TAKING RETAIL FURTHER //

Retail NZ

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Competition and Consumer Policy
Building, Resources and Markets
Ministry of Business, Innovation and Employment
PO Box 1473
WELLINGTON

SUBMISSION ON RETAIL PAYMENTS SYSTEMS IN NEW ZEALAND

EXECUTIVE SUMMARY

- New Zealand merchants pay substantially more to process credit and contactless debit card transactions than their counterparts in other markets such as Australia and the UK. A key difference is that, in other markets, Governments have moved to regulate the payments industry.
- Regulation is necessary because it is accepted internationally that card payment systems are inherently inefficient.
- High merchant service fees in New Zealand are driven by rewards programmes for high-spending cardholders, but the costs to merchants are generally spread across all customers. This results in a regressive wealth transfer from less well-off New Zealanders (who typically don't have access to high rewards cards) to better off consumers (who do have access to high rewards cards).
- We strongly support transparency around all merchant service fees, as well as the components that make up merchant service fees, and the removal of the honour all cards rule .
- We recommend the establishment of a formal regulatory body in New Zealand, to bring us into line with comparable jurisdictions abroad; as well as an industry oversight group to provide advice to the regulator.
- We also recommend that officials maintain a close watch on international developments, and are involved in relevant work programmes by the OECD and similar international institutions.

SECTION A - OVERVIEW

A1 Introduction

A1.1 The retail sector employs more than 200,000 New Zealanders, and around $80 billion is spent in retail every year. Retail NZ has around 4,200 members, ranging from large to small retailers, who together account for around two-thirds of all activity in the retail sector.

A1.2 This submission is made on behalf of the retail sector, and builds on the material we have already provided to MBIE, which shows that New Zealand merchants pay substantially more in merchant service fees than their counterparts in overseas jurisdictions. As part of preparing this submission, we engaged BERL to provide us with some economic analysis. A copy of the report that BERL provided to us is attached for your reference.

A1.3 In our submission, we make some general comments, and then, in section B, we respond specifically to the questions raised by MBIE. Our submission is underpinned by policy rationales, articulated in the BERL report, developed from economic concepts and substantiated by regulatory frameworks internationally. The policy rationales are described in four themes of:

- Inefficiency
- Competition
- Inducements
- Technology.

A2 Inefficiency

A2.1 Economic models widely show that retail payment card systems are inherently inefficient.

A2.2 According to Wright (2012):

> *the fee structure in debit and credit cards are likely to be distorted with merchants paying too much to accept payment cards and cardholders paying too little, resulting in excessive usage of payment cards by consumers, a cost which is ultimately passed on to consumers paying by cash.*

A2.3 This inefficiency is a consequence of the systems' characteristic arrangements, hence it is a systematic inefficiency, because:

- payment card systems raise merchant service fees (MSFs) in response to merchants' need to accept cards, despite the price rise, because merchants accept cards to attract customers from each other
- the issuing banks have substantial market power and this enables them to set high interchange fees that influence MSFs
- more intense competition (between issuing banks and/ or card schemes) alone will not reverse or mitigate this form of pricing.

A2.4 A rationale for policy intervention to provide oversight or regulation in New Zealand to remedy the excessive inefficiencies of payments systems is supported by:

- economic analysis and assessment of international regulatory bodies
- oversight and regulation in foreign jurisdictions where regulatory bodies possess mandates to act.

A2.5 New Zealand currently lacks arrangements to implement such oversight or regulation. However, such an oversight regime will not be entirely foreign to the banks operating in the New Zealand market since:

- many are Australasian banks whose interchange fees, and ability to enforce card scheme rules, are already regulated in the Australian market
- many were previously subject to some level of constraint under Commerce Commission requirements for weighted average reduction in interchange fees following the 2009

settlement of the price fixing case against the schemes and banks[1] and remain subject to the prohibitions in the settlement on enforcing scheme rules restricting surcharging and steering.

A2.6 The inefficiency in the current payment cards market is exacerbated by merchants facing a "must take" situation, they must accept cards at any fee because if they do not then they lose patronage.

A2.7 Additionally, the inefficient payments system leads to an inherent regressive wealth transfer from better off New Zealanders to those who are less well-off. This is because prices increase across the board to take account of inefficient merchant service fees, while it is only those with high-rewards cards who benefit, and these cardholders tend to be wealthier.

A3 Competition

A3.1 Many jurisdictions have regulatory bodies to uphold competition in markets. In New Zealand there is a power to do this within the Commerce Act (1986). Such power in New Zealand is not capable of improving the competition of the retail payment card system in ways that will improve its efficiency.

A3.2 An effective policy intervention would be to improve the competiveness of the acquiring market, this may be achieved by:

- increased transparency
- improved access to the acquiring market
- regulation prohibiting actions by incumbents to prevent entry of competitors or the exercise of countervailing power by merchants. Regulation should allow the prohibiting or monitoring of scheme rules which prevent or hinder the exercise of countervailing power by merchants (such as, for example, the honour all cards rule).

A3.3 The absence of the three rules (OECD, 2012): no surcharging; (ii) no steering; (iii) honour all cards (and products) enhances competition in the payments system and thereby increases efficiency.

A3.4 As noted above there are no regulatory frameworks to provide such increased competitiveness, in contrast to other countries. However, the validity of such intervention is highlighted by regulations in countries with such frameworks, as noted by the Reserve Bank of Australia in 2016 (http://www.rba.gov.au/publications/annual-reports/psb/2016/retail-payments-policy-and-developments.html):

- Australia – Acquirers and payment facilitators will be required to provide merchants with easy-to-understand information on the cost of acceptance for each scheme from 1 June 2017. Schemes and Acquirers in Australia are already prevented from enforcing an honour all cards rules that would require merchants to accept both scheme debit and scheme credit cards.
- the United Kingdom – the Payments Systems Regulator published a report on the competitiveness of the country's payments systems infrastructure. The report noted that the same group of banks owned both the UK's major interbank payments systems, and the infrastructure provider that services these systems. The PSR found that these ownership arrangements limited innovation and competition, and proposed that the banks sell their stake in the infrastructure provider.

[1]http://www.comcom.govt.nz/the-commission/media-centre/media-releases/detail/2009/creditcardsettlementslowernewzeala

A4 Inducements

A4.1 There is a rationale to support policy intervention to constrain excessive loyalty rewards from issuing banks to consumers. Such excessive rewards produce excessive inefficiency with an increase in overall costs and no increase in benefits overall to consumers as a class and a decrease in benefits for many.

A5 Technology

A5.1 There is a policy rationale to provide a payments system with infrastructure to support diverse contactless and other disruptive technologies. The rationale is underpinned by the need to support future consumer practices with adequate standards of security, privacy, safety and reliability. Such future need will likely be:

- driven by different leaders than currently in the payments card market
- based to some extent on an interchange model and its associated incentives
- segmented more than currently, since new technologies will provide additional payment card options
- influenced by short-term trends (such as towards contactless debit)
- similar to current needs, as well proven technologies, such as EFTPOS, endure, although somewhat modified.

A5.2 This policy rationale is demonstrated internationally. Regulatory bodies such as the Payments Systems Board of the Reserve Bank of Australia recognise the final report of the Murray Financial Sector Inquiry (FSI). The FSI suggests that regulatory frameworks for the RBA and ASIC be clarified to ensure that they can accommodate new mediums of exchange, including digital currencies. The Australian government has undertaken to ensure that ASIC and the RBA "have the power to regulate new payment systems in a graduated way".

A5.3 This rationale is strengthened by the incentives faced by incumbent platforms, Issuers and Acquirers with substantial market power to prevent the entry of new payment systems – particularly if these new payment systems remove the need for these firms entirely.

A5.4 Concern to provide for the diversity of long-term potential preferences, notwithstanding short-term trends, underpins a policy rationale to develop infrastructure to maintain the current EFTPOS system as a highly efficient payment method, which risks elimination and replacement by highly inefficient methods. The Reserve Bank of Australia has recognised this rationale and acted upon it. At the same time the infrastructure and governance of EFTPOS needs to be innovated to bring it in line with other new and emerging payment methods.

A6 Recommendations

A6.1 We have shown issues for public policy arising from the current operation of the payments card system, in terms of four themes:

- Inefficiency
- Competition
- Inducements
- Technology.

A6.2 The issues arising under inefficiency and competition require oversight and/or regulation by a regulatory body with appropriate powers. This is clear from international practice. The absence of a similar body in New Zealand means New Zealand is not addressing the presence of excessive and undesirable inefficiency.

A6.3 Inefficiency in the payments card market needs to be addressed with regulation. That is a widely held view of economists and international bodies. Accordingly, we recommend the establishment of a regulatory body with powers in payments card systems to:

- identify excessive inefficiency
- investigate cases of excessive inefficiency
- propose remedies for excessive inefficiency
- enforce remedies for excessive inefficiency.

A6.4 A large part of remedying excessive inefficiency will focus on setting and enforcing interchange fee and scheme fee levels. Overseas regulation has tended to address interchange fee levels but there is equal scope for overly high scheme fees to have the same inefficient outcomes as overly high interchange fees.

A6.5 It is also desirable to improve the competiveness of the acquiring market. This may be achieved by:

- increased transparency
- improved access to the acquiring market
- regulations prohibiting actions by incumbents to prevent entry to the acquiring market
- absence of the three scheme rules: no surcharge; no steering; accept all cards (and products).

A6.6 The absence of a suitable level of competition is not easily remedied, since the definition of a market can be disputed as can the level of appropriate competition in these cases of imperfectly competitive markets, where some degree of a lack of competition is expected.

A6.7 Additionally, competition can be encouraged and guided. Accordingly, we recommend the establishment of an oversight group in the payments card system to:

- identify opportunities for improved competition in the payments card system
- recommend actions for the regulatory body to improve competition.

A6.8 The competition oversight group and the inefficiency regulatory body would work together. The oversight group should recommend actions which the regulatory body can investigate and implement. The oversight group should advise the regulatory body.

A6.9 The issues arising and potential future issues from new technology are complex and risk being misrepresented by various sector interest groups. New Zealand agencies and institutions do not possess the resources to commence their own investigations of global developments. Hence it seems reasonable to keep close contact with global organisations that do perform these investigations.

A6.10 Accordingly, we recommend that the government allocate resources to developing international networks with forums such as the OECD, where these information exchanges occur.

A6.11 In summary we recommend a range of actions ranging from regulation through to networking. These would likely occur simultaneously and so we can envisage a continuum of policy action to address the policy issues arising from the operation of the payments card system.

SECTION B - RESPONSE TO SPECIFIC QUESTIONS IN THE ISSUES PAPER

B1. Are these objectives for retail payment systems appropriate?

B1.1 We generally support the objectives you outline. Competition in the acquiring market is an important topic and so an objective for competitiveness should be included.

B1.2 We observe that objective 2 is the paramount objective of efficiency. Objectives 1 and 3 are necessary but insufficient conditions for objective 2.

B1.3 By itself a fair (efficient) allocation of costs in imperfectly competitive markets can only be determined by society.

B1.4 Marginal cost and marginal benefit are not common knowledge in the market at any point in time. We suggest the phrase "taking into account the" be replaced with "having regard for the likely".

B2. Are there any other emerging payment methods that we have missed? If so, what is their likely impact on the market?

B2.1 We identify Bitcoin and distributed ledger cryptocurrencies as additions to this list. These technologies replace our fiat currency altogether and remove the issuing and acquiring banks from the transaction. However, these have almost no practical application in retail or hospitality at the present time.

B2.2 We note that Visa and Mastercard are already working to release biometric payments technology. This will replace the need for a consumer to carry any wallet or device because their information is part of their body. Accepting these technologies may allow merchants to track consumer behaviour and increase automation, but there is unlikely to be much marginal benefit beyond the benefits gained from existing infrastructure. These new technologies are, in any event, built on the standard credit card infrastructure, and from a merchant's point of view incur the same level of fees.

B2.3 A number of recent reports canvass new technologies, including McKinsey (2014).

B2.4 In the context of the introduction of new technologies, it is important to recognise that EFTPOS is a highly efficient incumbent technology. EFTPOS use is diminishing and anecdotal reports attribute this to an active campaign by banks and card schemes to attract customers to new scheme debit cards, on which issuing banks may later apply interchange fees similar to those on credit cards, once EFTPOS has entirely ceased.

B2.5 Importantly these technologies will be differently relevant to different consumer groups. For example consumers engaging in personalised transactions vs mass market ones.

B2.6 The extent of the impact is limited because of the general reliance of new technologies on the existing infrastructure. Another constraint will be the acceptability of security and privacy standards for these technologies.

B3. What explains the decline in the revolve ratio on credit cards?

B3.1 As the BERL analysis shows, consumers are incentivised to use credit cards by the rewards schemes. This means that even though consumers may have ample funds to pay for their goods via different payment methods, they use their credit card to gain the rewards. In order to avoid the interest costs the consumers pay the balance within a specified time. In effect they are using their credit card just like a debit card – but obtaining rewards. If the use of credit (rather than rewards) were the driver, then consumers would likely use low-cost credit cards rather than expensive rewards-credit cards. The significant increase in consumer take-up of rewards cards points to the driver being rewards programme, rather than simply a desire to access credit.

B4. Do you agree with our explanation of the rationale for interchange?

B4.1 While we agree with the explanation, as evidenced by BERL's analysis which references Wright (2012), we feel the explanation is rather complex and should be clarified.

B4.2 The explanation could usefully articulate who sets the interchange fee, when it is set, and how it is set. Such an explanation will then easily illustrate why interchange is driven upwards by the systematic effect.

B4.3 The interchange model is the prime cause of inefficiency in payment card systems. Inefficiency is a consequence of the systems' characteristic arrangements, hence it is a systematic inefficiency, because:

- payment systems raise merchant service fees (MSFs) in response to merchants' need to accept cards, despite the price rise, because merchants accept cards to attract customers from each other
- the issuing banks have substantial market power and this enables them to set high interchange fees that flow on to the setting of MSFs
- more intense competition between issuing banks and/ or schemes alone will not reverse or mitigate this form of pricing.

B4.4 Wright (2012) presents a model that captures these two themes and establishes that privately set interchange rates and therefore MSFs are systematically too high. Of these two themes, Wright indicates that merchants' need to accept cards is the primary source of the excessive inefficiency.

B4.5 MSFs in this model are expected to systematically trend upwards, because as Carlton and Frankel (1995) observe, it is likely that the growing use of inducements from issuing banks to card holders, is: "a direct function not only of intensified competition among credit card Issuers, but also of high interchange fees". In fact in these retail payment arrangements, excessive interchange fees enable issuing banks to offer more inducements to consumers, thereby leading to increased consumer use of cards.

B5. Have we accurately described the incentives on parties in relation to interchange?

B5.1 We suggest the influence of schemes should be emphasised more.

B5.2 Schemes have an important role in setting interchange fees. By setting a cap it can become a target to which the interchange fee is driven. We note that in practice all banks consistently charge the maximum level of interchange permitted by the schemes.

B6. Why are interchange rates falling for large merchants but increasing for small-medium merchants?

B6.1 This question is incorrect in its statement that interchange rates are falling for large merchants. Further, it is incorrect to treat falling interchange rates as evidence of increased benefit to merchants. Interchange rates for credit transactions are increasing over time. Contactless scheme debit products (which attract interchange fees) have only been recently introduced, but contactless debit transactions are rapidly being substituted for EFTPOS (where no interchange applies).

B6.2 Interchange levels have risen for non-strategic rate merchants and total interchange paid has risen as a total cost of electronic payments, in part due to the growth in contactless scheme debit and the movement of credit card customers to premium card products. Issuers are charging interchange on debit cards and increasing interchange on credit cards. Hence, the levels of overall interchange fees and the levels of associated MSF's are rising significantly.

B6.3 The average rate over all cards behaves differently to the total level across all cards. Because the rate of interchange charged on scheme debit cards is (currently) much lower than the rate charged on scheme credit cards, and because the number of scheme debit card transactions is increasing, the average rate over all cards is falling. This obscures the increased levels of MSFs that merchants are paying.

B7. Is the resource cost data robust? Is the Australian data likely to over-state or under-state the costs of running New Zealand payment systems?

B7.1 There are a number of components of resource costs. We recommend that the regulatory body (potentially established within the Commerce Commission) that we propose to investigate and to remedy excessive inefficiencies, be tasked with investigating resource costs in New Zealand.

B7.2 Overall, the evidence for New Zealand is that the per-transaction cost is not falling despite the increase in transaction volume in recent years. This suggests excessive inefficiencies in the New Zealand market.

B7.3 Potentially, the resource costs in Australia are over-stated because Australia has many more switches than New Zealand and the cost to link these switches is far greater than in New Zealand. On this basis, we expect that in total the infrastructure cost in New Zealand will be lower than that of Australia.

B7.4 Alternatively, the Australian resource costs may understate the New Zealand resource costs, because economies of scale may prevail for infrastructure in Australia.

B7.5 Better information in this area is vital to assessing the extent of excessive inefficiency in the retail payments card market. The proposed regulatory body should have sufficient power to obtain such information.

B8. Do you agree with the logic underpinning our assessment that there is inefficiency in the credit card market?

B8.1 We do agree with the MBIE logic, but believe the analysis is incomplete because the fundamental determinant of the inefficiency, as reported in the BERL analysis, is the merchants' need to accept cards. Consequentially, Issuers can charge excessive interchange fees to provide inducements to consumers. This is explored in full by Wright (2012).

B8.2 This inefficiency is a consequence of the systems' characteristic arrangements, hence it is a systematic inefficiency, because:

- payment systems raise merchant service fees (MSFs) in response to merchants' need to accept cards, despite the price rise, because merchants accept cards to attract customers from each other

- the issuing banks have substantial market power and this enables them to set high interchange fees that influence MSFs
- more intense competition (between issuing banks and/ or schemes) alone will not reverse or mitigate this form of pricing.

B9. Do you agree with the logic underpinning our assessment that there are regressive cross-subsidies in the credit card market?

B9.1 We agree. We argue that the result hinges on banks' strategies, along with price coherence. We submit our own assessment and logic of the situation as follows.

B9.2 There are multiple payment methods available: no reward cards and cash; low reward cards; and high reward cards. In addition, due to merchants not knowing what payment method a consumer will use *ex ante* there is "price coherence". All consumers face the same price of goods no matter what payment method. In addition to this, as we have argued, most merchants in New Zealand are not able to surcharge effectively.

B9.3 We note that the structure of the market is such that any rewards obtained from loyalty schemes are ultimately paid for by the consumer. The Issuer uses the interchange fee to fund the rewards, this is charged to the Acquirer who then charges it to the merchant in the merchant service fee. Merchants then pass on the costs of the merchant service fee through prices to consumers.

B9.4 Because of price coherence it then follows that the no and low-reward payment methods users do subsidise the rewards of high-reward payment method users.

B9.5 In addition we argue banks are risk averse and more likely to offer high-reward cards to users who have a high income. Consumers with low income are more likely to be using cash or no-reward credit/debit products due to their ineligibility to gain access to the high rewards cards.

B9.6 Therefore, it follows that consumers with a higher income are receiving rewards subsidised by consumers with low income.

B10. Do you agree that self-Acquirers are unlikely to place downward pressure on interchange?

B10.1 We agree.

B10.2 The OECD (2012) notes that:

> *It is generally accepted that competition authorities and regulators should try to minimise barriers to entry or exit into payment system and to abolish restrictions on market participants' behaviour, like the "no surcharge" rule, the "no steering" rule, or the "honour all cards" rule. However, there can be unintended consequences and not all systems require the same approach.*

B10.3 Imposition of the three rules (above) prevent merchants from steering customers towards certain bank Issuers or towards lower-interchange products. With the ability to surcharge, not honour cards and steer, merchants can exercise some degree of countervailing power on the setting of interchange fees and therefore MSFs. Consequently, Acquirers (including self-Acquirers) have the capacity to negotiate with different Issuers. This places downward pressure on interchange and MSFs. The no-surcharge and no-steering rules no longer apply in New Zealand following the settlement of the Commerce Commission's interchange fee litigation, but in practice merchants are reluctant to surcharge. Sufficient countervailing power is therefore not achieved with no surcharge and no steering only, but also requires removal of the honour all cards rule.

B10.4 With the honour all cards rule present, self-Acquirers are unlikely to place downward pressure on interchange.

B10.5 MBIE's discussion paper reports evidence of a situation where a large retailer became a self-acquirer. Subsequently, a card scheme exercised its market power and raised the scheme fee, which removed any cost savings the self-acquirer would have had by processing transactions directly to the Issuer, and sent a signal that other aspirants would face similar action.

B11. How much negotiating power do merchants have over the merchant service fees they face? Is this likely to change in the future?

B11.1 In the absence of the three rules noted by the OECD (2012) (above), merchants have significant countervailing power. When the three rules are present, the countervailing negotiating power of merchants is influenced by their size and type. The largest merchants or merchants with captured markets have more negotiating power. Sufficiently large merchants qualify for strategic merchant rates, but even a number of the nation's largest retail chains do not have negotiating leverage.

B11.2 Countervailing power is also influenced by information available to merchants. Information costs vary by merchant size and type.

B11.3 Countervailing power can increase with greater regulation that limits the constraints of the three rules. This is done in other jurisdictions including Australia where there are regulatory limits on the no surcharge and honour all cards rules.

B12. Do you think that the issues in the credit card market are of a scale that warrants intervention? If not, do you think that the size of the issue is likely to grow over time?

B12.1 Yes. Intervention is warranted. We have shown issues for public policy arising from the current operation of the payments card system, in terms of four perspectives:

- Inefficiency
- Competition
- Inducements
- Technology.

B12.2 The issues arising under inefficiency and competition require oversight and/or regulation by a regulatory body with appropriate powers. This is clear from international practice. The absence of a similar jurisdiction in New Zealand means New Zealand is not addressing the presence of excessive inefficiency that is undesirable to society.

B12.3 Inefficiency in the payments card market needs to be addressed with regulation. That is a widely held view of economists and international bodies. Accordingly, we recommend the establishment of a regulatory body with powers in payments card systems to:

- identify excessive inefficiency
- investigate cases of excessive inefficiency
- propose remedies for excessive inefficiency
- enforce remedies for excessive inefficiency.

B12.4 A large part of remedying excessive inefficiency will focus on setting and enforcing MSF levels. We also recommend the removal of scheme rules which entrench the market power of schemes and issuing banks such as the honour all cards rule.

B12.5 It is desirable to improve the competiveness of the acquiring market. This may be achieved by

- increased transparency
- improved access to the acquiring market
- regulations prohibiting actions by incumbents to prevent entry to the acquiring market
- absence of the three rules: no surcharge; no steering; accept all cards (and products).

B12.6 The absence of a suitable level of competition is not easily remedied, since the definition of a market can be disputed as can the level of appropriate competition in these cases of imperfectly competitive markets, where some degree of a lack of competition is expected.

B12.7 Additionally, competition can be encouraged and guided. Accordingly, we recommend the establishment of an oversight group in the payments card system:

- to identify opportunities for improved competition in the payments card system
- to recommend actions for the regulatory body to improve competition.

B12.8 The competition oversight group and the inefficiency regulatory body would work together. The oversight group should recommend actions which the regulatory body can investigate and implement. The oversight group should advise the regulatory body

B12.9 The issues arising and potential future issues from new technology are complex and risk being misrepresented by various sector interest groups. New Zealand agencies and institutions do not possess the resources to commence their own investigations of global developments. Hence it seems reasonable to keep close contact with global organisations that do perform these investigations.

B12.10 Accordingly, we recommend that the government allocate resources to developing international networks with forums such as the OECD, where these information exchanges occur.

B12.11 In summary we recommend a range of actions ranging from regulation through to networking. These would likely occur simultaneously and so we can envisage a continuum of policy action to address the policy issues arising from the operation of the payments card system.

B12.12 We believe the following reports are useful guidance also.

- **economic analysis** - Wright (2012, discussed above) notes retail payment systems are inherently inefficient and their problems are exacerbated, not improved by competition. Accordingly a regulatory solution is required. Carlton and Frankel (above) and Cabrel (2005) also concur that regulation is necessary in some instances.
- **regulatory policy** – the Payments System Board (PSB) of the Reserve Bank of Australia (RBA, 2016), is mandated with the power to promote competition and efficiency in payments system markets and among other things has expressed the following important views:
    - there is little justification for significant interchange fees in mature card systems. It concluded that there is an ongoing role for regulation in the cards market, in part because of the perverse way in which competition between card schemes can drive up costs in the payments system

  - the right of merchants to surcharge for expensive payment methods is important for payments system efficiency and helps to hold down the cost of goods and services to consumers generally.
- The Reserve Bank of Australia has also played an important role in regulating restrictive card scheme rules. For example, in July 2006 (with effect from 1 January 2007) it notified required reform, of card scheme honour all cards rules, preventing schemes from mandating that merchants must accept the scheme's debit cards, as a choice of accepting the scheme's credit cards. This has been important in providing merchants with some countervailing power to the substantial market power of the schemes.
- **regulatory policy globally** – Covec (2015) reviewed global policy interventions and concludes that a trend is emerging towards a structure in which a single body is charged with oversight and directed to pursue goals that include economic efficiency. These global interventions were also summarised by the Reserve Bank of Australia in 2016.
- **a review of governance of payments systems** (Summers, 2014) identified that the existence of a governance body leads to greatly reduced payments fees. The study established six principles for the effective governance of such systems:
  - explicit objectives that reflect public policy considerations
  - a means for measuring whether each of the major payments schemes meets the needs of end-users
  - broad stakeholder participation in key decisions including strategy, design and rules
  - arrangements that provide clear responsibility and accountability for outcomes
  - incentives that promote the policy objectives, including fair and effective enforcement
  - openness and transparency.

B13. Do you agree with our assessment of the incentives held by different parties in relation to debit card usage?

B13.1 In general we agree with the assessment of incentives. In addition, we recognise that card Issuers will provide inducements to scheme debit cardholders for contactless debit as incentives for them to use these debit cards.

B14. Do you agree that there is little incentive to invest in proprietary EFTPOS?

B14.1 As reported in our analysis, EFTPOS is a viable, efficient method of payment from which Issuers, Acquirers and schemes cannot profit, hence there is no incentive to invest. It is, however, unclear what level of cost is recovered from low income groups who pay transaction fees on their EFTPOS accounts.

B14.2 There is a policy rationale to develop infrastructure to maintain the current EFTPOS system as a highly efficient payment method, which risks elimination and replacement by highly inefficient methods. The Reserve Bank of Australia has recognised this rationale and acted upon it. At the same time, innovation is needed in the infrastructure and governance of EFTPOS to bring them in line with other new and emerging payment methods.

B14.3 Importantly it is necessary to emphasise that consumers and merchants benefit from EFTPOS yet there is no regulatory body to uphold their interests in the face of the rising substitution of EFTPOS with new technology scheme debit cards.

B15. Do you agree that it is unlikely that schemes will start imposing interchange on swiped/inserted scheme debit transactions?

B15.1 No. We do not agree.

B15.2 The Issues Paper indicates that MBIE believes the schemes won't start imposing interchange fees on swiped and inserted scheme debit transactions. In our view this is incorrect: the schemes will have an incentive to introduce interchange in the near future. The only question is when this will occur.

B15.3 Soon, a substantial proportion of retail transactions will be contactless. Once that occurs the proprietary EFTPOS system may not continue at all and certainly it will no longer be the competitive constraint that it has previously been on the imposing of interchange fees and MSFs in relation to scheme debit transactions.

B15.4 MBIE suggests at para 231 that there is likely to be an increase in the level of interchange and MSFs on contactless debit once a threshold level of acceptance is reached. We agree and suggest there is no constraint on this.

B15.5 The card schemes and issuing banks do not have an ongoing incentive to encourage or preserve the EFTPOS system which does not earn them revenue in terms of scheme and interchange fees.

B15.6 Once the acceptance by merchants of contactless scheme debt has reached sufficient critical mass the incentive on the schemes and banks will in fact be to ensure that debit transactions are conducted solely by way of scheme debit (with interchange fees applying) rather than EFTPOS.

B15.7 Cardholders will not resist this change, as to them a scheme debit transaction achieves the same functioning as an EFTPOS transaction. Going forward, the schemes may also feel that they can rely on the honour all cards rule to insist that merchants accept scheme debit cards if they want to accept credit cards. Para 292 on page 78 of the issues paper suggests that the Commission's settlement with schemes and banks prevents enforcement of an honour all products rule. That is incorrect. There is nothing in the Commission settlement to that effect.

B15.8 Accordingly, there is nothing to prevent Visa from enforcing its honour all cards rule to an honour all products situation. (There would be an argument that the honour all cards rule is anti-competitive in breach of the Commerce Act but that argument would require the bringing of expensive litigation).

B15.9 MasterCard's rules would currently not allow it to require merchants to accept scheme debit as a condition of accepting scheme credit but those rules could easily be changed (and MasterCard might well choose to make such a change, particularly if Visa chose to enforce its own rules in an honour all products situation).

B15.10 The Australian regulations recognise the undesirability of an honour all products rule by prohibiting it (as noted in para 267 of the Issues Paper on page 72). In the United States a settlement of the Wal-Mart litigation provided for a similar outcome preventing schemes from requiring the acceptance of debit cards as a condition of accepting credit cards.

B15.11 New Zealand should have this reform as well – it provides an important constraint on the exercise of market power by the schemes and issuing banks.

B15.12 The continuity of EFTPOS is to a degree currently constraining the capacity of schemes to charge interchange on debit transactions. Therefore, the likelihood that schemes will start imposing interchange depends on the cessation of low-cost EFTPOS. Consequently it is likely schemes will impose interchange on debit, but the extent is contingent on the continuity of EFTPOS for mass market transactions. As discussed above, the growth of contactless scheme debit makes that continuity doubtful if not unlikely.

B15.13 As noted above, other nations have regulatory frameworks to maintain EFTPOS. Such arrangements in New Zealand will require development of EFTPOS infrastructure and governance.

B15.14 Importantly, some users will prefer debit card products irrespective of interchange, and many are being steered down this path by their banks. Some credit users effectively use their credit cards as debit cards, by repaying credit within the interest-free period, in order to receive rewards.

B16. Do you agree that merchants facing a per-transaction charge for accepting debit payments is not an issue in itself?

B16.1 We agree. What is at issue is the level of the charge and the ability or otherwise to select lower-cost options. Other jurisdictions (including Australia) do provide for some cost for accepting debit payments. In Australia the cost of EFTPOS is also regulated.

B17. Is the shift towards contactless debit cost-effective, taking into account the costs and benefits to all parties in the system?

B17.1 Under the current retail payments card system where interchange applies to scheme debit (which it does) the value and number of transactions are excessive (Wright, 2012). When the associated excessive costs with the interchange imposed exceed the costs of maintaining EFTPOS, then the shift is not cost effective.

B18. Do you agree that the lack of price signals in the debit market is likely to lead to inefficient outcomes of a similar nature to those in the credit card market?

B18.1 Yes, they behave the same way. The only difference between debit and credit cards (when EFTPOS is not available) is the ability for consumers using credit cards to make intertemporal consumption decisions easier. When a cardholder uses a scheme for debit cards and an interchange fee is applicable, debit cards are no different from scheme credit cards from the point of view of the payment cards market.

B19. Do you agree that merchant service fees are likely to increase for contactless debit once acceptance reaches a certain threshold?

B19.1 Yes. Since contactless debit is similar to credit card usage in that the merchant service fee is driven by the merchant need to accept cards, then the merchant service fees (MSF) will increase.

B19.2 MSFs in this model are expected to systematically trend upwards, because as Carlton and Frankel (1995) observe, it is likely that the growing use of inducements from issuing banks to card holders, is: " a direct function not only of intensified competition among credit card Issuers, but also…of high interchange fees". In fact in these retail payment arrangements, excessive interchange fees encourage issuing banks to offer more inducements to consumers, thereby leading to increased consumer use of cards.

B20. Do you agree with our assessment that the interchange business model imposes significant barriers to entry in the debit market?

B20.1 Yes. In the interchange model, the issuer bank controls the consumer's bank account and has the capacity to charge interchange to Acquirers. This control is a barrier to new Issuers whose prospective customers are reluctant to incur transaction costs in changing bank accounts from current Issuer to new Issuer. Presence of the three rules noted by the OECD (2012) (above) is a barrier to entry of Acquirers. Merchants lacking countervailing power, who wish to change acquirers, must incur transaction costs. This limits the number of merchants likely to change to a potential new Acquirer. This is a disincentive to new Acquirers and represents a barrier to entry to them.

B20.2 The interchange model also acts as a disincentive to the development of new (non-Interchange) technologies for the simple reason that banks control access to consumers' bank accounts - and they have no incentive to support any new systems that might undermine their interchange revenues.

B21. How do you think the debit market is likely to evolve in respect of these 'unknowns'?

B21.1 The McKinsey (2014) report is optimistic about the growth of all products that are based on current interchange infrastructure. We are similarly confident that new interchange-based-contactless and other interchange-based payment methods will emerge. This is especially since they will be supported by issuer banks, who will likely drive technology development for them.

B21.2 Without investment for the innovation of EFTPOS infrastructure and governance, as provided in Australia, Germany and other nations, we believe EFTPOS will decline in overall use and may exit the market altogether as banks may see no reason to continue to support the EFTPOS system. Scheme debit cards are indistinguishable from EFTPOS cards to customers so there is unlikely to be opposition from customers.

B21.3 The OECD (2012) notes that:

> *It is generally accepted that competition authorities and regulators should try to minimise barriers to entry or exit into payment system and to abolish restrictions on market participants' behaviour, like the "no surcharge" rule, the "no steering" rule, or the "honour all cards" rule. However, there can be unintended consequences and not all systems require the same approach.*

B21.4 Imposition of the three rules (above) prevents merchants from steering customers towards certain bank Issuers or towards lower-interchange products. With the ability to surcharge, not honour cards and steer, merchants can exercise some degree of countervailing power on the setting of interchange fees and therefore MSFs. Consequently, Acquirers (including self-Acquirers) have the capacity to negotiate with different Issuers. This places downward pressure on interchange and MSFs. Hence absence of the three rules enhances competition in payment card systems. While the no-surcharge rule and no-steering rules are no longer applicable in New Zealand, this is insufficient on its own to apply downwards pressure on merchant service fees.

B22. Do you consider the extent of the difference in the interchange relating to small and large merchants to be justified?

B22.1 As noted in our report, merchants differ in their ability to negotiate merchant service fees. Sufficiently large merchants are able to access strategic merchant rates. It is telling, however, that even some of New Zealand's largest retail chains appear unable to secure strategic rates, or to have negotiating power.

B22.2 What is justifiable in terms of the difference in fees charged by large and small merchants is difficult to assess and is best left to a regulator or oversight group. However, it is clear that all merchants are charged excessive merchant service fees in relation to contactless credit and debit, especially when compared to merchants in comparable overseas jurisdictions.

	New Zealand	United Kingdom	Australia
EFTPOS	0.00%	0.36%	$A0.09
DEBIT (Swiped/Dipped)	0.00%	0.36%	$A0.09
DEBIT (Contactless)	1.00%	0.36%	$A0.09
CREDIT	1.70%	0.89%	0.78%

Source: Retail NZ 2016 Payments Survey, http://www.retail.kiwi/advocacy/payments/2016-payments-survey-show-upwards-trend-in-new-zealand-merchant-service-fees-for-credit-card-payments

B23. Do you agree with our assessment of the two markets against our proposed objectives?

B23.1 Yes. In relation to innovation:

- In credit, New Zealand is an innovation taker in the payment cards market and cannot influence product innovation.
- In debit, we agree that there is concern. The interchange model will impose barriers to new entrants at least in the medium term.

B23.2 Efficiency:

- In credit, we agree that there are concerns because payment card systems are inherently inefficient as noted in the BERL report.
- In debit, we note that, while future developments are not certain, current concerns are growing that debit systems will most likely follow the (inefficient) structure of credit systems.

B23.3. Fair costs:

- The international opinion is that gross unfairness exists in unconstrained systems, and there are growing concerns, in relation to both debit and credit.

B24. Would greater transparency have any material benefit for merchants or any other parties in the system?

B24.1 As the BERL report indicates, we believe greater transparency is critical, as it will provide merchants with greater bargaining power for merchant service fees and the capacity to surcharge. Both of these effects will help reduce the bias against merchants we identify in our analysis.

However, it is important to acknowledge that the ability to surcharge will not in itself provide sufficient countervailing power for merchants in the absence of removal of the honour all cards rule. Customer resistance to surcharging means that the availability of surcharging is clearly insufficient on its own as an effective constraint on the market power of card schemes and issuing banks to set and impose excessive interchange fees. For merchants to have effective countervailing power requires:

- transparency of costs of different cards and products, and
- most importantly, the discretion of merchants to decline to accept products and cards inconsistent with their business models and product and service offering (i.e. through removal of the honour all cards rule).

B24.2 It is clear that different merchants are affected differently by the excessive MSFs. Some have a degree of capacity, through economies of scale for example, to negotiate MSFs while others do not.

B25. Would there be any benefit in schemes publicly clarifying their intentions in relation to charging for swiped and inserted debit payments?

B25.1 There is no material benefit in schemes signalling their intentions because the inefficiency in the market will prevail regardless. The inefficiency will prevail because it is not driven by the intentions of schemes being unknown, it is driven by the mismatch in benefit internalisation of merchants and consumers (Wright, 2012). Hence, we consider that greater oversight and transparency is more important than a signalling of intentions. Further, intentions can, and likely will, change due to natural changes in incentives once contactless debit reaches a critical mass of use in the New Zealand market. A firm commitment not to charge for these payments would, however be positive.

B26. Do you think that the benefits of interchange regulation are likely to exceed the costs?

B26.1 Yes. The opinion of international regulators (such as in Australia) and economists is that interchange regulation is cost effective.

B27. What unintended consequences could arise from interchange regulation?

B27.1 It seems likely that the main result of removal of the revenue is simply to remove the artificial incentive to cardholders to use cards, rather than to impact on innovation in any material way. We are confident that unintended consequences can be avoided, if a best-practice regulatory regime is well-designed and takes into account learnings from overseas jurisdictions.

B28. Under what conditions, if any, should debit interchange rates be regulated?

B28.1 Under the same conditions as credit, where they are excessive. This is because debit is similar to credit in every respect in the interchange model. Consumer preference selects between them.

B28.2 For the reasons suggested above (in the answer to question 15) an increase in scheme debit interchange fees is inevitable as the share of the market captured by contactless transactions leads to a position where there is no real constraint on an increase in interchange fees. Accordingly, the same market failure will arise for debit transactions as MBIE describes in the issues paper for credit transactions. Further, as the MBIE issues paper accepts at para 256 the stakes are higher for debit transactions as they have a larger market share than credit transactions. The risk is that the low-cost EFTPOS system ceases and is replaced with a high-cost and inefficient scheme debit system.

B29. Aside from the financial barrier imposed by the interchange business model, what barriers to entry for new debit payment products currently exist?

B29.1 The main barriers are the three scheme rules noted by the OECD (above). In addition, social and cultural barriers exist. Potentially some new debit products would be preferred for personalised transactions only and others would be preferred for mass market transactions. Further, there will be infrastructure barriers for the introduction of new debit products that do not use current infrastructure, particularly any non-interchange based technologies.

B30. Are there good justifications for these barriers being in place?

B30.1 The lack of infrastructure for as yet unknown future technologies is reasonable. Barriers due to the three scheme rules are not justifiable. Barriers due to personal preferences are justifiable in the medium term, but public awareness will lead to transition from old technologies to new ones. We note that barriers to entry stifle innovation, and are not generally in the interests of the economy at large.

B31. Are there ways in which any unjustified barriers could be removed?

B31.1 Removal of the three scheme rules noted by the OECD (2012) (above) would remove unjustified barriers.

B31.2 In terms of options for reform the main omission from the options for reform referred to in the issues paper is regulation similar to that applying in Australia restricting the imposition or enforcement by the schemes of scheme rules limiting or preventing the exercise of countervailing power by merchants as illustrated by the RBA decision to restrict the enforcement of an honour all products scheme rule. (See para 267 of the Issues Paper on page 72).

B31.3 In the United States a settlement of the Wal-Mart litigation provided for a similar outcome preventing schemes from requiring the acceptance of debit cards as a condition of accepting credit cards.

B31.4 Any New Zealand regulatory solution should provide for the removal of an honour all products scheme rule as well – the removal of such a rule provides an important constraint on the exercise of market power by the schemes and issuing banks. It prevents schemes and issuing banks from saying to merchants that they must accept debit cards as a condition of accepting credit cards.

B31.5 However to provide a more compelling constraint on the exercise of market power by the schemes and issuing banks it would be desirable to also remove other aspects of the honour all cards rule. A full prohibition of an honour all cards rule is useful as it allows merchants to exercise countervailing power in other ways:

- First, this would allow merchants to choose to refuse to accept high interchange or premium products.
- Secondly, this would allow merchants to refuse to accept the cards of particular issuers with high interchange rates (allowing for proper downwards competitive pressure on the interchange rates of different issuing banks).

B31.6 The full removal of the honour all cards rule would help ensure true competition between banks for the custom of merchants.

B32. Is there merit in exploring options in addition to interchange and barriers to entry?

B32.1 We believe there is merit in exploring options and recommend a complete survey of the options available. We recommend this survey be designed and carried out so as not to be biased by any market participant. The options internationally are wide and varied, we need to consider them in the context of the preference for regulation.

B32.2 We recommend this work be developed under an oversight group spanning representative market participants.

B33. Have we missed any options?

B33.1 As indicated above, the main option for regulatory reform not discussed in detail in the MBIE issues paper is:

- the removal of the honour all products scheme rule as has occurred in other jurisdictions such as Australia and the United States and
- preferably, removal of the honour all cards scheme rule in its entirety, and
- power of the proposed regulatory body to remove or monitor any other scheme rules that restrict the ability of merchants to constrain the market power of issuing banks.

B33.2 At the same time it is important to preserve and enhance EFTPOS as an effective payment card method. Potentially a future EFTPOS system will require co-investment by financial institutions, together with innovation of its infrastructure.

33.3 It would be sensible to maintain a knowledge base of current technology development through close contact with global regulatory bodies establishing access regimes for new technologies.

SECTION C - CONCLUSION

C1.1 We thank you for the opportunity to submit on the issues paper - and would be happy to provide any further information that may be of assistance.

Yours faithfully

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Retail NZ