between schemes, EFTPOS or card types.

Contactless cards remove the need and possibility for cardholders to have any interaction with the terminal for transactions under a certain limit. For the cardholder of a multi-function card and for the accepting merchant, this removes the ability to choose the payment type and network choice at the EFTPOS terminal for contactless payments.

The issuer pre-determines the payment type and network default. The cards are in fact single scheme cards when they operate contactless. The one step process eliminates the ability of the merchant to surcharge the card.

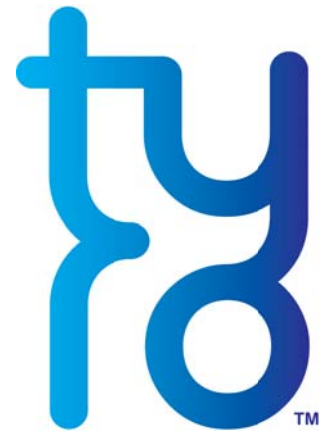
The technology is designed in a way that requires the amount of the transaction to be determined by the terminal before there is any knowledge of the type of card in the wallet tapped on the terminal. The card creates a cryptogram which includes the amount in the algorithm used and sends it to the issuer. This is done to prevent modification of the amount after approval by the card, as there is no other proof of the amount accepted, i.e. no signed paper authorization.

The surcharge right for contactless transactions has been in effect eliminated. Theoretically, a merchant can surcharge all card payments with the same rate applied to all cards; credit, debit, EFTPOS, swiped, dipped or tapped. A default surcharge amount for scheme contactless does not work technically and would not accurately offset the actual cost to the merchant of processing each individual transaction.

The Reserve Bank of Australia could attenuate unwarranted effects due to the inability to surcharge by subjecting contactless card payments to the same interchange regulation as applicable to debit cards. This would only reflect the economic reality that cost-based surcharging is essential a reversal of high interchange rates. It would also give the schemes an incentive to implement contactless chip and mobile payments in a way that maintains network choice and allows surcharging.

Visa account level processing (ALP) eliminates the ability to differentiate card type at the terminal

Visa has announced that it will implement changes to support account level processing (ALP) in Australia. This change marks a fundamental shift in the way that transactions will be processed in Australia, enabling issuers to customize consumer credit products at the account number level (instead of using a six-digit Bank Identification Number (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 having to obtain 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. That way acquirers and merchants would retain the possibility to surcharge 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 allowing 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 is happy to provide its merchants the required technology, should the industry move towards differential surcharging. The disarmingly simple alternative is to eliminate or significantly reduce the interchange fee and with it the surcharging requirement.

Yours Sincerely

A handwritten signature in blue ink, appearing to read 'Jost Stollmann', written over a light blue horizontal line.

Jost Stollmann
CEO