Deloitte Access Economics

Regulatory Treatment of PayPal Australia

PayPal Australia

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Contents

Glossary

ADI	Australian Deposit-taking Institution
AFSL	Australian Financial Services Licence
AML	Anti-Money Laundering
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
BIS	Bank for International Settlements
CTF	Counter Terrorism Financing
DAE	Deloitte Access Economics
FDIC	Federal Deposit Insurance Corporation
FSI	2014 Financial System Inquiry
KYC	Know Your Customer
MAS	Monetary Authority of Singapore
NCCL	National Consumer Credit Laws
PPF	Purchased Payment Facility
RBA	Reserve Bank of Australia

1 Executive Summary

The 2014 Financial Sector Inquiry (FSI) Final Report included a number of recommendations to reform the Australian payments system. Against the background of a rapidly evolving payments system that is being disrupted by new technologies, this paper seeks to help the Government better understand the role of PayPal Australia as it considers policy reform.

PayPal is the world's leading digital wallet provider that allows buyers and sellers to send and receive payments online, by mobile device or in-store (in some countries). PayPal Australia facilitates the transfer of funds from customers' credit or debit card, bank account and/or PayPal balance to the accounts of other PayPal users. PayPal also stores value in account balances on behalf of some of its users for the purposes of making payments. PayPal focuses primarily on facilitating low value payments, and is still a relatively small player in the Australian payments ecosystem.

PayPal operates in a two-sided payments market and – for the limited transactions that are funded from PayPal account balances – it operates like a three-party arrangement. However, it is fundamentally different from the three- and four-party card schemes, such as Visa, MasterCard and American Express, as it does not employ an interchange fee-like mechanism to materially balance incentives between participants.

PayPal Australia holds an Australian Financial Services Licence (AFSL) from the Australian Securities and Investments Commission (ASIC) to provide non-cash payment products. Given that PayPal also stores value in account balances on behalf of some of its users for the purposes of making payments, it is considered a Purchased Payment Facility (PPF), and is subject to prudential regulation by the Australian Prudential Regulation Authority (APRA).

The FSI Final Report identifies a number of payments service providers that are active in different areas. It is useful to separate and regulate differently the various types of payments service providers. We delineate three classes of electronic payments products that each comprises payments service providers that are different in nature: (i) payment scheme providers; (ii) digital wallet providers; and (iii) digital currency transactors. In addition to payments system regulation, a fourth class of product consisting of holders of stored value would be subject to prudential regulation.

- **Payment scheme providers** include Visa, MasterCard, American Express, BPAY, eftpos, and direct entry. In particular, the three- and four-party card schemes, which function largely through indirect merchant and consumer relationships and employ an interchange mechanism to balance incentives between consumers, merchants, and card issuers and acquirers will continue to be subject to payment system regulation by the Reserve Bank of Australia (RBA).

- **Digital wallets**, such as PayPal, allow customers to store personal credentials and financial details electronically to enable commerce transactions. Given a recent expansion in the number of available digital wallets from multiple parties (e.g. Visa, MasterCard, American Express, Apple), it is important to manage the associated risks, such as a potentially greater risk of fraud. Consumers may be better protected by expanding the ASIC ePayments Code to support these new developments, and by mandating adherence as suggested by the FSI.

- **Digital currencies** are not currently regulated and may not be regulated easily. However, the entities that allow customers to transact in them and link them to the traditional payments ecosystem can, and should, be appropriately regulated. Moves to regulate digital currencies in Australia should not capture digital wallets and payment system providers, which are a completely different kind of electronic payment product.

- **Holders of stored value.** Conceptually separating a service providers' payments function from its holder of stored value function allows a clearer understanding of the regulatory perimeter between payments regulation and prudential regulation. This will help provide clarity to potential new entrants. PayPal is currently subject to prudential regulation because it is a holder of stored value, but it is conceivable that another provider of a digital wallet which does not hold stored value would not be subject to any prudential regulation.

Three recommendations in the FSI Final Report could affect the regulation of ePayments:

Recommendation 16 (clearer graduated payments regulation). A graduated framework that allows for a more proportionate approach – matching the relative risk with the regulatory impost – is a good principle which would likely lower barriers to entry, thus improving competition, choice and efficiency. A strong regulatory framework for digital wallets that hold stored value (currently PPFs) is important for ensuring continuing payments system stability and confidence. The two-tier framework proposed in the FSI could accommodate these considerations. Digital wallets that hold stored value would be subject to different levels of regulation based on their level of materiality. The quickly evolving payments landscape means that the test of materiality should be a dynamic and ongoing consideration. A volume- and/or funds-based thresholds should take into account the potential for regulatory gaming and the designing of products that elude regulatory threshold triggers. Should a graduated regime only capture holders of stored value that are over a certain materiality threshold, then the FSI recommendation to narrow ASIC's AFSL regime through a similar materiality criterion should take into account the risks of certain facilities being outside the regulatory perimeter of both regimes.

Recommendation 17 (interchange fees and customer surcharging). Policy makers should clarify the criteria that would determine which regulatory frameworks digital wallet providers and holders of stored value would be subject to under the regulations recommended in the FSI Final Report regarding interchange fees.

Recommendation 39 (technology neutrality). Technology neutrality promotes innovation and competition. It should be embedded into the development process for future regulation. Technology neutrality will allow for new products, innovations and technology to be adapted in the payments system. The regulatory regime should recognise and facilitate rapid technological change.

Looking to the future it is impossible to predict what will happen in payments. Regulators need to be agile and flexible to respond to changes in the payments environment. Setting principles for regulation, rather than prescriptive guidelines, will help to achieve this.

2 Background

The 2014 Financial System Inquiry (FSI) Final Report outlines 44 recommendations to Government, several of which pertain to Australia's payments system. The Report calls for further research, analysis, and stakeholder input before detailed policies are finalised.

Given the payments system – and the financial system more broadly – is evolving rapidly, the industry can perform a valuable role helping policy makers keep abreast of new developments in order to help them make the right decisions on policy and regulatory settings.

The purpose of this report is to assist Government to understand what PayPal Australia is (i.e. a digital wallet provider and limited Authorised Deposit-Taking Institution (ADI)), what it is not (i.e. a card scheme such as MasterCard or American Express), and how it is regulated.

This report begins by outlining what PayPal is, the core services it provides, and how it is regulated in Australia.

The report then suggests and defines four different classes of electronic payments products in Australia – including outlining how these classes are different from one another. The aim is to create a level, fair and competitive regulatory regime. The report notes that a payments system which does not employ a mechanism to materially 'balance' the dynamics between system participants, such as interchange fees, should not be regulated in the same way as the three- and four-party card schemes.

The report then outlines and responds to three key recommendations in the FSI Final Report which, if pursued by Government, are expected to affect the regulation of electronic payments and subsequently the competitive landscape in which they operate.

Finally, the report looks to the future and notes that payments regulation should accommodate technology development. Integrating and harmonising payments regulation in Australia is likely to improve stability in the sector, while a streamlined regulatory regime may increase legal certainty for incumbents and potential market entrants (thereby fostering competition).

3 What is PayPal

Founded in 1998, PayPal has been operating in Australia since 2005 and has almost 6 million active consumer accounts and over 110,000 merchant partners today.

PayPal is the world's leading **digital wallet** provider, allowing buyers and sellers to send and receive payments online, by mobile device or in-store (in some countries). These transactions can be funded through a variety of methods (e.g. credit card, debit card, bank account or PayPal stored-value balance). In Australia, PayPal is also a **limited ADI** regulated by APRA in that it allows customers to receive a payment as stored value in their PayPal account which may be reused to make a payment to other PayPal customers or it may be withdrawn via their linked bank account (in this sense it is "deposit like"). However, PayPal Australia is not permitted to undertake more traditional activities associated with deposit taking, such as charging and/or paying interest on any customer stored balances.

PayPal is a facility that provides consumers with the choice of how to fund their purchases securely using their existing payment methods and gives sellers the ability to easily accept payments via these different methods. In this sense, PayPal sits on top of the existing banking and credit card infrastructure,[1] aggregating these disparate financial services in the PayPal wallet, and providing consumers with the choice of how they wish to pay using these payment systems. PayPal provides a global, real-time payment service to users. PayPal processes transactions utilising the payments infrastructure provided by the card schemes and the broader banking system.

PayPal focuses primarily on facilitating low value payments. It provides a convenient way for consumers to make ad hoc payments and provides a useful alternative to more established payments mechanisms. It is still a relatively small player in the Australian payments ecosystem.

PayPal originated as an innovative offering to facilitate electronic payments online and continues to make it easy for sellers to accept secure digital transactions. In response to customer demand, PayPal now also functions in mobile and in-store channels; 1 in 3 transactions on PayPal now take place on a mobile device.

PayPal complies with diverse and rigorous regulatory requirements both domestically and overseas. Given its business model, PayPal Australia is appropriately regulated as a limited ADI and digital wallet provider in Australia. PayPal Australia is also regulated by Australian Securities and Investments Commission (ASIC) and the Australian Transaction Reports and Analysis Centre (AUSTRAC), as described below. PayPal Australia also subscribes to the ASIC's voluntary ePayments Code of Conduct which protect consumers from unauthorised transactions.

[1] PayPal effectively acts as the 'seller' to the end consumer and as a 'buyer' to the merchant.

3.1 Payment flows

For a typical PayPal transaction, both buyer/sender and seller/receiver need a PayPal digital wallet to send or receive funds. Transactions flow through a centralised global database connected to banking systems and card schemes. These transactions are supported by monitoring, compliance, and fraud prevention systems; and are required to comply with all appropriate legal and regulatory requirements to help prevent financial crime, such as Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) laws.

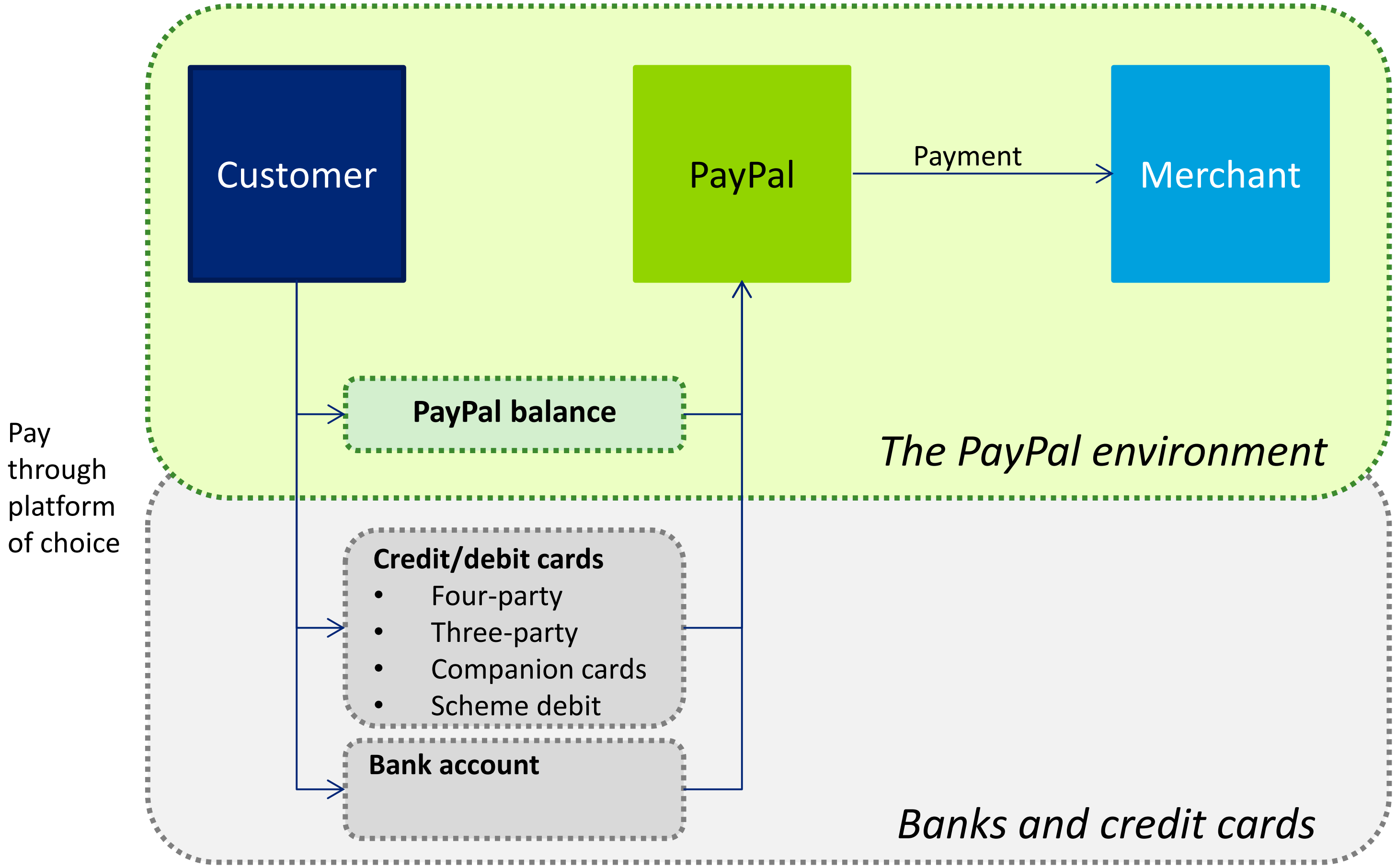
Risk management is a core service and competence of PayPal. PayPal takes on risk, as a provider of real-time payments to buyers and sellers. Thought its direct relationship with its customers, PayPal provides real-time processing on top of a banking and credit card infrastructure which, in Australia, does not function in real-time. In addition to this, PayPal also provides dispute arbitration and seller/buyer protection.

In transactions that are funded from a buyers' credit/debit card or bank account, PayPal processes the payment to the seller at the same time as the buyer's payment to PayPal is being processed. In this capacity, PayPal plays a role much like a payments gateway or merchant acquirer.

As Figure 3.1 shows, PayPal operates differently to credit and debit card systems. As two-sided markets, all payment platforms seek to attract both customers and merchants to use their platform. For scheme credit and debit, this involves the incorporation of intermediaries who hold the primary customer and merchant relationships, issuing and acquiring banks. Schemes utilise an interchange mechanism to balance the economics between these parties and incentivise behaviour from consumers and merchants. In Australia, there has been increased issuance of premium cards with higher interchange fees that seek to incentivise issuers to promote particular products and increase use through better customer rewards and benefits.

PayPal, on the other hand, does not provide explicit financial incentives such as rewards to attract customers or drive merchant behaviour. As such, there is no material 'rebalancing' of the costs and benefits with buyers and sellers that is equivalent to the rebalancing facilitated by interchange fees in the schemes. As a result, merchant costs relate more directly to the cost of processing the payments, and do not subsidise incentive payments to customers.

Figure 3.1: The PayPal environment



Source: DAE

3.2 Why customers use PayPal

PayPal is typically used for low-value transactions and predominantly caters to small businesses, online merchants, and individual consumers.

The choice of payment options afforded allows buyers to choose the manner in which they fund the payment, as shown above, whilst not requiring them to disclose potentially sensitive financial information. This provides a better service for buyers/ sellers including:

- **Convenience**. Consumers only have to enter their payment and shipping details once into the PayPal system, reducing the need to duplicate data input for multiple merchants.
- **Privacy**. The merchant does not see the financial details of the consumer, because the information has already been stored in PayPal's record management system.
- **Assurance**. A secure, closed loop system, where PayPal can identify both sides of a payment, with in-built buyer and seller protection plans.
- **Real time payments.** The seller's PayPal account is credited and buyer's account is debited in real time.
- **Fee transparency.** Merchant fees more accurately reflect the cost of processing the payments, and are not aimed at subsidising incentive payments to customers.
- **Risk management.** PayPal manages transaction risk for buyers and sellers which forms part of its cost base.

For **personal transactions**, the sender of the payment usually chooses who pays the fee. This fee seeks to reflect the underlying cost drivers of making the transaction. For example, for a transfer funded by either the customer's bank account or PayPal stored balance between two Australian PayPal accounts there is no fee; whilst for a payment funded by a credit card the fee is typically 2.4% plus $0.30, reflective of third-party scheme and network fees.

PayPal is also commonly used by **sellers** who would not otherwise be able to accept card/bank payments, such as businesses/merchants too small to have merchant card facilities or occasional or one-time sellers, such as on eBay. The service provides an easy, seamless capability to accept electronic payments that is quick and low-cost to set up.

For **commercial accounts**, the service fees also seek to reflect the underlying costs. There is a standard transaction fee to cover operational, fraud and acquiring costs, but this may decrease based on a seller's total transaction volumes to reflect economies of scale. Similarly, a fee for a transaction funded by an overseas credit card will attract a commensurately higher fee to reflect the costs charged by the card schemes.

Myth Busters – Common misunderstandings of PayPal

The operation and services provided by PayPal can be misunderstood – several of these 'myths' are outlined below:

1. PayPal is like a bank but is unregulated

Myth – While PayPal Australia is not a bank, it is regulated by the Australian Prudential Regulation Authority (APRA) as a 'Purchased Payment Facility'. The PayPal product is not an investment product and no interest is payable on the stored balance component of the PayPal product.

2. PayPal is a card scheme like Visa, MasterCard or American Express (as defined in the FSI's Final Report, Fig 11, p. 172)

Myth – While PayPal operates as a three-party arrangement for 10 per cent of its transactions that are funded from PayPal account balances, it is fundamentally different from the three- and four-party card schemes, such as Visa, MasterCard and American Express. These card schemes function largely through indirect merchant and consumer relationships, typically facilitated by banks, and employ an interchange mechanism to balance incentives between consumers, merchants and card issuers and acquirers.

PayPal has direct relationships with its buyers (customers) and sellers (merchants) and does not employ an interchange fee-like mechanism to materially balance incentives between participants.

3.3 How is PayPal regulated?

PayPal Australia, as a digital wallet provider and limited ADI, acts like a merchant acquirer which sits atop existing Australian banking and credit card infrastructure, as depicted in Figure 3.1. It is subject to a variety of legislation and is regulated by multiple regulators. This is described in the box below.

PayPal Australia is licensed by APRA as an ADI limited to undertaking business as a Purchased Payment Facility (PPF), providing payment services typically for the sale of goods and services and for person to person transactions. PayPal Australia also holds an Australian Financial Services Licence (AFSL) from ASIC to provide non-cash payment products. In addition, PayPal Australia is regulated by the AUSTRAC as a Reporting Entity relating to AML and CTF.

Given the types of services provided, PayPal Australia is therefore appropriately regulated in the Australian market.

Regulation of PayPal around the world

The Bank for International Settlements (BIS) summarised the regulatory treatment of PayPal in selected countries.[2] It notes that regulation generally focuses on PayPal's operations as a provider of stored value or 'electronic money', and as such is not often treated as a bank.

European Union. In the EU, PayPal is prudentially regulated as a bank, but is not considered a deposit-taker (since its main service is the issuance of electronic money), and so is not protected by the deposit guarantee system. This replaces previous regulations, where, between 2004 and 2007, PayPal Europe was licensed as an electronic money issuer with the UK Financial Services Authority.

Singapore. In Singapore, PayPal Private Limited is considered a holder of stored value, and is not considered to be a deposit-taker by the Monetary Authority of Singapore (MAS). Holders of stored value facilities in Singapore are encouraged to adopt guidelines set out by the Monetary Authority of Singapore, addressing issues such as redemption, disclosure and protection. PayPal has adopted the recommendations of MAS.

United States of America. PayPal is licensed as a money transmitter in a majority of US states, and is registered with the US Treasury as a money services business. The Federal Deposit Insurance Corporation (FDIC), in 2002, stated that it does not consider PayPal to be a bank. However, it is subject to AML/CTF laws and consumer protection regulations.

Australia. PayPal Australia is considered a provider of purchased payment facilities. APRA regulation requires all holders of stored value in relation to PPFs to be ADIs, unless otherwise exempt. As such, PayPal is prudentially regulated by APRA and subject to capital, liquidity and other operational requirements. It is also the holder of an AFSL issued by ASIC and is a reporting entity regulated by AUSTRAC.

[2] Bank for International Settlements, *Non-banks in retail payments*, September 2014

4 Electronic payment products

The FSI's final report identifies the objectives of its Recommendation 16 to ensure that retail payments system regulation:

- maintains confidence and trust in the payments system;
- is better understood by the industry, particularly new entrants, and accommodates rapid market development;
- provides adequate consumer protections; and
- provides competitive neutrality for PPFs.

In addition, the recommendations highlight the need to:

- clarify regulation and enhance competitive neutrality between system providers; and
- improve the efficiency and effectiveness of price signals, and reduce the potential for cross-subsidisation between customer groups and merchant groups.

In support of these objectives, it is useful to separate and regulate differently the various types of payments service providers operating in the Australian retail payments system. As illustrated in Figure 10 (p. 164) of the FSI Final Report, there are numerous payments service providers active in different areas. For the purposes of identifying an appropriate approach to achieving the objectives described above, we delineate three classes of electronic payments (ePayments) products in Australia. These classes each comprise payments service providers that may be fundamentally different in nature, for example, credit card scheme providers differ from providers of digital wallet services, which in turn differ from digital currencies.

The three suggested classes are:

- Payment Schemes (e.g. Visa, MasterCard, American Express, BPAY, eftpos, direct entry)
- Digital Wallet Providers (e.g. PayPal, MasterPass, ApplePay)
- Digital Currency Transactors (e.g. Bitcoin)

However, in addition to payments system regulation, some payments service providers such as PayPal Australia are subject to prudential regulation related to their holding of stored value on behalf of another person. As previously mentioned, this is currently regulated under the PPF regime. We believe that a function as a holder of stored value should be conceptually separated from the function to make payments, and that this will provide greater clarity to potential new entrants. Essentially, this adds an "additional" class of product:

- Holders of stored value (e.g. PayPal account balances)

Given the differences between these classes of ePayments products, each class should be subject to regulations which are appropriate for its specific nature. Regulatory overlap should be minimised.

Globally there are typically three broad policy considerations that dictate the level of regulation for stored value payment/non-cash payment holders of stored value (or 'e-money' as defined by the European Commission) services (as applicable):

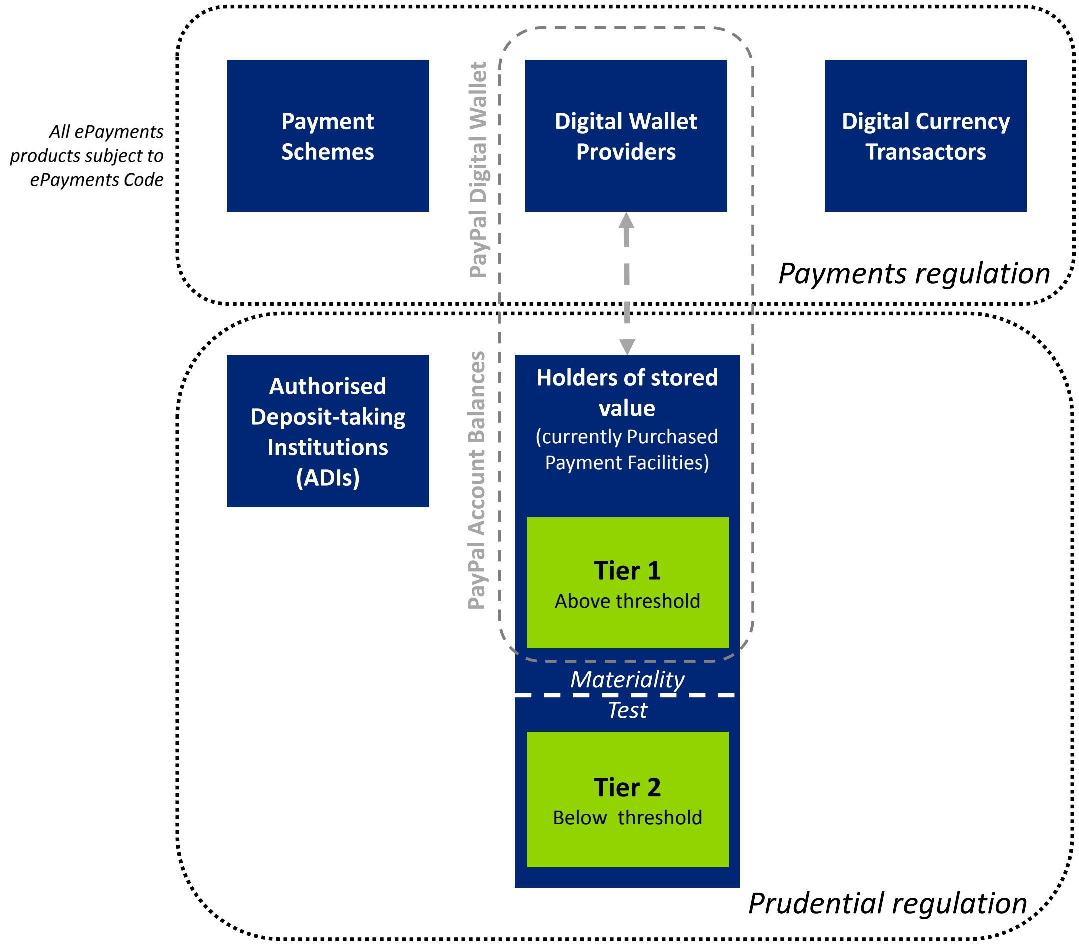
1. consumer protection;
2. transaction security and financial crime prevention; and
3. prudential oversight, liquidity and capital requirements relative to risk.

These policy objectives would need to be taken into account by all payments service providers.

The ASIC ePayments code of conduct is a voluntary industry code designed to ensure adequate consumer protection for payment facilities. Policy makers should adopt the FSI's recommendation to make this code mandatory for all ePayment product providers. Similarly, appropriate 'Know Your Customer' (KYC), AML/CTF, fraud and other financial crime prevention measures should also be required of all service providers.

Figure 4.1 provides an illustration of the proposed classes of ePayment products and the payments and prudential regulations that apply to each.

Figure 4.1: Regulated classes of ePayment products



Source: Deloitte Access Economics

4.1 Payment Schemes

In Australia there are several payment platforms which operate in the two-sided payments market. These include cash, scheme cards, eftpos, direct entry and BPAY. Of particular relevance are:

- four-party card schemes such as MasterCard and Visa; and
- three-party card schemes such as American Express and Diners Club.

Four-party card scheme transactions are facilitated by exchanges between the merchant's bank (the acquirer) and the cardholder's bank (the issuer) with a payment known as an interchange fee. As discussed above, while interchange fees were originally used to encourage issuers to join the schemes, they are currently used to encourage cardholders to use particular brands. The Reserve Bank of Australia (RBA), as the payments system regulator, felt that these incentives were leading to an inefficient over-utilisation of scheme cards, since cardholders were receiving the benefits from cards but not bearing the cost. As such, the RBA decided to regulate interchange fees in 2004.

Traditional three-party proprietary schemes operate according to a broadly similar structure to four-party schemes. However, instead of separate acquiring and issuing entities within the platform, the card scheme itself directly fulfils both of these roles. More recently, the three-party schemes have begun issuing cards via bank partnerships ('companion cards'), effectively adopting the four-party model. Incentive payments have been paid to issuing banks that are similar in function to the balancing role the interchange fee plays in traditional four-party schemes.

Given transactions for three- and four-party card schemes are facilitated by interchange fees, this is where the FSI has focused its attention in Recommendation 17. Should a payments system not employ a mechanism to materially 'balance' the dynamics between the parties in the system, such as interchange fees, then the system should not be regulated as a Payments Scheme.

PayPal does not apply interchange fees as a mechanism to 'balance' the dynamics on the two sides of a payments market. It is only in limited circumstances where payments are made from one PayPal balance to another (constituting a closed loop service) that PayPal operates in an arrangement of three parties. As depicted in Figure 3.1, the majority of payments through PayPal Australia involve multiple parties that are external to the PayPal environment. As such, PayPal should not be defined as a three-party system in the same sense as the charge card systems such as American Express and Diners Club.

4.2 Digital Wallets

A digital wallet is an electronic service that allows a customer to store personal credentials and financial details electronically to enable commerce transactions (e.g. purchasing items on-line, using a smartphone, or in-store).

Given a recent expansion in the number of available digital wallets from multiple parties (e.g. Visa, MasterCard, American Express, Apple), it is important to manage the associated risks, such as a potentially greater risk of fraud. Consumers may be better protected by expanding the ePayments Code to support these new developments, and by mandating adherence.

PayPal is a provider of a digital wallet and provides payments processing services. As a provider of payment processing services, PayPal Australia facilitates the transfer of funds from customers' credit or debit card, bank account and/or PayPal balance to the accounts of other PayPal users. PayPal stores value in account balances on behalf of some of its users for the purposes of making payments. For this purpose, PayPal Australia is currently a PPF and holder of the stored value under the *Payments System (Regulation) Act 1998*.

To provide greater clarity we suggest separating the digital wallet's payments facilitation function and the holding of stored value function. This allows a clearer understanding of the regulatory perimeter between payments regulation and prudential regulation. Conceivably, a provider of a digital wallet that does not hold stored value would not be subject to any prudential regulation.

4.2.1 Holders of Stored Value

The requirements for a PPF and holder of stored value to be a licensed ADI (albeit with limitations) relates to the need for the holder of stored value to hold adequate liquid assets to meet its liabilities to make payments and hold adequate capital commensurate with the risks of its activities.

Given the objective of maintaining confidence and trust in the broader payments system, any consideration of reduced prudential requirements for payments service providers that hold stored value should be subject to an assessment of materiality. We recognise that the magnitude of risk presented to the system by any given player may be a function of payments volume, but other criteria may also be appropriate (discussed in Section 4). The two-tier framework proposed in the FSI may be able to accommodate these considerations.

On the other hand, should the prudential requirements be maintained at the current standard, we nonetheless believe that the conceptual separation of prudential and payments regulation will still assist to provide clarity to potential new entrants.

4.3 Digital currencies

With respect to digital currencies, the regulatory framework in Australia is not currently clear. Digital currencies are difficult to regulate directly because there is typically no clearly identifiable operator. However, it is increasingly clear that, whilst currencies themselves may not be regulated easily, the entities that allow customers to transact in them and link them to the traditional payments ecosystem can, and should, be appropriately regulated.

As PayPal Australia highlighted in its submission to the Digital Currency Inquiry:

"It is important to draw a distinction between digital currencies, versus the companies that trade or facilitate transactions in digital currencies. While the currency itself should not be regulated, and transactions by individual users without the assistance of intermediaries should not be regulated, companies that provide a financial service for digital currency transmission, for issuance or sale of digital currency, or for exchange with other currencies

such as the Australian Dollar, should be regulated in a manner similar to the existing regulations that apply to other payment services."

Any move to regulate digital currencies in Australia should not capture digital wallets and payment system providers, which are a completely different kind of electronic payment product. However, any service providers that facilitate transactions across digital and fiat currencies should be covered by appropriate KYC, AML/CTF, fraud, financial crime, risk management and prudential regulation to ensure the integrity of the system and protect consumers.

4.3.1 PayPal's involvement in digital currencies

Recently PayPal has, through its payment gateway subsidiary, Braintree, enabled the integration of digital currency (specifically, Bitcoin) payments in the United States. The actual Bitcoin processing will not be conducted by PayPal, but by partners that have been verified to have appropriate compliance and risk programs. PayPal is doing this to be responsive to market demands and to support innovation. However, this does not enable the use of any digital currencies (including Bitcoin) within PayPal's core digital wallet services.

PayPal digital wallets are not digital currencies, nor do they hold digital currency and as such should not be captured under any definition of what constitutes a digital currency or any regulation applied to digital currencies beyond that with which PayPal already complies.

5 FSI recommendations

Recommendations outlined in the FSI Final Report may, if pursued by Government, affect the regulation of PPFs and the competitive landscape in which they operate.

The key recommendations of focus from the FSI are Recommendation 16 (clearer graduated payments regulation), Recommendation 17 (interchange fees and customer surcharging), and Recommendation 39 (technology neutrality).

5.1 Recommendation 16

Recommendation 16 is:

- to enhance graduation of retail payments regulation by clarifying thresholds for regulation by ASIC and APRA; and
- to introduce a separate prudential regime with two tiers for PPFs.

Given the potential for confusion created by regulatory overlap and the high barriers to entry for some payment providers, a graduated framework that allows for a more proportionate approach – matching the relative risk with the regulatory impost – is a good principle. This would likely lower barriers to entry, thus improving competition, choice and efficiency. It is also an opportunity to improve competitive neutrality by lowering liquidity requirements for service providers who are able to demonstrate strong risk management and compliance with other prudential requirements.

A strong regulatory framework for PPFs – or digital wallets that hold stored value – is important for ensuring continuing payments system stability and confidence.

The two-tier framework proposed in the FSI could accommodate these considerations:

- a top-tier, composed of digital wallets that hold stored value which are assessed as being more material to system stability (for example, PayPal Australia); and
- a second-tier, composed of new entrants and other stored value digital wallets which currently lie outside the regulated boundary, but may become sufficiently material in time.

Essentially, digital wallets that hold stored value would be included under both tiers, but subject to different levels of regulation based on their level of materiality. As these forms of electronic payments continue to grow in prevalence, and hold larger consumer balances, it will be important to have regulatory frameworks in place to ensure the protection of consumers as well as the payments system more broadly.

There are continuing questions about how to assess the materiality of the digital wallets with stored value, thus determining the tier they would fall under. The quickly evolving payments landscape means that this should be a dynamic and ongoing consideration, as particular PPFs enter the market and grow.

Some potential criteria for assessment could include:

- the sophistication of its users;
- the number of users;
- the total funds at risk; and
- the risk profile of the digital wallet that also holds stored value.

Consideration of volume- and/or funds-based thresholds should take into account the potential for regulatory gaming and the designing of products that elude regulatory threshold triggers. Should a graduated regime only capture holders of stored value that are over a certain materiality threshold, then the FSI recommendation to narrow ASIC's AFSL regime through a similar materiality criterion should take into account the risks of certain facilities being outside the regulatory perimeter of both regimes. This may raise concerns where retail consumers are clients of the facility. While a mandatory ePayments Code will be an important component of the consumer protection framework, certain AFSL obligations, including requirements to maintain adequate financial resources, will also play a role.

Policy makers should clarify and elaborate on the proposed two tier prudential regime so that services providers can determine their optimal tier of choice. Thresholds for the potential regime should also be clarified so that market players can determine whether they fall within the regulatory scope of the regime. Functional thresholds based on the level of risk posed by the nature and scope of activity may, however, be more appropriate ways to separate the gradations than simple dollar-value thresholds. Such a framework would seek to balance predictability and agility by being principles-based rather than setting prescriptive rules that may not be sufficiently responsive to market developments.

5.2 Recommendation 17

Recommendation 17 is to improve interchange fee regulation by clarifying thresholds for when they apply and broadening the range of fees and payments they apply to.

PayPal, as a facilitator of online payments, is different from four-party credit and debit card schemes as well as from traditional three-party charge card schemes, as previously discussed. It should not be captured under the proposal to broaden the range of fees and payments to which interchange fee regulations apply. Rather, PayPal Australia should be separately regulated as a digital wallet provider and a holder of stored value.

Policy makers should clarify the criteria that would determine which regulatory frameworks digital wallet providers and holders of stored value would be subject to under the regulations recommended in the FSI Final Report regarding interchange fees.

5.3 Recommendation 39

Recommendation 39 is to amend priority areas of regulation to be technology neutral. It acknowledges that current regulation may specify certain delivery mechanisms for products, which can impede efficiency and innovation by preventing the uptake of new technologies. The recommendation also suggests embedding technology neutrality as a factor for consideration in the development of any future regulation.

Technology neutrality promotes innovation and competition. It should be embedded into the development process for future regulation to allow innovation to continue to benefit economic efficiency and consumers in Australia.

Technology neutrality will allow for new products, innovations and technology to be adapted in the payments system. The regulatory regime should recognise and facilitate rapid technological change.

6 Looking to the future

The payments landscape has evolved quickly in recent years. New technologies and customer demands are fuelling growth and innovation. This is particularly evident in the digital payments space.

Many more changes are likely to come. For example, the introduction of the National Payments Platform in Australia is imminent, and new players and technologies (such as ApplePay) are emerging globally.

This pace of change shows no sign of slowing. Technological advancement and new business models will continue to facilitate the offering of diverse services and electronic payments to Australian merchants and consumers.

It is impossible to predict what the future will bring in payments. Regulators need to be agile and flexible to respond to changes in the payments environment. Setting principles for regulation, rather than prescriptive guidelines, will help to achieve this. It is also worth considering what existing tools may need to be expanded to support new developments, for example, the ePayments Code.

An even-handed approach to regulation will encourage innovation and competition, allowing new entrants and incumbents to flourish. By monitoring developments and being able to react quickly where necessary, regulators will ensure the continuing stability of the system.

Integrating and harmonising ePayments regulation in Australia is likely to improve stability in the payments sector. A co-ordinated, streamlined regulatory regime increases legal certainty for incumbents and potential market entrants – thereby fostering competition.

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