Westpac New Zealand Limited

Submission to the Ministry of Business, Innovation and Employment on the Issues Paper: Retail Payment Systems in New Zealand

2 February 2017

Mark Weenink
General Manager, Regulatory Affairs
Compliance and General Counsel NZ
Westpac New Zealand Limited

Loretta DeSourdy
Head of Regulatory Affairs
Westpac New Zealand Limited

1. INTRODUCTION

1.1 This submission to the Ministry of Business, Innovation and Employment (**MBIE**) is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the Issues Paper: Retail payment systems in New Zealand (**Issues Paper**). We appreciate MBIE granting us an extension of time in which to make this submission.

1.2 Westpac's contact for this submission is:

Loretta DeSourdy
Head of Regulatory Affairs
Westpac New Zealand Limited
PO Box 691
Wellington

Phone: (04) 498 1294
Email: loretta_desourdy@westpac.co.nz

1.3 Westpac welcomes the opportunity to submit on the Issues Paper. Westpac is a member of the New Zealand Bankers' Association (**NZBA**) and has contributed to, and supports the submission made by, the NZBA, which includes the accompanying paper by Axiom (**Axiom Paper**).

2. KEY SUBMISSIONS

2.1 Westpac agrees with the statement in the NZBA's submission that New Zealand's payment system is world leading in many respects. Westpac is committed to maintaining an efficient and balanced payments system which benefits all participants and strengthens New Zealand as a whole. An efficient payments market plays a critical role in the New Zealand economy. Westpac is committed to working with the Government and interested parties to ensure market efficiency and a level playing field for New Zealand consumers and merchants.

2.2 Westpac acknowledges the work that MBIE has done to date but considers that the assumptions and facts underlying the Issues Paper are not sufficiently robust to support regulation, which should only be considered where there is clear evidence that market solutions have failed. For reasons set out below, we consider that is not the situation in New Zealand.

1. **Challenging MBIE's analysis in the Issues Paper** – Westpac does not agree with many of the assumptions and facts underlying the analysis in the Issues Paper. The Axiom Paper considers these issues in more detail but our key concerns can be summarised as follows:

    - The Issues Paper relies on incomplete and possibly unrepresentative data;

    - The analysis of card and other payment related products and markets contains some flaws, particularly with regard to the assessment of cost in relation to service, competitiveness and contestability, and to the nature and significance of new payments technologies;

- The comparison of relative costs of interchange between New Zealand and other markets does not include EFTPOS transactions, thereby failing to provide a like for like comparison. Additionally the comparison of scheme and proprietary products is not appropriate given the added functionality and security provided by scheme products; and

- In our view the conclusions that there are persistent, significant and growing market failures are not correct.

2. **Overseas experience does not support regulation** – The Issues Paper's conclusion on the benefits of, and necessity for, a certain level of regulation is, for a number of reasons, unfounded. Again, the Axiom Paper addresses these issues in more detail but it should be noted that:

   - Intervention in overseas markets has had adverse impacts on those markets. Empirical evidence indicates that regulated reductions in interchange rates have had negative impacts on the consumer and, in places, on market competition;

   - Where intervention in overseas markets has been implemented regulators have had to follow up initial interventions with an ongoing series of further interventions to address the 'unintended' policy impacts; and

   - There is no evidence to suggest benefits from regulated interchange have been passed on to consumers in markets where interchange has been regulated.

2.3 While we do not consider that there is a case for regulation in New Zealand, we agree that more transparency is desirable and would support increased transparency and more disclosure of fees and charges by acquirers to merchants. We also think this is where the market is inevitably moving.

2.4 We think this can be accomplished by the industry agreeing steps to make New Zealand's retail payments system more transparent for participants. While these steps would need to be agreed between participants, we anticipate that they would include principles dealing with transparency and disclosure, notification of fees and changes, dispute resolution and the issuance of premium cards. We provide more detail on these proposals in the Next Steps section in Part 3 of this submission.

3. GENERAL SUBMISSIONS

Westpac's response to the five key issues identified in the Issues Paper

Issue 1: Economic inefficiency in the credit card market

3.1 The Issues Paper states that "*current market incentives drive at least $45m per year of additional cost to the economy through the use of more expensive credit card networks compared to lower cost EFTPOS networks*".

3.2 The statement is based on the following two assumptions which in our view are not appropriate and which are considered in turn below:

- That credit card or card scheme "*rails*" are inherently more expensive, on a "*resource cost*" basis, than are domestic EFTPOS rails; and

- That market factors drive excessive or in some sense unwarranted use of card scheme rails in preference to EFTPOS rails, which are presumed to be more efficient.

Scheme vs EFTPOS resource cost

3.3 The conclusions drawn in the Issues Paper are based on a Reserve Bank of Australia (**RBA**) study of the Australian payment system. We are not aware of work being done to establish whether the study's estimates are appropriately robust in this context and directly applicable to the New Zealand payment system. It appears that it was assumed that these conditions are met and that the cost differentials in New Zealand are even larger than in Australia.

3.4 Further, it is not appropriate to simply compare estimates of the "*headline*" direct cost of payments through scheme and domestic EFTPOS networks as this is not a like for like comparison. Scheme networks support more extensive value-added functionality than do domestic networks in relation to transaction types (including e-commerce and cross border), risk management, and other value-added services.

3.5 Finally, as noted in the Issues Paper, the apparent cost effectiveness of domestic EFTPOS may be misleading since there has been minimal investment in the system. If EFTPOS were upgraded to become more competitive, its resource costs would almost certainly increase.

Excessive or unwarranted use of scheme networks

3.6 The assessment that there is "*excessive*" use of scheme cards and networks is based on MBIE's estimate that:

- 40% of credit card use relates to "*transactors*" who pay off their balance on or before the due date;

- These transactions would not have occurred in the absence of rewards programmes; and

- These cardholders could have effected EFTPOS transactions instead.

3.7 This analysis ignores the other reasons why transactors may choose to use credit cards rather than EFTPOS. Consequently, the proportion of credit card transactions that are paid off on or before the due date should not be considered a reliable measure of the impact of rewards programmes on consumers' choices of payment instrument.

3.8 In particular, credit cards deliver significant benefits in terms of cash flow management. Cardholders can use the free credit period (typically 30-50 days) to smooth expenditure and better align payments to their cash flow and are also able to retain money in interest bearing accounts for longer periods. In the absence of the credit card facility they might need to transact more often in smaller amounts or utilise other short term credit facilities. Scheme cards can also deliver other benefits, including the ability to support e-commerce, overseas acceptance, increased security and the option of chargebacks where the terms of a transaction have not been met. The interfaces available for scheme products are another relevant factor in consumer choice, for example, an increasingly important consideration is that scheme debit and credit cards also support Near Field Communication (**NFC**), a technology deployed through mobile wallets which support other integrated functionality. These interfaces and platforms deliver services which are valued by consumers and many merchants and are unrelated to reward programme factors.

Issue 2: Increased prices for all consumers, with only higher income consumers benefiting from rewards

3.9 The Issues Paper states "*We estimate that merchants have to increase their prices to all consumers by around $187 million per year to fund rewards paid to certain credit card users. Because of the way credit card reward schemes are structured, this leads to an annual regressive cross-subsidy of $59 million from low-income to high-income households.*"

3.10 This statement reflects several views with which Westpac disagrees. The first of these is that rewards on their own drive a significant proportion of credit card spending. This has already been discussed in relation to Issue 1 above. While rewards programmes drive some use of credit cards, we do not agree with MBIE's estimate of the credit card spend that can be attributed solely to these programmes.

3.11 Similarly we do not agree that there is a one-to-one relationship between interchange and rewards. Rewards are not funded through specific components of credit card income but are one of the many components of the profit and loss of offering the card. Income sources include: interest income, interchange, annual fees and certain transactional fees. Related costs which partially offset this income include rewards, insurance costs, domestic processing and scheme fees, as well as credit and fraud risk management.

3.12 MBIE has concluded that only the highest 40% of households benefit from rewards but does not cite evidence in support of this conclusion which is inconsistent with Westpac's assessment of its customer base.

3.13 MBIE has also concluded that most of the competition in the market relates to premium, high rewards card products. However, this view may have been influenced by the time period in which MBIE's study took place. There was a significant increase in activity in the premium cards space in 2015 driven by the

Air NZ Airpoints programme. However, the current focus for competition amongst banks is around low rate cards, which earn a considerably lower rate of interchange. A review of credit card offers in the market at any point in time will show that many in fact relate to low rate cards.

3.14 Having regard to the points noted above, we do not agree with the conclusion that market dynamics will inevitably drive a continued upward trend in interchange rates and hence in merchant acceptance costs. There will be short term fluctuations in response to market factors but empirical evidence, as evidenced by information MBIE notes it received from the card schemes, shows that the overall long term trend is for interchange rates to fall. It is also relevant to note that the overall objective of card schemes is to maximise the acceptance and use of their card products. A strategy which entailed continued increases in interchange and hence acceptance costs would be inconsistent with these objectives and unsustainable in a competitive sense.

3.15 While MBIE considers that merchant acceptance fees are high in New Zealand relative to some other countries and that they will trend upwards, we consider that the correct relative measure is to look at acceptance costs across all card products, including domestic EFTPOS, scheme debit, and scheme credit. On that basis merchant acceptance costs in New Zealand are not materially different to costs in comparable countries, including those cited in the Issues Paper. We also note that acceptance costs for credit cards vary widely from country to country.

3.16 We do not agree that regulating interchange would have no material unintended adverse impacts, for instance on risk management, retail turnover or innovation. Since there is not a one-to-one relationship between interchange and rewards, a regulated reduction in interchange that is effected without regard to the other elements of the issuing and acquiring business models would inevitably have wider consequences outside the impact on rewards programmes.

3.17 As noted above, one effect that has impacted consumers in overseas markets would be an increase in the fees faced by cardholders, including for low cost/ no rewards cards. There could be other effects as well. Rewards programmes would certainly be impacted, but so would the extent to which banks could invest in new technologies and value-added services. For instance, investment in integrating payments into mobile wallets, and investment in new fraud and risk management systems to limit potential cardholder and merchant exposures would likely take a different path.

3.18 There are also likely to be impacts on market competitiveness. As has been demonstrated in overseas markets, regulated reductions in interchange can reduce the incentives for new competitors to enter the market and can have a particular impact on the competitiveness of smaller issuers, who may lack economies of scale.

3.19 While MBIE concedes that cross subsidies are endemic in retailing, it considers them to be immaterial in a public policy context but has not provided any further analysis to support this proposition. However, the costs of these elements are built into overall price structures and therefore also have the potential for regressive impacts on income distribution. MBIE has not attempted to establish that there are grounds for public policy to address just one of many of these possible cross subsidies.

3.20 Finally, we are not aware of there being any evidence, in Australia or elsewhere, that shows that regulated reductions in interchange rates have resulted in a net increase in consumer welfare or a reduction in any regressive effects on income distribution. While economic theory suggests that in principle, in highly efficient markets, cost reductions would be passed on in prices, all of the available evidence instead suggests that reductions in interchange and in merchant service costs have not been passed through into prices. The main impact of these measures has been simply to transfer income from householders to retailers, which could potentially have even more adverse outcomes in terms of income distribution.

Issue 3: Emerging inefficiency in the debit card market

3.21 The Issues Paper states that: "*we are concerned that the competitive constraint on fees to merchants currently provided by proprietary EFTPOS will reduce. This could result in the interchange dynamics we currently see in the credit card market driving inefficiency and large scale cross-subsidisation in the debit market as well.*"

3.22 The primary components for concern are MBIE's conclusions that:

1. There are significant and growing inefficiencies and cross subsidisation with scheme cards;

2. Fees relating to contactless debit transactions are only constrained by the zero cost (to merchants) of EFTPOS transactions; and

3. EFTPOS transactions will decline over time to a minimal level, removing any current constraints that may apply on contactless debit acceptance costs.

3.23 As regards the first point, we have noted above that we do not consider that MBIE has identified significant and growing inefficiencies and cross subsidisation in the market for scheme cards.

3.24 With respect to the second, that scheme debit fees are only constrained by EFTPOS, as has also been noted above, banks and card schemes wish to maximise acceptance and use of their payment products, including scheme debit. In order to achieve this, these products must deliver value to cardholders and be cost effective for merchants. Current fees for scheme debit achieve this balance and are favourable in an international context. We consider that there is scope for further reductions in effective cost as economies of scale efficiencies are realised and new value-added services are included to the core payment products.

3.25 Further, in our view there is no basis for concluding that EFTPOS will remain the only competitor to scheme debit. Banks, both in New Zealand and globally, are developing and launching a range of payment services based on new technologies and business models. These include, in the near term, payment services based on APIs and open API frameworks, and in the medium term, payments utilising blockchain and distributed ledger technologies.

3.26 While we agree that EFTPOS transactions are likely to decline over time as cardholders choose to use other payment options, we consider this would be of no significance in relation to the future direction of transaction fees and acceptance costs. Although banks are likely to issue fewer EFTPOS cards over time as a result of customers' preferences for NFC enabled scheme cards, cardholders will still be able to effect EFTPOS transactions where they choose by swiping or dipping their scheme cards. Our understanding is that there is no current intention by banks and card schemes to impose interchange fees on these transactions or to require them to be switched to acquirers rather than issuers and in paragraph 3.46 we note the NZBA's proposal to seek a stronger commitment from the card schemes.

3.27 Westpac does not support regulation of the domestic EFTPOS system and notes that the system is not "*free*" as the Issues Paper states. Banks, switches and other parties have made significant commitments to ensuring that it continues to operate efficiently and reliably. These parties must be able to continue to make investment decisions that ensure that the right outcomes are delivered based on customer and merchant needs.

Issue 4: Barriers to entry in the debit market

3.28 MBIE notes in paragraph 21 of the Issues Paper its concerns about the impact that a scheme dominated debit market would have on market entry and expansion and considers that the interchange model sets up entry and expansion barriers by giving card issuers (banks) significant financial incentives to favour payment systems that offer interchange income. This reflects MBIE's view that:

- Any new payment services will have to replicate the four party card business model, and retain a mechanism similar to interchange. These services will then inevitably replicate the issues MBIE believes apply to credit cards; and

- There may be other barriers to entry to the payment system which may restrict the development of viable alternatives to EFTPOS.

3.29 It is not correct that new payments services must necessarily include an interchange component in order to be commercially viable. New payment services that are under development both globally and in New Zealand, including emerging API based services, and planned blockchain/distributed ledger systems, do not require or incorporate interchange. Nor is interchange a component of any of the real time "*P2P*" and "*P2B*" payment mechanisms that are in operation overseas. There is an emerging global consensus that most of the future growth in payments services will be driven from these new payments technologies and not from business models which replicate the traditional four party card scheme business model.

3.30 In addition, we do not support the conclusion that further scheme related barriers will emerge to prevent entry to the payments system. Given the nature of technological change and the rapid deployment of "*disruptive*" technologies and business models in banking and payments, it seems more likely that the payment system will become progressively more open, rather than closed.

Issue 5: Impact on small business

3.31 The Issues Paper notes that "*there appears to be systemically higher costs placed on smaller merchants to pay for the processing of retail transactions"* and that "*a closer look at the marginal costs involved in processing transactions suggests that differences in underlying system costs are unlikely to be a dominant driver of the growing differential*"*.*

3.32 This reflects MBIE's conclusions that:

- Acceptance rates for small merchants are much higher than those for large or "*strategic*" merchants; and
- The differential may be unjustified (in some economic sense) and effectively may involve a cross subsidy (from small merchants to large merchants), so warrants attention in terms of public policy.

3.33 In general, rates for small merchants may well be higher than those for very large merchants in the same market segments. However, we have not seen any adverse trend in the rates faced by smaller merchants relative to large ones.

3.34 MBIE has acknowledged that its conclusion may be influenced by the transition away from an earlier Commerce Commission settlement involving the replacement of interchange rebates for some merchants with lower settings for interchange. MBIE appears to accept that the acquiring market is highly competitive. Banks compete actively for business and there is no basis for considering that acquiring banks have some systemic bias against smaller merchants.

3.35 In addition to economies of scale and marginal processing costs, there are other material factors which influence pricing for merchants. There is in general a much higher level of acceptance of contactless transactions at large, strategic, merchants than at smaller merchants and interchange fees for contactless transactions, are, other things being equal, lower than they are for swiped or dipped transactions. Average "*ticket*" sizes or transaction values also have a bearing on rates and can tend to be larger than average at large merchants, for instance, supermarkets. Rates are also set with regard to the overall value of the banking relationship. Where a merchant has additional business with their acquiring bank, including lending facilities or transactional banking, their acquiring rate for card transactions will reflect the value of this additional business.

3.36 In a wider economic context there are strong commercial reasons to promote and ensure acceptance at large and influential (hence "*strategic*") merchants.

These factors do not apply to the same extent to many small businesses. However, this is simply another aspect of the bargaining power that large merchants have. This power is also manifested in their ability to obtain more favourable terms for the supply of other goods and services involved in running their businesses. But it should be noted, that while small merchants may lack bargaining power individually, they are able to negotiate more favourable terms through collective arrangements and by optimising their wider banking business arrangements.

The Impact of Regulation: Lessons from overseas

3.37 We have outlined above our reasons for concluding that no regulatory intervention in the New Zealand retail payment system is needed at this time, or at a minimum, that much further work is required before it would be appropriate to consider any form of intervention or regulation, particularly in the form proposed by MBIE.

3.38 In addition to reviewing MBIE's analysis and conclusions, the Axiom paper examines in some detail the overseas experience with policy interventions of the type endorsed by MBIE.

3.39 That paper outlines evidence that indicates strongly that those interventions have not delivered the expected outcomes in terms of market efficiency and economic welfare, and have required successive follow up measures in order to address some of the distortions and other adverse impacts that were initially introduced. The Axiom Paper also outlines why similar issues could be expected to arise if similar public policy measures were also deployed here.

3.40 We concur with the analysis and evidence presented by Axiom and consequently do not repeat those arguments here.

3.41 If further work is done to better define and understand the nature of any current problems in the domestic payment system, it is essential that a detailed review is also undertaken of the likely effectiveness of any potential intervention and regulatory policy measures.

3.42 In particular, the evidence and experience from overseas that is documented by Axiom suggests that simply regulating down market prices to potentially arbitrary levels is likely to have very limited success in improving economic efficiency or welfare.

3.43 In a small, efficient and dynamic payment system like New Zealand's, it could also have other unintended and adverse effects over the longer term, on competition, innovation and growth.

Next Steps: Increased transparency and disclosure

3.44 While we do not consider there is a case for regulatory intervention in New Zealand, improvements could be made with respect to transparency and disclosure. The industry has had discussions on the matter while formulating the industry's position set out in the NZBA's submission. Westpac agrees with that submission which proposes that the industry agree steps to make New Zealand's retail payments system more transparent for participants. These steps would need to be agreed between participants but we anticipate that they would include the following principles:

(a) *Transparency and disclosure of key information.*

- Acquiring institutions will agree clear standards around the provision of key acquiring related information to merchants, including cancellation and renewal terms and conditions.

- This information will be disclosed in a way that is clear and simple.

- Where possible, acquirers will also make information about interchange rates set by schemes available to customers.

(b) *Notification of fees and changes.*

- Acquirers will disclose their fees, fee structures and the costs to merchants in a clear and readily accessible form, and provide a reasonable minimum period of notice (to be determined) of changes to fees and fee structures.

(c) *Disputes resolution*.

- Each acquirer will maintain, and raise awareness of merchant access to, an approved dispute resolution scheme (as defined in the Financial Service Providers (Registration and Dispute Resolution) Act 2008) for the investigation and resolution of complaints.

(d) *Premium* cards

- Issuers will continue to only provide premium cards to consumers who expressly apply for or consent to such cards.

3.45 Participants would need to agree reasonable timeframes to implement these changes. We believe that competitive pressures would quickly ensure widespread adoption across the industry.

3.46 Westpac agrees with the proposal in the NZBA submission that commitments be sought from the card schemes that they will continue to allow the current practice of switching dipped and swiped scheme debit card transactions to issuers in order to provide certainty to the market.