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Competition and Consumer Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
P O Box 1473
Wellington 6140

Attention: Steven Sue

Dear Steven

RETAIL PAYMENT SYSTEMS IN NEW ZEALAND

ASB Bank Limited (ASB) welcomes the opportunity to provide feedback on the *Issues Paper: Retail Payments Systems* dated October 2016 (the Issues Paper).

ASB is a subsidiary of Commonwealth Bank of Australia and a related company of Sovereign Assurance Company Limited.

ASB acknowledges the significance of retail payments systems to the New Zealand economy and appreciates the focus and interest of the Ministry on these matters. We are pleased the Issues Paper recognises the complexities involved in payments and look forward to continuing the open and collaborative engagement we have with you.

Our response addresses a number of the themes and issues arising from the Issues Paper and then provides responses to the specific questions raised.

We have contributed to the submission on this matter being made by the New Zealand Bankers' Association and we support the points made in that submission.

We acknowledge that ASB's submission may be made publically available by way of publication on the MBIE website, or may be released in response to a request under the Official Information Act. ASB does not seek confidentiality for any aspect of this submission.

1. Objectives for the study

The Issues paper have uses the objectives of innovation, efficiency, and fair distribution of cost to assess whether good economic outcomes are being delivered by New Zealand's retail payment systems, and asks whether these objectives are appropriate.

While ASB is broadly supportive of objectives set for the study, the Issues Paper very quickly narrows its focus to the pricing of a sub-set of retail payment products only. ASB views the issues in retail payments need to be considered in a broader context than just card payment pricing, and the study risks missing an opportunity if too narrow a view is taken.

ASB considers that a more holistic study would have drawn out different issues, such as the need to nurture the environment that will be necessary to encourage emerging innovations that will lead to the next step change in payments, and would have more readily identified the interconnected nature of payment systems and the shared benefits and opportunities that these present.

We also have concerns that having focused in on card payment pricing that some of the theory underpinning the conclusions subsequently drawn is incorrect.

2. Retail Payments Types

Emerging payment methods that do not rely on card models are only briefly discussed in section 2.6 of the Issues Paper, but the Issues Paper largely downplays the significance of these emerging payments in paragraph 234 where it states that: "even if there is an incentive for a particular bank to develop new products that do not utilise an interchange model, they will still need to bilaterally negotiate access to other banks' systems to achieve a workable network. This could be difficult to achieve."

The Issues Paper later acknowledges that "… technological developments could allow for significant retail payments innovation", but notes that "the timing and scale of any new developments are difficult to predict." While that is true, it can also be said of any change programme.

In paragraph 238 the Issues Paper concludes that "there is seemingly little prospect of the successful emergence of a competitor that does not rely on the interchange model."

ASB disagrees with that conclusion. Based on our assessment of global and local developments, ASB strongly believes it is inevitable that new payments models will in fact emerge driven by non-bank solution providers bringing new innovative solutions to market, working with banks to access customer accounts via Application Processor Interfaces (APIs).

ASB is of the view that while card-based payments are currently the most popular non-cash payment type for retail transactions, these will begin to progressively reduce in share as emerging low-cost 'next-generation' software-based account-to-account payments become more mainstream.

ASB submits that software-based payments will provide the next step change in retail payments. There have been many established and start-up companies worldwide over the past few years working on innovative payments solutions, and ASB expects this trend to continue. Accordingly, we think it is likely that new payment options and functionality will come to market, although some, as you have pointed out, will leverage existing cards and infrastructure e.g. PayPal, ApplePay, AndroidPay, SamsungPay.

ASB is already working with a number of established payment solution providers to link their innovative new merchant and biller propositions to consumer bank accounts. Philosophically, ASB is supportive of an environment where third party solution developers partner with banks to bring their new innovations to market as this will provide our customers and merchants with greater choice, increased value and better transaction experiences.

Over time, we expect these new models will provide strong competition for card-based payments, and that such competition will address the Ministry's concerns outlined in the issues paper. ASB further believes that New Zealand is well positioned to take a lead in creating the open environment that will foster greater competition in retail payment methods, coupled with greater collaboration between innovators and banks. To accelerate the development of this environment will, however, require the active support of the merchant community and ASB believes the Ministry should be bolder in how it is thinking about its role in supporting these developments.

ASB's future view in respect of retail payments is aligned to changing models in retail including click 'n' collect and 'pay in advance' style payment. These models require new and innovative solutions for payment including in-app payments and 'messenger' style payments. These types of payment will reside natively in merchant applications that will be positioned for mass adoption of mobile commerce enacted from smart devices. Our view is that consumers will drive demand for this innovation and the industry should have available both domestic 'direct from account' and scheme based payments options to meet customer need for choice.

3. Card-Based Payments

While we address aspects of card based payments in response to the specific questions later in our submission, we have a general concern that the issues relating to card based payments are more complicated than stated in the Issues Paper. This is particularly so when considering the relative benefits and costs with credit cards.

Although retailers pay transactional fees for some of their card-based payments, they also receive significant economic and related benefits from a 'bank-managed' credit card model. This is acknowledged in the Issues Paper, but it should be noted that payment cards that extend credit for purchases were originally a merchant-driven innovation developed by various merchants (albeit overseas) in the 1920s to enhance their own profitability. While those card programs proved attractive to consumers given the payment convenience and ready access to credit they provided, they were not very efficient for merchants since each merchant needed to:

a. market its own program, process and evaluate applications, and issue its own cards;
b. develop its own system for accounting and billing, including posting every transaction to the proper account, mailing billing statements, and tracking payments;
c. operate its own customer service function to handle billing inquiries and disputes;
d. incur the costs involved in funding the credit transactions;
e. conduct its own underwriting to determine which customers qualified for credit and which did not;
f. establish and maintain debt collection programs;
g. bear all the credit losses; and

h. develop and implement fraud prevention strategies.

Merchants realised that while sales can be increased by providing lines of credit to their customers, managing that credit can be challenging and expensive. Furthermore, merchants discovered that collection activities against a customer generally run counter to retail efforts to create customer loyalty that will hopefully generate future sales. Compliance costs also began to mount as more and more laws were enacted regulating consumer credit transactions.

So rather than continuing to develop and operate their own systems, merchants over the years have increasingly chosen to take advantage of other options such as those offered by their banks using products and networks of Visa, MasterCard and others. It is ASB's view that current Merchant Service Fee pricing on credit card payments represents good value for merchants when compared to the alternative of merchants operating their own credit programmes. The costs and risks associated with running these card programmes are now borne by issuers who rely on interchange paid by retailers as part of their transaction fees to cover these costs.

We reiterate at this point that merchants have also enjoyed substantial benefits from effectively fee-free eftpos transactions since the 1980s and it is important that this feature of historic pricing does not distort how the issues are being considered now.

Furthermore, the Issues Paper's assertion that rewards points distort the market, ultimately driving up the cost of goods and services is overly simplistic. Although many customers may use credit cards to transact when they don't need the credit, this is not necessarily driven by a desire to earn rewards. Often it is to take advantage of the chargeback protection offered by this payment method, or to utilise the interest free period, allowing them to leave funds in their revolving mortgage facility, for example. Furthermore, when consumers use a premium card to transact, they tend to spend more. It is true that consumers are drawn to higher interchange premium cards partly due to rewards points, but rewards are only one factor in the choice of card that customers use to transact.

And while ASB sees great value for our (consumer and business) customers in the scheme products, ASB is also supportive of maintaining an independent low-cost domestic debit proposition for the benefit of New Zealand consumers and merchants.

4. Regulatory Intervention

ASB considers the Ministry should be cautious about the unintended consequences of regulatory intervention. It is apparent to ASB that in those overseas markets where regulatory intervention has been introduced to try to influence consumer payment behaviour, and/or to directly lower merchant fees (often coupled with greater price transparency), consumers have invariably ended up worse off.

Typically, as the Issues Paper highlights, as issuing banks in those markets suffered from a reduction in interchange revenues, they responded by increasing the level of other fees and reducing cardholder benefits. However, the number of merchants imposing a surcharge also increased significantly, with the level of surcharges often being greater than that of the merchant fees from their bank.

In Australia, for example, the RBA expected the mandated decrease in weighted-average interchange to result in a reduction of merchant service fees that they would then see passed through to consumers as lower prices, thanks to competition at the retail level. However, no evidence has been found either of a reduction in retail prices nor of an improvement in the quality of products. This is similar to the experience seen in other jurisdictions and in our view, reflects the reality that merchant service fees are a very minor factor among a multitude of other cost choices made by merchants in the setting of retail prices.

5. Domestic Eftpos

In essence, eftpos has been a major success story for New Zealand, but is basically a 1980s artefact that is nearing the end of its product life cycle.

The RBA mandates to protect and enhance domestic eftpos in Australia have not led to the competition the RBA had hoped would drive lower transactional pricing and innovation. Rather, it has merely added systemic cost and led to duplicated and undifferentiated customer propositions compared to the scheme offerings. ASB believes that any regulator-mandated investment in the existing eftpos model would result in a similar outcome in New Zealand.

To be truly competitive and provide genuine value to users, a domestic debit proposition must have a meaningful point of difference to the scheme propositions. Simply enhancing the current eftpos product to match functionality and features that the scheme products already have, will not make domestic eftpos a competitive alternative to scheme. Further, continuing to provide it as a free offering is not commercially sustainable.

6. ASB Recommendation

ASB believes that the New Zealand market would be best served by key stakeholders, including Government, working together to develop the environment that will encourage innovation (by both existing and new market participants) where next generation payment services can thrive, rather than focusing market incumbents on compliance effort in respect to a payment type that is expected to be progressively substituted over time. Compliance costs, both real and in innovation opportunity cost, would be significant with regulatory intervention and we do not believe MBIE has adequately demonstrated a market failure, or that regulation is warranted.

Retailers have options for supporting alternative payment types and should be encouraged to focus on supporting alternatives instead of seeking cost relief in respect of some of the current options.

ASB has already launched examples of these ‘next generation’ products in conjunction with partners, and is actively looking to engage other market participants to drive uptake for the benefit of all New Zealanders. We would be happy to discuss these new payment options and our plans in more detail with the Ministry.

Alongside a collaborative Government and industry effort to advance the innovation environment, ASB would also be open to participating in industry initiatives that assist to alleviate concerns raised in the Issues Paper in regards to card-based retail payments, such as:

- greater transparency and disclosure of fees and charges to merchants;

- improved notification of fee changes;
- certainty regarding the fee-free status of swiped and inserted debit payments; and
- any assurance necessary for merchants about access to dispute resolution processes that provides for investigation and timely response of complaints (with respect to banks this is currently provided by the Banking Ombudsman service).

If you require any further information in relation to this submission, please do not hesitate to contact me.

We look forward to further discussions.

Yours sincerely

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APPENDIX: Responses to Specific Questions

1. Are these objectives for retail payments systems appropriate?

ASB is a great believer in providing our customers (both consumer and businesses) with choices, and therefore agree with the proposed innovation objective. ASB however believes that innovation and development of payments options that are valued by consumers and businesses will be best achieved through investment in next generation retail payments (i.e. software-based account-to-account models) rather than trying to upgrade the 1980's eftpos product. ASB is in the process of driving market acceptance of some new software-based payment options we have developed in conjunction with partners.

Further, ASB believes that costs must also be allocated at a system level, not just at an individual level, as proposed in the Issues Paper. At present, banks wear significant costs associated with providing eftpos services from which retailers gain significant benefits, but without paying for those benefits. ASB agrees that there is an opportunity for larger retailers to assume a greater share of the costs of scheme transactions to alleviate the burden on smaller retailers and for retailers generally to pay a fair price for domestic non-scheme retail payments.

ASB would also like to emphasise that there is a need to balance innovation and efficiency with security and interoperability. Significant cost and effort is required to keep payment systems safe and secure, as well as to ensure compliance with the various evolving rules and standards of each payment system that enable payments to operate reliably between participants as intended.

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

The Issues Paper in section 2.6 focuses heavily on specific products. ASB's experience is that there are numerous solution providers working on innovative new solutions in payments. Many new options will be looking to link to bank accounts through the API environment and we expect a myriad of new solutions to emerge and transform the NZ payments environment over time. While these are mentioned in the Issues Paper, we do not think they have been given sufficient weight in the subsequent analysis as we believe these solutions have significant potential to support the business growth agenda in New Zealand.

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

The reduction in revolve rate is driven by two key factors. Firstly, the current low interest rate environment and sound economic conditions are enabling more customers to repay their card in full each month as opposed to having to borrow or revolve. As interest rates start to rise and the economy shifts, we expect revolve rates to increase. Secondly, the younger demographic have less appetite for debt and prefer alternate access methods such as scheme debit cards to spend their own money. Historically these customers would take a credit card and also were more likely to revolve a balance.

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

Your explanation of the rationale for interchange focuses on the balancing function of interchange through the lens of profit maximisation. Your rationale does not sufficiently recognise the underlying cost models with card schemes and why interchange payments flow to issuers. Establishing, maintaining and managing the risks of an issuing book is a significant cost which is borne by the issuing side and avoided by the merchant side.

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

The Issues Paper has approached the issues of incentives simplistically. While it is correct that interchange does not directly flow to schemes it underpins the functioning of the four party model which in turn indirectly drives scheme revenue. Similarly a product attracting high interchange may not necessarily be more attractive to an issuer than a lower interchange product, as it will also come with higher cost profile. A broader perspective is required reflecting that issuers will typically take a portfolio approach to ensure they have a range of products available to cater for a diverse customer base. This is necessary to ensure than an issuer can compete.

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

ASB regularly reviews its standard pricing schedules to ensure they reflect any changes to cost inputs, and that they remain competitive with what we understand others in the market are doing, including emerging substitute services. At the top end of the market, large merchants have considerable bargaining power in respect to negotiating their pricing, which in some cases involves rebates in addition to strategic merchant rates. Another segment of merchants are on individually negotiated fixed-rate agreements. ASB believes that competition from emerging non-card direct-to-account payment options will ultimately drive down card acceptance pricing for all merchant segments as these options become more mainstream.

7. 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?

ASB's view is that the NZ and Australian payment markets are very different in how they are structured and how they operate. The Australian model utilises multiple bi-lateral agreements between banks, each with their own proprietary switch, and large retailers with proprietary switches also. Whereas the New Zealand market has one dominant switch linking banks and retailers. While we recognise that all payment types will have cost profiles, we do not believe it can simply be applied across to NZ, and meaningful and accurate conclusions made.

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

ASB disagrees with the logic underpinning the assessment that there is inefficiency in the credit card market on the basis that some of the assumptions used are unsubstantiated and or highly questionable, and that the methodology used to calculate economic impacts is flawed in that it does not correctly distinguish between wealth transfers and efficiency gains, or properly consider associated benefits.

9. ***Do you agree with the logic underpinning our assessment that reward schemes result in higher overall prices and cross-subsidies?***

ASB does not agree with the logic underpinning the Issues Paper's assessment that reward schemes result in higher overall prices and cross-subsidies.

As discussed above, customers choose to use higher cost credit card products for a variety of reasons, and are not necessarily primarily motivated by earning rewards points.

Furthermore, the commentary and analysis of cross-subsidy from low to high-income households is methodologically flawed, overstating potential welfare benefits achievable from regulatory intervention. The Issues Paper's analysis relies on unsubstantiated assumptions, presupposing that any input cost reductions would be passed-through by merchants to final prices, and ignoring the fact that there are likely to be much more effective ways of redistributing wealth

10. ***Do you agree that self-acquirers are unlikely to place downward pressure on interchange?***

Interchange reimburses issuers for the costs incurred in operating and maintaining a cards portfolio. Whichever party acquires the transaction is not relevant to these costs.

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

Firstly, it is common practice for merchants, including small business merchants, to rate shop around providers to seek out the best deal in market. Secondly, it is misleading to consider merchant negotiating power in respect to their merchant facility in isolation. A merchant's pricing typically reflects the value of their total banking relationship, which in turn might be reflected in the pricing of other services, such as a discounted mortgage interest rate for a small business owner, for example.

12. ***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?***

For the reasons outlined previously we do not believe looking at the issues in the credit card market in isolation is the correct approach. We believe a wider consideration of the functioning of the payments markets shows that support for innovation and new payment options will address the issues being considered. We also have real concerns that the assumptions and thinking driving the economic conclusions drawn in the Issues Paper are incorrect.

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

With respect to the incentive for a merchant to accept contactless (scheme currently) debit we do agree that the merchant inevitably will weigh up the benefits that accrue to them for this decision. This is the same decision faced by a merchant with respect to the acceptance of credit cards – will this benefit them? Indeed many merchants do, and will continue to make the choice to invest in the acceptance of electronic payments while choosing not to accept scheme credit and debit payments.

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

ASB is of the view that there is no value investing in the current proprietary eftpos model. Over the course of 2013/14 a group of industry stakeholders (including banks and retailers) actively explored how to respond to the declining relevance of domestic debit. Various options were considered, including a managed re-investment in domestic debit; the establishment of a domestic debit scheme similar to the EPAL scheme in Australia; and a collaboration with the international schemes to agree on a New Zealand specific model for debit. It was clear from these discussions and from evaluating the Australian experience that upgrading eftpos to match the scheme products simply duplicates cost without delivering genuine choice for consumers and retailers. To be of value, ASB believes that a proprietary low-cost domestic model needs a point of difference to be competitive, and that this will be best achieved through investing in next generation software-based direct-from–account payment models.

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

You will need to ask the schemes what their intentions are in this regard. Our experience, however, is that the schemes are conscious of how the NZ payments environment has evolved and will work in its best interest.

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

Yes we agree this is not an issue in itself. Zero cost on proprietary eftpos has acted as a price distortion. A holistic view of the payments market shows that there are a growing number of options available to merchants and consumers.

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

The various parties will assess the costs and benefits of contactless debit for themselves and will choose to participate if there is sufficient perceived value. Market experience to date suggests that a growing number of consumers and merchants are convinced that contactless debit has value for them, although a number are also clearly not convinced, and as such have made the choice not to participate.

18. 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?

As non-card direct-to-account payment options become more widely available in market, merchants will have increasingly more opportunity to influence consumer payment choices to alternatives. On that basis, we believe the debit market is not likely to be inefficient longer term.

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

We believe that competition from emerging non-card direct-to-account payment options will ultimately drive down debit card pricing as these options become more mainstream.

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

As the API and other software-based non-card payment environment matures, any barriers to entry for new payment solution providers will increasingly diminish.

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

We believe that it is inevitable that non-card direct-to-account payment options that compete with card-based payments will become mainstream, not only in New Zealand, but globally. It is not a question of if, but when. The New Zealand market is well placed to accelerate adoption of new payment options.

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

Large merchants will always have the market power to command lower prices. ASB believes that competition from emerging non-card direct-to-account payment options will eventually drive down transaction pricing for small merchants and make the differential in interchange pricing become increasingly less relevant over time.

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

ASB believes that the proactive development of next-generation payment options will alleviate the concerns described in your assessment of the two markets against proposed objectives.

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

Merchant pricing currently takes into account the mix of card types and associated pricing. Greater transparency will enable merchants to better understand how their pricing was determined based on the mix of card types, but that will not necessarily lead to lower pricing. ASB believes that pricing benefits are most likely to be achieved for merchants from greater competition as new and emerging payment types become mainstream.

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

We believe that merchants would appreciate some certainty that swiped and inserted debit payments will remain fee-free.

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

Overseas experience clearly shows that interchange regulation leads to unintended consequences and that consumers typically end up worse off.

27. What unintended consequences could arise from interchange regulation?

As issuing banks in regulated markets suffered from a reduction in interchange revenues, they responded by increasing the level of other fees and reducing cardholder benefits. However, the number of merchants imposing a surcharge also increased significantly, with the level of surcharges often being greater than that of the merchant fees from their bank.

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

Under no circumstances should interchange rates be regulated. In overseas markets where this has occurred, consumers have ultimately been disadvantaged through increased merchant surcharging and higher bank fees. If there are concerns about the market pricing of particular payment instruments in use today, the only viable solution is to encourage competition from modern lost-cost alternatives.

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

In an environment where payment solution providers can develop innovative new solutions that link to bank accounts via APIs, ASB expects the barriers to entry to be relatively low.

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

Encouraging the environment for next-generation payments will erode any existing barriers to entry.

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

Actively develop the environment for next-generation payments innovation to thrive.

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

ASB believes there is an opportunity to take a broader view on the issues in the retail payment system that also:

- focuses on the opportunities for innovation to address the market issues identified; and that
- recommends options to address any roadblocks and barriers to innovation in payments.

33. Have we missed any options?

We believe that MBIE should champion innovation as the path to help solve the issues identified in the Issues Paper.