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BusinessNZ
GROWING PROSPERITY AND POTENTIAL

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

Dear Sir/Madam

Re: Retail Payment Systems in New Zealand

Background

I am writing to you regarding the Ministry of Business, Innovation & Employment (MBIE) Issues Paper, *Retail Payment Systems in New Zealand* (referred to as "the Issues Paper").

The Issues Paper is a reflection of recent developments (both domestically and internationally) and while in principle we have no objection to a proper and considered review of policies that might be improved in order to enhance growth, MBIE's examination of New Zealand's retail payment systems seems to have jumped the gun. While pre-consultation and the identification of issues are a good start, testing identified issues and providing preliminary views on the effectiveness or otherwise of proposed changes tend to lead to certain expected conclusions. Therefore, it is important that there is ample room for open discussion throughout the process.

Given recent research that has been undertaken by and for Retail NZ, BusinessNZ believes MBIE has tried to provide a comprehensive Issues Paper. However, we have a number of concerns about the likely policy direction outlined, and would favour an industry-led approach. Specifically, these include question marks around the figures describing the current state of play, unintended consequences associated with technological advancement, and the fact that industry-led options do not appear to have received proper consideration around what we consider to be a complex issue.

The submission is in three main parts - initial observations/comments, issues identified and next steps.

Initial Observations/Comments

BusinessNZ's wide ranging membership
BusinessNZ has a wide-ranging membership covering almost all businesses by size, industry and region and including large and small merchants (retailers, wholesalers and utilities companies) and many banks and other financial entities operating in New Zealand with various schemes.

Therefore, it is important to point out that a number of our members and representatives in the retail and hospitality sector (which combined as a sector make up 43% of the economy) have been involved with this issue for some time and have dedicated significant resources towards research and reports expressing their major concerns with New Zealand's current retail payments systems. This includes research and economic analysis that RetailNZ have commissioned through Covec, which compared New Zealand's payment systems with comparable jurisdictions in other countries.

At the same time, a variety of our members in the finance and banking sector (including credit card companies and individual banks) have taken a strong opposite view and have also outlined various points and key concerns around why any movements down a regulatory path should not take place.

In addition, we would like to point out that another sector of our membership includes the non-bank card issuing sector, which also has a significant presence in the New Zealand economy. These include, among others, finance companies and company issued cards that MBIE need to be aware of when considering changes in this space.

Consequently, in expressing our view we are aiming to ensure not only that the process leads to a positive outcome for the business sector and the wider New Zealand economy but that the issue is considered within the current Government's moves towards better quality regulation. This includes MBIE's recent focus on its regulatory management strategy.

Undertakings before the Issues Paper
Section 1.4.3 of the Issues Paper briefly mentions the 2009 settlement reached between the Commerce Commission and the card schemes/major banks in relation to undertakings to address what the Commission considered to be anti-competitive conduct in the operation of retail payment systems.

The subsequent research report, evaluating the interchange and credit card settlements published in late 2013, provides three interesting results from BusinessNZ's perspective:

- Merchants/retailers paid over $70m less in interchange fees over the three years compared with what they would have paid without the changes;

- While some merchants/retailers are now paying lower merchant service fees, it is believed others are paying more than in 2009; and

- Some merchants have used their ability to surcharge or steer when negotiating a merchant service fee with the bank. However, this proportion is relatively small.

Broadly speaking, BusinessNZ supports the use of such evaluation reports to ascertain how successful or otherwise policy changes have been. Basing policy decisions on clear evidence is a key part of regulatory stewardship and these findings show mixed results for all parties involved. So it is important to note that both the process and the findings themselves have played a role in our thinking on the retail payments systems issue.

<u>Pre-consultation process</u>
We are pleased a wide range of stakeholders was consulted prior to the Issues Paper's release (annex 3). Given the sizeable number of interested businesses which also shows through in our membership, it was imperative MBIE consult widely to gain a strong handle on what is involved. However, the pre-consultation process needed to take two points on board.

First, the possible influence of the round of policy changes in 2009 might have influenced pre-consultation as some parties (but not all) would have considered the matter largely dealt with.

Second, discussion with members suggests that in a few instances there has most likely been a disconnect between the purpose of the consultation rounds and what has come out of the Issues Paper. Some members have expressed to us satisfaction around the pre-consultation rounds in terms of their major concerns being heard. However, others have indicated they thought discussions with MBIE were more about fact finding and initial ground work whereas the Issues Paper contains some hard-hitting options disproportionate to the manner of its discussions with some in the banking community. Had all those consulted known the extent to which analysis and policy options were to be included in the Issues Paper, a different and no doubt deeper conversation might have taken place.

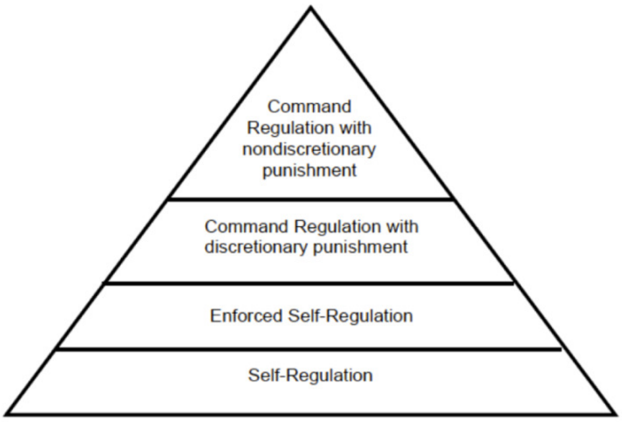
<u>Issues Paper vs recommendations</u>
In relation to the point above, BusinessNZ believes that in most cases, following initial discussions on a topic government believes might need to be addressed, an issues paper should be released before a review of specific provisions is conducted. This will help both to garner the public's view on aspects of the review and with formulating options to be canvassed in a subsequent options/discussion paper.

However, we must reiterate a point made in previous submissions to MBIE that is, the need to be careful a subsequent Issues Paper does not suggest a future options paper where the options are in the nature of a *faît accompli*. While it is useful to know MBIE's initial thinking and where it believes changes are needed, a strong implication that an options paper will follow, even though submitters' views have not yet been collated and analysed, undermines the Issue Paper's purpose.

In our view, an Issues Paper's primary purpose is to gauge the public view and then decide whether or not an options paper is needed. For instance, if most submitters consider there is little problem with New Zealand's retail payment systems, realistically, how much weight is this likely to carry in future decision-making?

Moreover, MBIE needs to ensure from the outset that any move from an Issues Paper identifying a possible problem to an options paper outlining solutions to rectify significant market failure follows the regulatory pyramid model shown below. As will be further discussed, while this seems to be MBIE's approach, the rush to more heavy-handed regulation appears greater than appears necessary.

Figure 1: Regulatory Pyramid



1. Issues Identified

The Issues Paper identifies five main issues for submitters to consider. These can be broken into the three broad groups outlined below.

Issue 1: Economic inefficiency of $45 million dollars of additional cost annually as a result of the induced usage of the relatively more expensive credit card network.

Issue 2: Increased prices for all consumers (estimated at $187 million annually) to fund credit card rewards mainly benefitting higher-income consumers.

We note that in relation to the issues above, the retail and hospitality sectors have raised a number of specific concerns. This includes the cost of handling credit card transactions rising substantially over the past two years as the cost of rewards schemes have increased; and the fact that merchant service fees in New Zealand are higher than in other markets, including Australia and the UK. These sectors also have concerns around the unique situation whereby competition between providers (banks) leads to increasing costs, raising question marks around the efficiency of the market.

2a. Initial BusinessNZ comments

Regarding issues 1 and 2, question nine in the Issues Paper "asks *whether submitters agree with the logic underpinning our assessment that reward schemes result in higher overall prices and cross-subsidies".* To assist submitters, paragraphs 191 to 197 of the Issues Paper broadly outline MBIE's reasoning for arriving at these values and mention two other macroeconomic costs, giving the impression that the total cost to the New Zealand economy is sizeable. However, for a number of reasons, BusinessNZ questions these figures.

First, from a broader perspective does a deemed inefficient cost of $232m ($187m + $45m) warrant policy changes? While that might seem a large sum, in the context of all payment card transactions (which match a similar calculation made in paragraph 8 of the Issues Paper) it equates at present to around 0.3% of the total industry. Does that deem the problem (however defined) significant? At present we would argue not, although it could become a larger issue as time goes on, or it might not, for legitimate technological reasons.

2b. Time vs money

In generating the economic inefficiency figure of $45m, paragraph 193 of the Issues Paper points out that *"40 percent of credit card users have no need for the credit; they have sufficient funds in their accounts to pay for the purchases".* Therefore, it is believed that a rewards scheme incentivises them to use credit while not facing the full cost of doing so. BusinessNZ believes that is a bold assumption. Credit card users with sufficient funds in their accounts have used credit to maximise the time value of their money long before rewards schemes became available, although this purpose can also be achieved through the use of low-fee, no-rewards credit cards. This is alluded to in paragraph 122 but in our view not given sufficient credence, much like other countervailing aspects of the discussion we consider below.

More recent developments (building on our point above), mean that with the increased use of revolving style mortgages there is good reason to use credit cards to delay payment and thereby minimise mortgage interest rates. While reward schemes might be an added bonus, they do not necessarily reflect the primary reason why payments are made via a credit card.

2c. Not all rewards users are created equal

In relation to the $59m per annum cross-subsidy (footnote 34 in the Issues Paper), BusinessNZ disagrees with the formula settings that only the highest-earning 40% of households earn rewards. MBIE appears to have a mistaken belief that because around 40% of people use credit cards just for rewards, only those people enjoy the rewards' benefits. But just because someone pays interest on their credit card, does not automatically mean they do not redeem their rewards. This "all or nothing" approach to the formula setting is most likely out of step with reality. Further information on the significance or otherwise of these sub-groups would be useful to know.

2d. Cost modelling relevance

It is also worth mentioning some of the other figures identified in paragraphs 191-197, namely the estimation that *"the use of credit cards instead of proprietary EFTPOS adds $147 million in costs to the New Zealand economy annually"*. As section 3.4 of the Issues Paper outlines, this figure is based on attempting to calculate the resource cost of various payment methods by way of applying modelling work carried out for the Australian market. BusinessNZ finds it difficult to see the relevance of these figures. Although not given further credence among the key issues identified, nevertheless they are an attempt to make the case for inherent problems with the current interchange business model.

Apart from the very simple application of Australia's modelling to the New Zealand situation by way of taking into account exchange rates, we have two other concerns with using the above figure to support MBIE's argument. First, the figure by itself does not really tell us anything. There is an inherent cost in any activity or decision, a pure financial cost and/or an opportunity cost. Therefore, that one form of payment system contributes more cost than some other cannot be considered either a shortcoming or an advantage. The second argument (following on from the first) is that cost is only one part of the equation and does not indicate to submitters the benefits of using credit cards instead of perhaps EFTPOS or cash. Indeed, there is an unequal weighting of costs vs benefits throughout the Issues Paper.

2e. Both sides to the equation - costs and benefits

BusinessNZ has strong reservations about the numbers and methodology used to determine the cost figures in the Issues Paper and, as noted above, the unequal weighting given to costs vs benefits throughout the entire Paper.

Given that this is an Issues Paper, the full costs versus benefits would be better examined in a follow-up discussion document once, after consultation with the private sector, there is a clear signal that further investigation and options for discussion are warranted. As indicated above, scope for further investigation is mentioned in paragraph 25 where the net benefits of each option are considered. However, by providing considerable cost detail and analysis but minimising or avoiding any discussion of benefits, the Issues Paper is telling submitters only one side of the story.

As an example, paragraphs 196 and 197 allude to potential benefits to consumers, but do not attempt to calculate these. Indeed, only part of one sentence (*"the increase in costs faced by consumers can be offset for the holders of rewards – offering credit cards, who in some cases may receive rewards that greatly exceed the overall increase in price that they face"*) shows any sign of giving both sides of the discussion. Unfortunately for submitters, it then jumps to estimating the ongoing cross-subsidy from low-income to high-income households, although a number of benefits to consumers could mitigate perceived costs.

For instance, what is the cumulative saving in time for consumers who choose to use contactless options such as paywave? The total savings to consumers may be marginal, but getting a better handle on these types of figures provides for a better policy conversation. We note that in attempting to provide a New Zealand equivalent cost from the Australian modelling, paragraph 174 states that the resource cost for contactless credit is NZ$0.70, compared with NZ$0.48 for EFTPOS but NZ$0.81 for standard credit cards. However, the benefits in terms of time when looking at the wider implications of technological options may greatly mitigate or even completely negate the resource cost differentials outlined. But because we are not given both sides of the argument we cannot make a fully-informed decision.

Issue 3: Given the dynamics of the interchange business model, the inefficiencies and wealth transfers of the credit card market could also emerge in the debit market.

Issue 4: There might be technical or institutional barriers to entry or expansion for new debit payment products.

<u>BusinessNZ Comments</u>
There seems be significant concern throughout the Issues Paper that the interchange business model in the debit market is about to head down a certain path that will be detrimental to both merchant and consumer welfare. This is best summed up in paragraph 8 of the Issues Paper that states *"we expect that these fees could increase significantly in coming years with rapid uptake of contactless payment. This could increase the fees paid by another $216 million"*. BusinessNZ has concerns about this conclusion for a number of reasons.

First, while future scenarios cannot simply be ignored, at the same time a possible single future option should never dominate policy thinking. Driving policy towards what might be the most severe outcome means regulatory options appropriate to the level of risk are not given due consideration. This plays out in chapter 5 of the Issues Paper, where immediate industry-led actions are identified, yet are considered *"unlikely to resolve the wider policy issues discussed"*.

Second, MBIE's thinking in chapter 5 provides submitters with a telling view that industry-led actions are unlikely to be sufficient and are not to be given time to be introduced and assessed for adequately addressing the issues involved. We accept it will sometimes be necessary, at one and the same time, to move two or more steps up the regulatory pyramid but in general, we believe such an action goes against the direction MBIE should take if it is to introduce more effective and quality regulation. At worst it shows a complete lack of faith in industry-led options.

Third, the current lines of thinking runs counter to earlier discussions between the Commerce Commission and the banking sector. In 2009 the Commission reached a number of settlement agreements with banks and financial institutions relating to the setting of fees charged to merchants/retailers for accepting credit card payments.

Last, and most importantly, there has been no indication from the banking sector that fees will be charged on debit schemes, either soon or in the future. Background discussions on this issue on pages 57 & 58 of the Issues Paper make this clear, including the statement that *"in our discussions with them, schemes have been adamant that they will not introduce interchange on scheme debit"*.

In summary, the points outlined above lead to two conclusions. First, we see little in the way of the emerging concerns in the debit market on which MBIE places considerable weight. Second, there is a real risk of putting the cart before the horse when trying to determine the best way forward in regard to the issue of debit cards.

Issue 5: The gap between merchant service fees paid by large ("strategic") merchants and others is significant and seemingly growing, reducing smaller businesses' competitiveness. The lack of pricing and cost transparency may be reducing the ability of smaller businesses to negotiate better fees with acquiring banks and to make decisions about which payment options to accept and whether to surcharge.

<u>BusinessNZ Comments</u>

As initially stated, BusinessNZ's membership is very broad, and includes a wide range of SME enterprises through to large corporates. Therefore, balancing the needs and issues of the entire business community can be complex, due to competing objectives and the general cut and thrust of business competition. BusinessNZ's stance looks to provide the best outcome for the business community and therefore the New Zealand economy generally. Often, this means examining issues more broadly to determine the kind of regulatory environment which will best see New Zealand improve its growth rate.

Section 4.4 of the Issues Paper outlines what is considered a large gap between the Merchant Service Fees (MSFs) faced by small and large merchants. Paragraph 241 points out that there are differences in bargaining power between small and large merchants which are pervasive across a number of industries. We believe the press release from Minister Goldsmith accompanying the Issues Paper picks up on key factors to consider when viewing this issue strictly from a small vs large enterprise perspective. In particular, Minister Goldsmith stated that *"the sector is experiencing rapid technological change and innovation. In that context, I remain cautious about regulation that could affect innovation"*. Also, he stated that *"the Government …. is prepared to consider regulatory options if competition fails to moderate costs. As an initial step we will be seeking greater transparency around the fees paid by merchants"*.

The rapid changes in technology taking place across numerous industries are developments on which MBIE needs to place considerable weight. One only has to look at the recent introduction of Uber to see how a phone app can radically change the need or otherwise for industry regulation. At best, regulatory intervention can delay the speed at which innovation can improve outcomes for a sector, while at worst it can simply block technological innovation because of regulatory hurdles too high to overcome and/or an inappropriate fit.

The often cyclical and important relationship between innovation and technology is seen in table 6 on page 64 of the Issues Paper, by way of the first of three objectives MBIE has outlined as part of this investigation, namely:

- Objective one: Innovation
- Objective two: Resources are allocated efficiently at a system level
- Objective three: The cost associated with payment systems is distributed fairly across consumers and merchants at an individual level.

The assessment of each of these objectives against both the credit and debit markets is telling. In terms of the credit market, innovation is viewed as of "n*o significant concern"*, while for the debit market is viewed as of "*some concern"*. This does not equate to a mandate for regulatory intervention from an innovation perspective.

With the other two objectives, there is deemed to be significant concern about the credit market, while only "g*rowing concern, but future development unclear"* for the debit market. In totality, MBIE's assessment of the two markets against their proposed objectives indicates that of the six assessments, only two are deemed to be of "significant concern". Therefore, BusinessNZ is disappointed to see MBIE already taking the view that market forces are unlikely to resolve these issues and that some form of government intervention will be required if they are to be addressed.

<u>In Summary</u>
Given the questions we have raised about the validity of the figures used and the mistaken belief about an impending need for a charge on debit card fees, together with the technical impediments regulations might introduce, BusinessNZ does not support the introduction of some form of government intervention in relation to interchange fees.

Primary recommendation: That MBIE does not introduce some form of government intervention in relation to interchange fees.

Notwithstanding our primary recommendation above, if MBIE decides changes are to proceed, we believe the following paths would be the most advantageous to ensure an outcome creating the least harm for growth, as well as providing the entire business community with a lead role in focusing on self-regulation.

2. <u>Possible next steps</u>

Chapter 5 provides a range of possible next steps for submitters to consider. These are broken up into *"immediate actions"* and *"further work to address the wider policy issues"*. At a principled level, BusinessNZ is pleased to see MBIE has chosen to outline industry-led actions that could improve the transparency of the market as it is currently configured. If changes are to be made or new regulations introduced, it is imperative options take a bottom up approach in relation to the regulatory pyramid whereby sharp-ended and prescriptive options are seen as a last resort for use only where significant market failure has been clearly identified.

The fact that those in the business community who seek change do not primarily want the first response to be more formal regulatory options spearheaded by government speaks volumes for the strong possibility of additional uncertainty and costs. For instance, in the publication *"Towards Fairer Payments Fees"*, released in November 2015, RetailNZ does not support heavy handed and direct regulation by the Government. While they pointed out that *"given the similarities between the Australian and New Zealand markets, it is likely that direct regulation will ultimately prove to be the most appropriate way of regulating payments systems",* they also understood that there is a need for an appropriate response, by stating that *"However, this would require legislation and potentially significant administrative expense"*. BusinessNZ agrees. A proportion of the immediate actions advocated are more towards the bottom of the regulatory pyramid.

Overall, we believe it is vital for MBIE to understand that while parts of the business community might strongly disagree about certain aspects of this issue, the various industries involved typically have a common approach, namely, any changes needed should be <u>industry-led in the first instance</u>, not Government-led.

And it goes without saying that if any future steps are taken in this area, they must, to be successful, be both appropriate to the level of actual risk involved and have the broad backing of the business community. Therefore, the two immediate actions outlined in chapter 5 warrant further discussion and primary consideration.

<u>Immediate action 1: Greater transparency in regard to unbundled MSFs</u>
Paragraph 65 of the Issues Paper recommends acquirers provide merchants with greater information about MSFs. In turn, it is believed this would allow merchants to negotiate better with schemes and acquiring banks on the mix of payment options and fees to be incurred. It would also mean a more effective consideration of how to deliver payment options to consumers.

However, paragraph 250 also points out that the impact of these changes is likely to be limited given the other incentives placed on the parties by the interchange business model and that further intervention is likely to be required. By contrast, BusinessNZ is not as dismissive of this option as an advantageous way forward.

There are a few points to consider in deciding whether or not to go down this path:

- First and foremost, there may be legitimate business reasons why some acquirers choose to and others choose not to release details of their fees to their customers. Any decision to take the proposed approach further needs to involve an understanding of why this is the case, and ensure appropriate systems are put in place.

- If there is to be greater transparency about MSFs, we believe MBIE needs to look at this option with the right mind set, rather than immediately taking the view that further intervention will be required. Choosing this option in addition to heavier regulatory options means MBIE will effectively be choosing all options in the regulatory pyramid, rather than taking the appropriate bottom up approach.

- In relation to the above point, we would expect such changes to be given sufficient time to bed down so that alterations in all parties' behaviour can be properly observed. To that end, we would expect at least two years' worth of data to be available before other options are considered.

- Ideally, this option should be industry-led through some form of code of conduct stipulating what the fees should be and how often they are to be updated.

Regarding the last bullet, Issues Paper's annex 1 provides an overview of approaches to interchange regulation in a number of countries. While a few - including Australia - have taken a heavier-handed regulatory path, the Canadian example outlines the development of a code of conduct for the card payments industry. To that end, paragraph 275 points out *"In the course of the work we have undertaken, schemes have pointed to the Canadian voluntary code of conduct as an example of a successful model that New Zealand should look to follow"*.

If MBIE does go down the path of choosing regulatory options for change, we would not expect a simple transference of the Canadian rather, a scheme that takes into account both the Canadian scheme's positive and negative learnings and so is fit for the New Zealand market would be required.

<u>Immediate action 2: Schemes publicly clarifying their intentions in relation to charging for swiped and inserted debit payments</u>

From a certainty point of view, BusinessNZ broadly agrees that clarification around whether schemes and issuers would, at some stage in the future, start applying interchange to scheme debit products would be advantageous.

As we have highlighted above, it is clear in the Issues Paper that possibly charging for debit payments is a significant concern for MBIE. Given the level of unease that future schemes could be saying one thing but doing something else, we believe a more direct option would be a better way to settle any undue concern over the direction of debit fees. In short, if major players in the private sector declare they will not charge for debit transactions through some form of formal signed agreement, we would expect this to put the matter to rest.

<u>Another Option: Making Debit Card Transactions Free</u>
As indicated above, the tone of the Issues Paper in relation to debit cards tends to suggest that any decision involving the imposition of interchange on swiped/inserted scheme debit transactions would most likely lead to regulation in this area.

Given there is the option of schemes publicly clarifying their intentions in relation to charging, there is also the opportunity for the industry as a whole to progress the issue a step further by agreeing to make a formal declaration that debit card transactions will be free. This would send the clearest possible signal to the Government about where the industry is going and minimise any uncertainty over future fees.

Overall, we believe that if there is to be some form of regulatory change, the industry-led options discussed are the best way to go.

Secondary recommendation: If MBIE is to consider options to address perceived problems, then industry-led rather than government-led actions are to be given sole consideration.

Thank you for the opportunity to raise this matter and we look forward to further discussions.

Kind regards,

Kirk Hope
Chief Executive
BusinessNZ