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Financial System Inquiry
GPO Box 89
Sydney NSW 2001

BY ELECTRONIC UPLOAD

Dear Secretariat,

Thank you for the opportunity to provide feedback on the Financial Systems Inquiry Interim Report and the observations made within.

PayPal would like to reassert the points made in its initial submission, and would like to provide additional feedback to the Inquiry's observations on the following priorities:

- Funding for small businesses,
- Stability and the prudential framework,
- Consumer outcomes and conduct regulation,
- Regulatory architecture,
- Technology opportunities and risks, and
- International integration.

1. <u>Funding for small businesses</u>

PayPal notes the observation within Part 2 of the Interim Report that there are structural impediments to small business access to financing.

PayPal has recently announced expanding its Merchant Working Capital product to Australian customers. This product serves as an advance and is offered to select PayPal customers based on their sales history for a single fixed fee. It is repayable over time based on daily sales and there are no due dates, minimum monthly payments, periodic interest charges, late fees, pre-payment fees, or penalty fees.

This is one example of a new and innovative approach to supporting small businesses with access to faster, easier funding alternatives to applying for a traditional loan through a bank.

2. Stability and the prudential framework

PayPal is supportive of adjusting the prudential perimeter to apply regulatory and supervisory oversight to institutions or activities that may pose higher systemic risks. There are a number of new payment services either currently being offered in Australia, or which could potentially enter the market including:

- Stored value accounts by private and public network operators
- Stored value/reloadable travel money cards
- New digital wallet or m-payment businesses
- Money transfer services or payments offered via social media, and
- Crypto currencies and virtual currencies.

There is currently a broad range of facilities already available (with no doubt unforeseen ones to come) which all pose varying consumer protection and prudential risk. It is therefore important that risk-based principles and standards should be further developed by financial regulators which are commensurate with the aggregate risk that is posed by different payment services – such considerations should include:

- the total customer liabilities that are held or processed by an organisation,
- how those liabilities are protected by the payment provider (for example, whether they are required to be held on trust or maintaining capital commensurate with the risk),
- what happens to the funds in an insolvency event.

It is also critical that such organisations are required to have adequate disclosures as to the nature, risks and benefits of those products for consumers.

This must all be balanced against a need for technology neutrality, to leave space for participants to demonstrate various security control models and fraud prevention mechanisms.

Regulation should recognise that the inherent risks of any given service are not uniform across all entities and will vary depending upon the product configuration, delivery channel, and customer type. For example, a service which uses a closed loop system is likely to have an inherently lower risk than a service offering an open loop system. Similarly, systems that restrict the entry and exit methods of funds present a lower risk than those which allow cash or other anonymous forms of funding or withdrawal.

3. Consumer outcomes and conduct regulation

PayPal is committed to consumer protection, however the current regulations relating to product disclosure statements can present practical challenges to providing information which is clear and simple. At present, the product disclosure requirements apply equally to organisations regardless of the consumer risk they present.

In our initial submission to the Inquiry, we recommended a comprehensive review of the definition of financial products. The current definition is broad and should be reconsidered taking new and emerging technologies and payment methods into account. PayPal would like to see a clearer distinction between 'low' and 'high' risk products and services with different disclosure obligations based on risk profiles. We are also fully supportive of exploring new, more accessible and interactive opportunities of presenting disclosure information such as through layered notices which have proven very popular in the privacy disclosure arena.

4. Regulatory architecture

PayPal considers that there are opportunities to streamline and simplify the regulatory environment around financial products and services.

I. Global comparisons

When comparing the regulatory oversight within Australia with peer countries globally, PayPal would like to draw the Inquiry's attention to the European eMoney Directive. The current Directive promotes confidence amongst businesses and consumers by (i) harmonising the minimum standards for issuing electronic money across the EU, and (ii) creating a level playing field between traditional credit institutions and other firms issuing electronic money, allowing electronic money institutions (EMIs) to offer their services throughout the EU on the basis of regulatory supervision by their home Member State. The creation of legal certainty for electronic money encouraged new market entrants thus bringing greater competition.

The specific features of the eMoney Directive include:

(i) a technologically neutral and simpler definition of "electronic money", covering all situations where the payment service provider (an EMI or a credit institution) issues a prepaid stored value in exchange of funds. Electronic money is therefore defined as monetary value stored electronically on receipt of funds and which is used for making payment transactions. This definition covers e-money held on payment devices in the holder's possession (pre-paid cards or electronic wallets) or stored remotely at a server (network or software money);

(ii) a prudential regime ensuring consistency between prudential requirements of EMIs and payment institutions under the Payment

Services Directive (2007/64/CE). These prudential requirements include a lower initial capital enabling market entrance for smaller players, and a new formula to determine ongoing capital. A waiver regime - according to which small entities can obtain derogation for some of the authorisation requirements – is also introduced (similarly to that of the Payments Services Directive) and anti-money laundering requirements are updated to reflect the low-risk profile of electronic money;

(iii) a clarification of the application of redemption requirements, with special reference to their application to mobile telecommunications. Consumers have the right to claim back their electronic money at any moment, under conditions laid down by the new Directive.

II. AML / CTF Related Issues

The current breadth and pace of technology driven innovation within payment services has AML/CTF implications for the broader financial system. Whilst the traditional financial institutions explore online opportunities to service customers, there are also a multitude of players from non-financial sectors such as retail, telecommunications and technology seeking to offer payment services to consumers and merchants.

As we have stated in this submission, when considering the range of new payment products offered in the market it is clear there are numerous "accounts" that facilitate the transfer of value between parties that are not currently caught by the AML/CTF Act. Furthermore, in narrowly defining the unit of transfer, the Act fails to capture value transferred in other forms. For example value is stored in a myriad of forms including identity and billing or delivery information, payment credentials, credit for online content, phone credit for carrier billing, coupons and discounts, loyalty programs, etc.

This creates a regulatory regime in which providers of payment services, particularly those from outside the realm of licensed financial institutions are able to circumvent regulatory obligations and avoid supervision by developing products that avoid the specific criteria prescribed within the AML/CTF Act and associated Regulations and Rules.

Consequently, the ML/CTF risks of some new forms of payment services escape regulatory oversight. These unmitigated ML/CTF risks are then transferred into the financial system at the point where these new payment services and traditional financial products intersect.

III. *Graduated policy framework*

PayPal is supportive of the introduction of a graduated policy framework which seeks to align the inherent risk and scale of activities as an attempt to level the regulatory playing field for retail payment systems. This framework could include clear risk based thresholds (based on liquidity and capital) which transparently identify the point at which businesses would become subject to regulation and would provide much needed clarity and certainty for low risk operators (stored value cards, digital wallets, m-payment providers, prepaid / reloadable cards) and high risk operators (banks and superannuation funds) alike.

We also advocated in our original submission for the adoption of SMART Governance which combines the use of technology and data with a collaborative and iterative process to measure performance of regulated entities, creating a better informed regulatory development process. The SMART governance model is designed to help manage risks around the use and control of big data by financial institutions as well as develop regulatory strategies for protecting data.

5. Technology opportunities and risks

I. *Technology neutrality*

PayPal is pleased to see the emphasis on technology neutrality in the Interim Report. PayPal recommends the overriding objective of any future financial regulation should be to ensure technology neutrality.

II. *Digital identity*

PayPal is of the view that passwords and PINs may become obsolete and that the next step towards more secure security standards is likely to be in biometrics and other authentication methods[1].

PayPal supports innovations in digital identity as they not only enhance security but also make consumers' lives easier. Different methods of digital identity could be deployed based on a risk-based analysis of the specific product or service being secured.

PayPal announced a partnership this year which involves the integration of fingerprint identification technology within Galaxy S5 devices. This technology allows fingerprints to enable payment verification on PayPal and partner

[1] http://www.slashgear.com/paypal-wants-to-get-rid-of-passwords-in-favor-of-biometric-security-10281447/

ecommerce sites for making purchases.

PayPal is a member of the FIDO (Fast IDentity Online) Alliance, which is focused on the development of industry standards and specifications to reduce the reliance on passwords for authentication.

6. International integration

PayPal notes with interest that the Interim Report observed that the Australian Government could facilitate integration with Asian financial systems. PayPal agrees with this observation and considers that there are a number of opportunities that could be seized in this respect.

We made the recommendation in our initial submission that the Australian Government should consider leading a regional approach to ePayments regulation due to the inherently cross border nature of modern ePayments, especially across jurisdictions.

Thank you for the opportunity to respond to the Interim report.

Yours sincerely,

Jeff Clementz
Vice President
Managing Director, PayPal Australia