Westpac New Zealand Limited

Submission to the Ministry of Business, Innovation and Employment in relation to the Issues Paper: Regulating to reduce Merchant Service Fees

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1 Introduction

1.1 This submission is to the Ministry of Business, Innovation and Employment (**MBIE**) in relation to the Issues Paper: Regulating to reduce Merchant Service Fees (**Issues Paper**).

1.2 Westpac's contact for this submission is:

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2 Summary of position

2.1 Westpac understands that MBIE is seeking information to enable it to advise the Government on the most appropriate approach for regulating merchant service fees payable by retailers for debit and credit card transactions, and to test its understanding of issues related to high merchant service fees in New Zealand.

2.2 Westpac supports prudent changes that improve the resilience, functionality, and efficiency (including efficiency of cost to users) of the domestic payments system; and accepts that it is essential that payments costs (in general) and merchant service fees (in particular) are determined in an objective, transparent and commercially neutral way. However, in terms of the specific concerns raised by MBIE in the Issues Paper, Westpac's data indicates that:

(a) merchant service costs are materially less than those suggested by MBIE;

(b) interchange rates have been reducing steadily and demonstrably since 2016;

(c) taking all card transactions (including EFTPOS) into account, New Zealand merchants are *not* paying more than their counterparts in comparable countries, including Australia and the United Kingdom; and

(d) small merchants are being charged rates which are appropriate relative to the scale and nature of their businesses.

2.3 In this context, Westpac welcomes the opportunity to provide feedback on the Issues Paper and is willing to work with MBIE to ensure that it has a clear and complete understanding of the nature and extent of any issues it is seeking to address, and the objectives that are to be achieved (including assessment of any potential unintended consequences of regulatory intervention).

2.4 Westpac's response to the specific questions posed in the Issues Paper are set out in the table below.

1	Do you have any feedback on our proposed approach to this project?
	As noted above, Westpac supports prudent change that improves the resilience, functionality, and efficiency (including efficiency of cost for users) of the domestic payments system; and accepts that it is essential that payments' costs (in general) and merchant service fees (in particular) are determined in an objective and transparent manner. Westpac considers that the proposed approach is focused too heavily on costs and not balanced by the value that is being received by merchants through their acceptance of card payments. In order to determine whether and what kind of intervention may be needed and/or how any such changes should be implemented, it is essential that MBIE have a clear and complete understanding first of the nature and extent of the issues it is seeking to address, and second the objectives that are to be achieved (including assessment of any potential unintended consequences of regulatory intervention). In Westpac's view (for the reasons set out in more detail in the below submissions), neither of these two prerequisites to effective regulatory intervention have yet been achieved. By way of overview: • Westpac considers that the conclusions drawn about the costs incurred by New Zealand merchants (in relation to card acceptance) are materially inaccurate. Westpac's analysis demonstrates it is incorrect to assert that New Zealand merchants incur higher overall costs of card acceptance relative to their counterparts (in countries such as the United Kingdom and Australia). Westpac's data further indicates that it is incorrect to assert that small merchants incur pricing which is unfair or unjustified in relation to their business. • Closer examination of the domestic payments system makes it clear that there is effective competition across all market segments. In addition, the banking, and wider financial services, industry is making significant investment into new products and services which will compete strongly with existing payment products, including scheme and EFTPOS cards, and this will accelerate with the advent of open banking. • Any assessment of the need for intervention or regulation must consider the overall costs and benefits to the economy (as a whole) of the different components of the payments system. For instance, MBIE appears to conclude that because EFTPOS is free for merchants, it is an efficient and useful benchmark against which to measure other products. Westpac submits that this is incorrect, not least of which because New Zealand's EFTPOS system incurs significant operational cost but delivers few of the customer experience and functional benefits offered by competing instruments and is viable only because it is supported by other card issuing and transactional revenue. The focus for public policy, when considering the best possible outcome for New Zealand, should not be solely on the 'cheapest' solution but should consider also a range of other factors such as payment security, efficiency, competitiveness, interoperability, and providing sufficient incentive for providers to continue to invest in future innovation and development. The primary measure of the appropriateness of a fee should be whether it is consistent with the value that it delivers.

	Westpac would welcome the opportunity to work with MBIE to define the nature of any issues that may exist in respect of merchant service fees and card acceptance. Westpac submits that a full understanding of the nature and operation of the payments system is an essential precursor to any regulatory intervention. That work should include accurate, up-to-date information regarding card-related fees and other retail payments costs, and the scale and pace of change within the domestic payments system (of which open banking and open data initiatives are just two of many constituent aspects).
2	**Have we described the retail payments system accurately? Is there any additional information that you would like to provide?**
	MBIE's description and analysis of the retail payments system is incomplete and lacking critical elements. Westpac submits that a broad understanding of all primary payment instruments, together with the means by which they operate and interrelate, is essential before drawing comparisons as to relative convenience, efficacy and/or cost. In particular: • The retail payments system includes all payment methods used in retail transactions (both in person and online) and periodic (or recurring) transactions and bill payments. In addition to scheme cards and scheme transactions, New Zealand's payments system includes cash, EFTPOS, account-to-account payments such as bill payments, direct debits and automatic payments, store or private label cards, and the various credit payment facilities (which often substitute for, and compete with, scheme credit products). • The latter include the Buy-Now-Pay-Later (**BNPL**) services, with materially high costs to merchants, which continue to grow rapidly, alongside a range of in-store credit payment options (such as the no-deposit-extended-repayment purchase arrangements). • The retail payments system also includes modern API-based payment mechanisms which are already available online (and are planned for retail point-of-sale application) and which are growing in acceptance. • Open banking APIs will enable a broad range of new and important payment services which will compete with existing cards and other payment instruments. Each of these payment methods have direct (and indirect) costs and benefits, for merchants and consumers, payments service providers and the wider economy. It is essential, when considering public policy intervention, to: • account for all payment methods; • understand the full set of applicable cost drivers; • account for the end-to-end costs (and benefits) rather than just the direct costs (and benefits) that fall on one particular party; and • consider the potential unintended adverse consequences.

	For example, in regard to relative costs, it is not necessarily the case that scheme cards represent the most expensive payment mechanism for merchants, or more generally. A study by the European Central Bank found that the cost of a cash payment is 2.3% in comparison to 1.7% for a card payment. The study noted that "In the case of debit cards only, card transactions score lower than cash."[1] A United States study found that "the real cost of cash ranges from 4.7% to over 15% for some retail segments."[2] MBIE has primarily focused on interchange rates, but has misinterpreted the role that interchange income plays. It is incorrect to assert that the primary purpose of interchange fees is to fund rewards or inducements. Interchange income also finances the costs of credit and fraud, scheme and switching costs, providers' own processing systems and operational processes, and contributes to investment in innovation and security enhancements, all of which benefit participants in the payments system including those who use EFTPOS. It is also incorrect to suggest that card issuers incentivise high-cost payment methods, because they purport to provide higher returns. These services typically provide lower returns because a higher proportion of the income is returned to the customer in the form of benefits. Westpac also refutes the assertion that rewards cards are the most popular product in the issuing portfolio. Westpac data (which is consistent with wider market trends[3]) shows that low interest rate and scheme debit card products are generally more popular in terms of new account growth.
3	**Please provide information on your understanding of the levels of merchant service fees in New Zealand, any trends in relation to those fees, and how they compare to merchant service fees in overseas jurisdictions.**
	Westpac has prepared a categorised breakdown of merchant service fees across its acquiring portfolio, with associated explanations regarding how fees are set and the primary cost components of those fees. Westpac's data (from late 2020 and based on a view of our entire merchant customer base), presents a different picture from that which appears to form the basis of MBIE's hypotheses. Westpac's data (together with publicly available information) shows that: • merchant service costs are materially less than those suggested by MBIE; • interchange rates have been declining steadily since 2016; • taking all card transactions (including EFTPOS) into account, New Zealand merchants are not paying more than customers in other countries including Australia and the United Kingdom; and • small merchants are being charged appropriate rates, relative to the scale and nature of their businesses.

[1] The social and private costs of retail payment instruments a European perspective, European Central Bank September 2012

[2] https://www.ihlservices.com/product/costofcash

[3] https://www.nzherald.co.nz/business/credit-card-spending-and-new-applications-declining-across-all-ages

	If data provided to MBIE is based on a "write-in/opt-in" survey, Westpac submits it is likely that survey methodology limitations have delivered results which are incomplete and subject to error, and therefore cannot be validly extrapolated to obtain a true picture of the total domestic market.
	
	We note the following key points in comparing Westpac's data against that available to MBIE:
	
	Reductions in interchange and merchant service fees
	
	• Westpac's merchant service fees are in general materially lower than benchmarks cited by the Ministry. Westpac's preliminary conclusion is that this is because the data available to MBIE is materially out of date and incomplete. In particular, the Ministry's data does not appear to account for:
	
	  ○ the reductions in interchange and merchant service fees during 2020;
	
	  ○ the overall downward trend in rates since 2016; and
	
	  ○ the increasing move to more transparent and ultimately lower cost fee mechanisms such as interchange plus.
	
	• Contrary to MBIE's concerns, card issuers and the card schemes have been reducing interchange and merchant service fees. We are of the view that this reduction in effective cost is likely be a key factor in the growth of scheme card transaction volumes and contactless card transactions in recent years.
	
	EFTPOS transactions
	
	• MBIE's analysis does not appear to take into account EFTPOS which, at just under 50% of card transaction volumes, is the single largest component of New Zealand's payment system. NZ EFTPOS is globally unique as a mainstream card payment product in that merchant service fees are not charged for these transactions. It is also salient to note that most (if not all) New Zealand EFTPOS cardholders do not pay transaction fees for EFTPOS. None of the other countries to which New Zealand scheme card costs have been compared provide domestic debit card transactions at no cost to merchants.
	
	• Westpac data shows that its average card acceptance costs is equivalent to Australia and the United Kingdom. For merchants with a larger than average proportion of EFTPOS transactions (often small to medium sized (**SME**) merchants), the effective cost per transaction is lower than benchmarks referenced by MBIE for overseas merchants.
	
	Small merchants
	
	• For small merchants with relatively low average transaction values, interchange is not necessarily the largest determinant of the merchant service fee; fixed costs and other factors may be more significant. In these cases changes in interchange rates will not result in equivalent changes in merchant service fees.

- Transaction volumes and average transaction values are generally lower for small merchants than they are for larger operations. The effective cost involved in setting up and supporting the acquiring relationship and risk factors, are generally higher for small merchants, and small merchants typically do not qualify for the somewhat lower industry-specific (for example "utilities", government or charities) recurring billing or strategic merchant interchange rates.

- Smaller merchants can currently face higher merchant service rates for scheme card transactions than very large merchants, but smaller merchants generally have a very much higher proportion of EFTPOS transactions, which means that the overall cost of card acceptance between small and large merchants is not necessarily as significant as comparative merchant fees on their own may suggest.

- Westpac's data supports the view that small merchants are not materially disadvantaged in terms of overall card acceptance costs, relative to their larger competitors. Given the slow decline in the relative market share of EFTPOS, we do not believe this is likely to change for the foreseeable future.

Comparison to Australian counterparts

- Westpac has been unable to reconcile its data with a number of the "headline" statements made about merchant service fees, most notably the statement that "Retailers are estimated to pay on average $13,000 more than their Australian counterparts each year on merchant service fees" [4].

- Westpac's data shows that the average annual merchant service fee paid across our merchant base is significantly less than $13,000 per annum. [redacted]

- Westpac would welcome the opportunity to better understand the basis for the benchmark figures provided to MBIE, given the significant discrepancy between these and Westpac's own data.

Contactless debit transactions and low value transactions

- Contactless debit transactions have been a focus and concern in relation to the displacement of EFTPOS. Westpac's experience is that growth in contactless debit transactions (including recent growth related to COVID) has occurred largely in relation to relatively low value transactions, typically in the range of $10 to $15.

- While the effective cost per transaction to merchants is not zero (as it is currently for EFTPOS), it is significantly less than the figures indicated recently in various public forums.

- Westpac also notes that contactless debit delivers material benefits to both merchants and cardholders in terms of speed, security and convenience, that

[4] Small business plan to keep New Zealand moving - NZ Labour Party

	EFTPOS cannot provide. Furthermore, interchange rates for contactless debit are not materially different in New Zealand to those applied in comparable countries. • In relation to relatively low value contactless debit transactions, as we have noted elsewhere in this submission, interchange is not necessarily the primary component and cost driver for merchant service fees. The interchange component of a low value contactless transaction is minor compared to other components (usually the fixed costs) such as switching and processing costs associated with the transaction. • Therefore, for a significant proportion of scheme and scheme debit transactions (including the lower value transactions that are characteristic of many small merchants), changes to interchange rates are unlikely to have a material impact on merchant service fees. It is Westpac's understanding that despite extensive public policy regulation of interchange rates in the United Kingdom, the reduction in merchant service fees for small merchants, with relatively low value transactions, has been more gradual. As discussed in Q1 above, Westpac notes that it is important consider not only the fees incurred by merchants, but also the value received in exchange. Benefits of electronic card acceptance for merchants include: • Guaranteed payment – funds settled same day; • Faster transaction times – contactless payments; • Reduced cash handling costs; • Higher average transaction sizes; • Fraud prevention – merchant liability shift and investment in card number security; and • Customer insights – understand customer loyalty. Westpac's analysis highlights the importance of taking into account a broad view of the payments' environment and its cost drivers before drawing conclusions and designing solutions. It is also important to consider the risk of unintended consequences that could undermine the intended effect of any regulatory reform.
4	**What is your view on charges incurred by cardholders for the use of payment methods?**
	Westpac's experience is that in general, customers do not incur transaction fees that exactly reflect the full end-to-end cost of the payment services. For instance, consumers have never incurred the real cost of issuing cheques or of using cash, and generally pay no fees to use EFTPOS or electronic debit and credit transactions (such as direct debits, direct credits, automatic payments and bill payments). So, if it is the case that cardholders do not face accurate price signals in relation to scheme cards, the same is true for most of the other primary payment instruments. Westpac strongly submits that it is necessary to take an overall view before drawing

	any conclusions as to the extent to which price signals may be distorting the use of scheme cards relative to the other payment instruments that compete with, and substitute for, scheme cards in retail payments. MBIE should note that in extreme cases, where it is not feasible to charge customers the real cost of the product or service, but where those costs can no longer be supported across the overall business, it is often necessary to simply phase out the service entirely. The most recent example of this process at work is in relation to cheques and bank cheques, where there is no prospect of recovering the real cost of the service via product fees, but also that the business model is now simply unsustainable.
5	**What impacts do you believe rewards and inducements have on the retail payments system?**
	It is important to consider, when assessing the potential net impact of rewards and inducements, that these are a normal feature of a competitive market and not confined to some scheme cards. Merchants themselves compete by offering inducements to gain market share at the margin, including through special promotions, in-store and cross-industry loyalty programmes, and by providing other services such as extended free credit terms. The direct cost of all these mechanisms is necessarily built into the overall cost to serve and the headline price. However there will be offsets such as additional customer spending, and economies of scale. Westpac is not aware of any analysis that shows the effects of this wide range of products that drive market competition as being distortionary or regressive in nature and consequently needing public policy intervention. The operation of scheme card related loyalty programmes is little different to the other rewards and incentive mechanisms which characterise a competitive market economy. New Zealand examples include the Fly Buys loyalty programme, the One Card in store retailer programme, and the no-deposit extended credit facilities offered by furniture and home appliance retailers. There is recent evidence from both New Zealand and other comparable countries that market preference is moving away from scheme credit cards, including loyalty related credit cards, in favour of scheme debit and, in some cases, BNPL offerings. It is also important to consider the potential for unintended adverse consequences when attempting to “unwind” one element of this overall system of promotional, competitive incentive mechanisms. This is most clearly seen with reference to the regulated reductions in interchange rates in some overseas markets (refer to Westpac’s response to Q 9 below for further detail). In addition: • European evidence, outlined in a study by consultants Edgar Dunn[5], is that (as might be expected in a highly competitive market) the winding down of rewards programmes funded via interchange income has not eliminated competition amongst issuers for valued customers. Card related rewards programmes have simply re-emerged under a different business model.

[5] https://edgardunn.com/wp-content/uploads/2020/01/Interchange-Fee-Regulation-Impact-Study-Executive-Summary-EDC.pdf

	These new programmes are more tightly targeted to cardholders, and because the rewards are now partly merchant funded, incentivise spending only at those merchant partners, likely to be larger merchants and chains, who are better positioned to capture more market share from their competitors. This again highlights the potential unintended consequences of intervention in a complex, interdependent and very competitive market for payments services. • For card issuers, the sharp reductions in interchange income made economies of scale factors in relation to operational costs much more significant, materially improving the competitiveness of the larger issuers relative to others in the market, including a number of new entrants and Fintechs. It is notable that despite entering EU markets some years ago, these new entrants still have a minimal share of overall cards issuing business, and have not added materially to the degree of competition in the market. Westpac's analysis does not indicate that there are any material failings in the domestic acquiring market that necessitate regulation of interchange or other pricing components. However, even if there were grounds to consider policy intervention, it is essential to look beyond the likely immediate short-term impact, into the wider flow-on effects that the changes will have as existing business models respond and adapt.
6	**What is your view on charges incurred by merchants for the use (acceptance) of payment methods?**
	Most merchants also do not incur full costs in relation to cheques or cash, and do not incur merchant service fees in relation to EFTPOS. New Zealand is not unique in this regard. Westpac is not aware of any comparable OECD country that can deliver truly accurate price signals for its primary transactional banking products. Relationship pricing (that considers the overall value of the customer in the specific fees and charges that they incur) is an established feature of both the New Zealand banking system and those of similar OECD economies.
7	**Please provide your views on barriers to merchants steering consumers to lower cost payment methods and the extent that steering occurs?**
	There are a number of ways in which steering consumers to lower cost payment methods may occur. The simplest and most effective option by which a merchant can ensure that they are not faced with a payment method that does not meet their preferences (whether that relates to cash, a card product or some other mechanism), and where they consider that the cost of acceptance will exceed the benefit, is to not accept that payment method. For example, this has occurred in relation to cheques, and there are some merchants in the current economy who no longer accept cash. Similarly, there are many merchants who do not accept card products such as Amex or Diners, or QR code-based payment mechanisms such as AliPay or WeChat Pay. This is a simple mechanism for "steering". As an intermediate step, merchants may indicate to customers that they have a preferred option in respect of card related payments, but not refuse to accept a less preferred option if the cost of a refusal (for instance losing a major transaction) would very likely exceed the benefits. Some retailers have also taken the step of indicating that scheme cards would only be acceptable for transactions above a certain value (although this is inconsistent with current card scheme rules).

	Merchants may also steer their customers towards preferred payment options by applying differential pricing or, in terms of scheme cards, surcharging, which we discuss in our response to the next question below. Westpac does not have specific information on the prevalence of steering in the domestic economy. Based on discussions with some of our merchants, in many cases, there is simply little perceived benefit in attempting to steer customers and potential customers away from their preferred way of doing business. This is consistent with the findings of a recent study for the European Commission[6], which found that despite merchants being given specific rights to steer customers towards preferred payment methods, this option is rarely used.
8	**Please provide your views on the barriers to merchants surcharging and the extent that surcharging occurs?**
	MBIE has suggested that there may be technical factors, in relation to POS terminal configuration, or functionality, that limit the practical application of surcharging. Westpac does not understand that this is likely to be the case, as it is entirely feasible for terminal suppliers to incorporate surcharge functions that can be configured across card bases, into terminals. The domestic terminal supply market is competitive, and there are strong incentives for suppliers to respond effectively to any material level of market demand for a particular terminal-based facility. The alternative, more conventional and likely explanation for why surcharging may not be more widespread is that (as noted above) most merchants who have chosen to accept scheme cards believe that the overall benefits to their business outweigh the costs, and that enough of those benefits would be lost if they were to surcharge scheme card users. This is the same cost benefit decision that merchants make about every other aspect of customer service, including for instance whether or not to open on weekends or public holidays, open more checkout lanes to reduce queuing time, or provide free parking.
9	**What is your view of the wealth transfer by merchants passing on merchant service fees in the price of goods and services to all their consumers?**
	Westpac considers that the potential for regressive wealth transfers in relation to scheme cards and EFTPOS is considerably lower than MBIE's initial analysis suggests. This is in part because merchant service fees are in fact considerably lower than MBIE has identified, but also because the interdependencies between these card products (including the significant costs to operate EFTPOS but the absence of any revenue) mean that identifying net regressive impacts is not necessarily a simple matter. In relation to MBIE's characterisation of scheme cards as a product largely used by "wealthy" customers (and EFTPOS as one used mainly by less well-off customers), access to a credit card is determined by a range of factors, including the ability to manage credit. It is not simply a question of nominal income, nor is it necessary to have an income at or above the national average, or to otherwise be "wealthy" to obtain a scheme credit or debit card and to earn any reward points from expenditure via that card. As noted earlier, it is not the case that scheme cards with a loyalty aspect are either the most popular scheme product or the product that delivers the highest margin for banks and also, it is now clear that scheme credit card use in New

6 https://www.copenhageneconomics.com/publications/publication/study-on-the-application-of-the-interchange-fee-regulation

	Zealand and comparable countries has been declining for at least the past year or more[7]. As noted above in relation to Q2, other retail payment methods including cash and cheques, and non-scheme card credit facilities, also incur their own particular costs for merchants, and drive particular sales volumes. The overall net effect is reflected in the headline price for the merchant's services, but it would not be correct to argue that regulating one of these components down would necessarily deliver any meaningful change. There is now clear evidence from overseas, particularly the EU, where a comprehensive study by consultants Edgar Dunn found that the net impact of the regulated reductions in interchange rates was significantly negative in several unintended ways. The net effect on cardholders (for all types of cards) was significantly negative, through the loss of rewards, higher fees and charges, and more restrictive access to products. Furthermore, because the evidence indicated that there was no measurable pass through into retail prices of the reductions in merchant service fees that followed the reduction in interchange rates, there was no offsetting benefit for consumers. Merchants simply retained the reduction in costs. The second outcome was that the overall reductions in merchant service fees were largely captured by the larger merchants – the effective costs for SMEs did not fall materially at all. The net effect of the changes then was to transfer income and wealth from cardholders in general to merchants, primarily the very largest merchants – an outcome that is likely to have been, and continues to be, significantly regressive, in terms of the distribution of income and wealth.
10	**What barriers do small businesses face to obtaining competitive merchant service fees?**
	Westpac does not consider that there are any material barriers to small merchants obtaining competitive merchant service fees. In Westpac's merchant acquiring business, fees are set with reference to the characteristics of each merchant, including average transaction size and total turnover, and any particular risks entailed by the business. The extent to which the merchant has other (for instance lending or transactional banking) business with its acquiring bank may also be relevant if that enables an element of "relationship pricing", whereby the merchant service fee can be adjusted in the light of the overall value of the merchant's business. Another option for a small merchant is to consider the "preferred supplier" arrangements that some trade organisations provide, which enables the overall economies of scale generated by the members of that group to be reflected in the specific pricing that each merchant obtains. There are no material barriers to small merchants utilising this option and many of Westpac's own small merchant customers do benefit from the arrangements that we have established, for instance with Retail New Zealand.

[7] https://www.rba.gov.au/statistics/frequency/retail-payments/2020/retail-payments-1220.html
https://www.paymentsnz.co.nz/connect/industry-dashboards/cecs-report/?year=2020&month=11

	It is nevertheless true that, other things being equal, a business that has a very significant volume of turnover is likely to have an average merchant service fee that is lower than that for a business with a low volume of turnover, with economies of scale being a primary factor in this context (and also in terms of strategic or industry specific interchange rates). However, Westpac's data suggests that the differences are not anywhere as marked as the examples that have been raised in public and are based on objectively justifiable commercial factors. In general, these are the same market factors that apply to almost all the other (non-banking) services and supplies that are consumed by small businesses. The overall volume of business and the economies of scale involved, the breadth of the overall relationship and the risks or other costs entailed in doing business with that merchant are factors that determine the pricing that other service providers apply to their small business customers. In short, the fact that there are or may be differences in effective costs (including card acceptance costs) between smaller and larger merchants does not in itself mean that there is either a market failure or "unfair" treatment occurring, or that the differences can or should be remedied by public policy intervention or regulation without unintended or unexpected adverse market effects (such as adverse effects on the viability of acquiring).
11	**What information or assistance would assist small business to obtain better deals?**
	It is generally useful for merchants to periodically review market pricing, to confirm that their current arrangements remain competitive in terms of pricing and in terms of the broader range and quality of the services that they are getting – from their bank, and from their other suppliers. Advice and current market information is often provided by trade organisations (for merchants) and professional associations (for services), who may also have preferred supplier arrangements with a banking partner, which would entail preferential pricing for merchant acquiring and other banking services. The first and (in Westpac's experience) usually most useful step for a merchant is to discuss their position with their bank, to identify any options for reducing their effective transaction costs. We also believe that it would be in the overall interests of the market if there were wider understanding of the considerable benefits of the "interchange plus" merchant pricing model, in terms of cost efficiency, flexibility and transparency. It may be that there is scope for acquiring banks to work with MBIE to promote more widespread acceptance of this option across the retailing sector, and particularly for SMEs.
12	**What cost differences are there for providing merchant services to small businesses compared with larger businesses?**
	Please refer to Q10 above.
13	**How much competitive discipline does EFTPOS provide on scheme debit card merchant service fees and are there any barriers to domestic EFTPOS providing more competitive discipline on merchant service fees?**

	Westpac does not consider that domestic EFTPOS represents a material competitive constraint on scheme debit cards, or that any material reduction in EFTPOS' market share would have any material effect on the effective cost of scheme debit. For cardholders, although scheme debit has the same transaction effective cost as EFTPOS, its competitive advantage is in terms of value. Scheme debit cards deliver significant additional value over the EFTPOS alternative - the convenience and appeal of a contactless interface and integration into mobile wallets; online or card not present usage; international acceptance, security mechanisms such as tokenisation; and the capability to be used in recurring (card on file) payments. Widening acceptance of scheme debit and the planned implementation of "open loop" payments in public transport will only widen the competitive appeal. For merchants, although EFTPOS and scheme debit are close substitutes for low to medium value payments, scheme debit does not directly compete against EFTPOS, any more than it competes against cash or (in the past) cheques. The competitive advantages that scheme debit cards have rest with the additional value they create for merchants, relative to the cost of acceptance. Current data shows that scheme debit contactless interchange rates are now at levels consistent with comparable markets such as Australia and Europe and, as we have noted elsewhere, for the low value transactions that are being displaced from EFTPOS (and, to a less extent more recently, scheme credit) the benefits are now entirely consistent with the acceptance costs. It is worth noting again (as indicated by Westpac's data), that for low value contactless debit transactions, interchange fees are a minor component in the overall merchant service fee. Processing fees, particularly domestic switching fees, are the largest element proportionally. Any regulated business model changes could lead to the loss of benefits available to merchants and consumers, particularly in the form of risk management. We submit therefore any mandated changes to debit interchange rates would likely have a minimal net impact on the merchant service fees for these transactions. Furthermore, a large proportion of the non-interchange cost factors within the merchant service fee are not within the control of the acquiring bank.
14	**What impact is product innovation having on merchant service fees?**
	The Issues Paper suggests that the pace of innovation in the domestic payments system is slow, and its scope limited. That is not the case, although it could potentially seem that there is limited change if a broad view across the entire payments system is not taken. The significance of open banking and open banking APIs has been acknowledged, but there are a number of other important and far-reaching initiatives which are being developed within the payments system. These include seven-day interchange and settlement or seven day banking; scoping work on a new 24x7 real time payments system; and the implementation of a "data rich" messaging format in the form of the ISO20022 standard for domestic payments. Several of these changes will enable new payment services, such as the open banking API payment mechanisms which are already entering the market, and which will compete directly against other payment instruments - card products including both scheme cards and EFTPOS, and cash.

	It is important to recognise that the primary focus of innovation and new payment products and services is on creating new capabilities or new value and is not simply about competing in the market only on the basis of price. Westpac therefore does not expect that innovation (for example as a result of open banking or open data) will deliver lower per unit (or "free" as in EFTPOS) transactional fees, until possibly these new mechanisms have grown considerably in scale and market share. What these new products or services are more likely to do is to focus on delivering more value in relation to the cost of the service, and to compete against the more "commoditised" incumbent products, such as scheme cards and EFTPOS, on the basis of incremental value, rather than headline price. As outlined above, this is exactly the process that we are seeing in operation now, in relation to scheme debit contactless products. Finally, it is useful to briefly consider why the domestic EFTPOS system has not evolved its capabilities as the market has evolved. This is not, as the Issues Paper has suggested, that joint bank ownership of parts of the EFTPOS infrastructure removed any competitive reason to invest. The key issue lies with the flawed nature of the EFTPOS business model. While neither cardholders nor merchants face any material costs, issuing banks bear significant costs to maintain the system, with no countervailing revenue. The EFTPOS infrastructure is supported via the wider cards issuing business and revenue from transactional accounts (which in turn is required to support the wider payments processing environment, and investment in new payments services). There is no basis on which any material investment in EFTPOS can be made. By contrast, the equivalent domestic debit card product in Australia, also called 'EFTPOS', is not free, and Australia's EFTPOS capabilities have been progressively expanded as its domestic payments market has evolved. For example, the Australian EFTPOS system now supports EMV and NFC (with mobile wallet) capability; tokenisation for secure low risk (for both merchants and cardholders) online/ ecommerce use; and has provision to integrate with new open banking APIs and real time payment "rails". In MBIE's previous issues paper (*Retail payments systems in New Zealand*, October 2016) MBIE acknowledged that there are issues with the existing business model for EFTPOS. Westpac would be keen to discuss these issues with MBIE to determine if there are any potential ways forward to address current imbalances, and in particular the dependencies between EFTPOS and the wider cards issuing and transactional banking business, which is finely balanced in the current and expected future interest rate environment.
15	**Is open banking likely to provide sufficient competitive discipline on scheme debt and credit fees?**
	While there will be some overlap in functionality with existing payment options, the main significance of open banking payment mechanisms will likely be (as noted above) in terms of the new or distinctive value propositions they create or enable for merchants and consumers. The extent to which the new open banking payment products can compete successfully against scheme cards will likely depend on how strong or compelling these value propositions are, relative to scheme cards (and to other payment options). It is unlikely that open banking-based payment mechanisms would be successful if they could only compete by being priced lower than other existing payment options.

	Westpac considers that open banking mechanisms will have the capability to deliver material new value for all the parties in the payments system, and that this, rather than a lower headline cost, will be what drives market uptake. It is nevertheless likely that as volumes rise, economies of scale effects will drive down costs. However, this is unlikely to occur until those volumes have reached some critical mass, and where these newer products begin to take material market share from the incumbent products including scheme cards and EFTPOS.
16	**Do you agree that there is a gap in regulatory governance of the retail payments system relating to promoting competition and outcomes that are in the long term benefits of end-users?**
	Westpac does not consider that it is either necessary or useful to be considering potential public policy measures until the nature and scale of any underlying issues have been accurately identified. Please refer to our submission above, particularly with reference to data accuracy and completeness, in terms of why this has yet to be achieved.
17	**Please feel free to provide information on any other issues of concern with the performance of the retail payments system.**
	Westpac considers that the retail payments system is performing well. Consumers are choosing the payment method that best suits their needs, based on convenience and efficiency. This is seen in the shift to scheme debit cards from both EFTPOS and credit cards, for moves towards greater functionality and security as well as away from traditional lines of credit.
18	**Do you agree with the objectives for the retail payments system in New Zealand?**
	Westpac agrees that a principle of fair distribution of costs should be applied to the retail payments system, and supports greater transparency and simplification being applied to the system.
19	**Please provide feedback on the aspects of the proposal for interchange regulation, including any changes that would improve the impact of it, with supporting evidence of any benefits or costs.**
	No comment
20	**Please provide feedback on which body or bodies would be best placed to act as the regulator for interchange fee regulation.**
	No comment
21	**Please provide your views on the impacts of the above classes of options, with supporting evidence of the benefits and costs.**
	No comment
22	**Please provide your views on any other feasible options that should be considered, with supporting evidence of the benefits and costs of these options.**
	No comment