Payments Review

Submission to Ministry of Business, Innovation and Employment

Co-authored by Progressive Enterprises Limited and Sense Partners

PROGRESSIVE ENTERPRISES

SENSE PARTNERS
DATA LOGIC ACTION

1. Executive Summary

Thank you for the opportunity to provide comment on the Issues Paper circulated by the Ministry of Business, Innovation & Employment (MBIE), dated October 2016 considering New Zealand's retail payment systems. This submission is made by Progressive Enterprises Limited (PEL), in association with Shamubeel Eaqub from Sense Partners.

We agree with the issues outlined in the Paper, which are significant and it is timely that they are being considered in a comprehensive way. We appreciate that the Government is taking the time to get the views of a wide range of New Zealanders before deciding how it will proceed in terms of potential policy or regulatory change.

The New Zealand retail payments system as it stands is economically inefficient and inequitable. There are costs that do not lead to net gains for the country. There are unnecessary costs incurred by merchants from those customers, particularly those using rewards cards which carry platinum interchange fees. In addition, smaller businesses, who lack negotiating power face relatively higher interchange fees compared to larger business. There are significant issues with transparency, pricing signals and access in the payments sector, which affect economic efficiency, equity and innovation.

Policy makers around the world are working to ensure their retail payment system is underpinned by the values of safety, reliability, convenience, efficiency and equity (e.g. Australian Payments Clearing Association). **In New Zealand the Reserve Bank focuses on all these values except equity**

Over the last several years, New Zealand has witnessed significant changes to the way consumers purchase goods and services, with increased credit and scheme debit card use, and declining use of EFTPOS and cash. Further developments in this area are likely, with new technologies already in the pipeline. Consumer's appetite for ease and access to card reward scheme incentives is steadily rising. This is leading to increased costs, but with arguably insufficient benefits, especially when compared to other countries like Australia and the E.U. Because the changes are rapid and persistent, oversight and monitoring of the payments system must continue. **We recommend the payments system monitoring is continued in the long-term.**

The analysis of the costs and benefits suffers from a lack of consistent, transparent and accurate information. As such the policy efforts and critique may be misplaced on the veracity of the data, rather than the actual issues. Instead, we should base any future work on a transparent and accurate information base, including any decision to regulate or not. **We recommend New Zealand sets up a transparency framework**, perhaps modelled on Australia's Payments System Board and the way it collects data.

The monitoring and supervision of the payments system is currently insufficient, as the relevant enabling regulation and implementing organisations do not cover the whole range of issues facing the payments sectors now and the future. **We recommend that an empowered and independent regulatory body is set up.**

We believe it is necessary to ensure sound supervision of the payments system, and regulatory interventions as the evidence dictates. Our experience in Australia shows significant benefits of regulatory intervention through lower costs, and increased control and flexibility to control these costs.

The Australian approach has focussed on: increasing transparency; requiring the removal or modification of restrictions imposed on merchants that hinder competitive forces being (no-surcharge rules, honour-all cards rules, and no-steering rules); liberalising access arrangements to both the debit and credit card systems; and promoting more appropriate price signals to consumers by reducing interchange fees in the debit and credit card systems and requiring the removal of restrictions on merchants.

We do not have to blindly follow the Australian example as they are still implementing the new systems progressively. We can learn from their experience. However fast rising and inequitable costs associated with retail payments require New Zealand to take a considered approach to the oversight and functioning of the payments system. We suggest a graduated approach over time. This requires:

- Payments system monitoring is continued in the long term
- An immediate start to increase transparency of the payments system, perhaps modelled on the Australian system
- Give the responsibility of monitoring and supervision to a single empowered and independent authority, which will use evidence based approaches to regulating and intervening only when the overall benefits outweigh the inevitable costs of regulating.

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

Yours faithfully

Amrit Chaitanya

National Financial Services Manager

Progressive Enterprises Limited

Key parties:

Progressive Enterprises Limited: Progressive Enterprises Limited (PEL) is a subsidiary of the Australia based Woolworths group of companies (Woolworths Limited) and operates 184 supermarket stores in New Zealand trading as Countdown. PEL also includes Wholesale Distributors Limited who operates a franchisee grocery store model trading as Super Value and Fresh Choice with 64 stores nationwide.

Here are a few facts about Countdown that we hope you would find of interest:

- Customers: 3m transactions p/wk, 1m active Onecard users
- Team: 18,000+ New Zealanders employed
- Suppliers: 4000+ supplier partnerships, many long-term
- Electronic payment transactions (credit and debit) market share ~10%

Sense Partners: Shamubeel Eaqub is an experienced economist and partner at Sense Partners. He has broad interest in the economics of public policy. His highest profile works are on housing and regional economic decline. More details are available on request.

Sense Partners is a boutique consultancy. We are experienced economists with backgrounds in modelling, public policy, regulatory affairs and economic assessments. We use strong logical thinking, data and evidence to get to the nub of issues, and go beyond 'what' to 'why and so what'. We strive to do this to a new level of rigour, relevance and usefulness. We use economics as one of our key tools, but are open-minded, and able to partner with experts in a variety of fields.

2. Responses to MBIE questions

1. Are these objectives for retail payment systems appropriate?

The objectives within the context of the economic outcomes lens are appropriate but should be increased or expanded upon to ensure New Zealand has the correct institutional settings to oversee and regulate the payments system for economic good.

There should be an explicit expansion to include competition in the payment acquiring market.

There should also be an explicit addition to include transparency in pricing signals and market structure as an objective.

Furthermore objective two assumes that consumers and merchants know the costs and benefits of certain forms of payments to them and the system as a whole. In reality however, the marginal costs and benefits of a payment system are not widely known or understood by all participants. We suggest the “taking into account” wording in objective 2 be replaced with “being cognisant of” and that there should be some mechanism to assess if merchants are acting on that information.

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

MBIE has provided a comprehensive stock take of current developments.

There will continue to be further significant innovation driven by the Fintech sector. This may be aided by retailers wanting to bypass fee based systems promoted by banks and card schemes. For example, Wal-Mart is working on a stored value closed loop payment system to be used by shoppers across a consortium of likeminded retailers in USA.

The critical policy issue is **access**, subject to usual caveats on safety and security of the payments system. Currently New Zealand has neither guaranteed access rules nor an appropriately priced or clear set of access criteria that new entrants can use to gain timely access to the national retail payments system. For innovative new technologies to emerge and flourish in New Zealand, the regulator needs to ensure that the barriers to access are sufficiently low.

Australia in comparison is building a National Payments Platform with equal access rules under the direct supervision of the Reserve Bank of Australia. This will allow all participants access on an equal footing a standardized set of functionality plugging them into the national payments network with appropriate access into established participants within the payments value chain.

New payment technologies will face the largest hurdle when they bypass the interchange. But without access rules, issuer banks have little incentive to do so, as they gain significant revenue from interchange.

Policy focus should be to ensure the optimal conditions exist for innovation to occur and flourish. Barriers to entry are a significant issue and the focus should include scope for legislation or enforceable guidelines to secure access for potential new technologies to bank users.

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

The significant increase in credit card use, often not for the use of credit per se, is largely related to the use of credit cards and short term cash-flow smoothing and generous reward programmes on 'premium' scheme cards, for example those offering Airpoints.

There was a reduction in credit card use during the 2007-2008 recession. In large part, it was due to people trying to pay down their credit card debt in a weak labour market.

The subsequent recovery in credit card usage has been largely led by savvy credit card users who pay off their balance each month (also known as transactors). The motivation appears to be rewards programmes on 'premium' cards, which offer inducements to consumers in the form of rewards. Banks are motivated by the interchange fees and the Schemes by the additional scheme fees they generate.

There is a risk that the normalisation of credit card use may expose some consumers to overextend unsecured and expensive debt, especially if there are any shocks that affect their earning power.

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

We agree with the broad rationale presented, but emphasise the asymmetric nature of the incentives and behaviours of parties involved in the payments system. This asymmetry leads to economically inefficient outcomes that may not comfortably sit within the existing competition law framework.

Wright (2012) posits that interchange is the most important cause of inefficiency in payment card systems. Inefficiency is a consequence of the systems' characteristic arrangements due to:

- Merchants are willing to accept multiple forms of payment to attract customers. Payments systems use this willingness to accept cards to increase merchant service fees (MSFs), but the acceptance of cards by merchants does not fall with the same price sensitivity as in a normal market.
- The issuing banks and card schemes have extraordinary market power due to market concentration enabling them to set high interchange fees that influence MSFs

- Increased competition alone will not reverse or mitigate this form of pricing. The New Zealand Commerce Commission in its 2013 review of the cards action observed: “the Commission is aware that the average levels of interchange fees may be starting to increase again. If the trend back towards higher interchange fees continues then something other than noncompliance with the Commerce Act is likely to be the cause of the lack of competition. The Commission is not able to address anything other than breaches of the Commerce Act and so alternative regulatory intervention may be required”.

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

You have accurately described the incentives and behaviours in practice with interchange. It is because of these incentives that interchange fees have increased significantly in recent years, after the 4-year period set by the Commerce Commission action in 2009.

The caps on interchange fees set by schemes have effectively set the level of fees charged by the issuer banks. All New Zealand banks today charge the maximum level of interchange permitted by the schemes.

The increase in fees following the end of the 4-year period suggests the competition framework is not an effective and appropriate way to regulate interchange. Although the RBNZ is concerned with maintaining a sound and efficient financial system, the issues do not seem to fall within the RBNZ’s jurisdiction either, suggesting that there is a gap in the current institutional settings in New Zealand.

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

The Card Schemes – Visa and MasterCard publish and offer Strategic Merchant Rates (SMR), essentially a lower priced interchange across all cards under that particular scheme to certain merchants under contract. Whilst this may have the effect of lowering the larger merchants interchange impost it is often in exchange for the merchant starting to accept and promote new forms of payment or technology amongst other conditions. In today’s context this is in exchange for contactless debit. While the merchants’ credit interchange might go down slightly, they are now accepting expensive contactless debit cards paying interchange for those.

Small - Medium merchants often do not meet the criteria set by the card schemes for SMR and as such do not have access to this benefit. They are treated as price takers. Also it must be noted that whilst interchange might be falling for larger merchants, it is not at similar levels when compared to other countries where interchange is regulated e.g. Australia. The other contributing issue here is the increase in acquirers promoting “unbundled” merchant fees while Issuers undertake premiumisation of their card base. Classic cards are moved to platinum and lucrative reward schemes promoted on platinum cards. Platinum cards as you are aware carry substantially higher interchange fees and as such contribute to increased interchange bills for merchants not on a SMR. These merchants are forced to accept a broad range of payment forms, as while customers may use a single payment form, merchants must offer access to multiple cards. Once the merchants have to accept a form of payment, they have limited pricing power when they are small operators. There is little transparency in the way prices are set and negotiated. There are no clear and transparently set criteria to qualify for SMR.

In summary interchange rates are falling for some large merchants (including Countdown), because they have the scale and leverage to negotiate a better rate. Nevertheless the fees Countdown faces in New Zealand are much higher than its parent in Australia. On average New Zealand merchants pay merchant service fees of around 1.4%, while in Australia it is around 0.85% (according to estimates by COVEC and data from Reserve Bank of Australia).

Countdown has invested in its own technology that enables us to choose which cards we accept contactless payments from. This means we can decide which rates we choose to accept. But not everyone has this choice because of the significant cost and complexity of doing it.

Banks are reluctant to reduce prices, knowing full well that with a high penetration of 'premium' reward cards, merchants will not be willing to deny their customers the convenience and rewards of using these cards. Even for large retailers the negotiating power is limited as the scheme cards have become so embedded in consumer's wallets. Banks therefore are able to drive customer behaviour at a merchant level.

7. Is the resource cost data robust? Is the Australian data likely to overstate or understate the costs of running NZ payments systems?

There is simply not enough transparency in the New Zealand payments system to test the veracity of the resource cost estimates.

These types of estimates, by their very nature, are approximate. Nevertheless, the Australian experience provides a comparable benchmark and there should be further work undertaken to develop a true New Zealand specific estimate.

We believe the Australian data is likely to understate the resource cost. Networks, such as the payments system, tend to benefit from economies of scale. Because of New Zealand's small size and fragmented geographic dispersion, it appears very likely that scale related costs that are relatively high. It is impossible to predict if this would be larger than the benefits from New Zealand's more efficient switching compared to Australia's system of bilateral linkages.

The resource cost analysis and lack of comprehensive information highlights the need for transparency in the New Zealand payments system and further detailed New Zealand specific analysis.

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

We agree with the overall theme of the analysis.

The analysis in other jurisdictions finds a similar outcome, where the value of rewards to cardholders are much higher than annual card fees charged meaning these rewards are funded from the interchange impost these cards carry. This motivates the customers to use reward based cards, which carry higher fees.

Merchants do not want to alienate customers, therefore they accept all cards, do not apply surcharges and spread the cost to all customers.

The critical lynchpin not fully articulated in this analysis is the role of the merchant. The price signals do not reach the consumer because of the merchants' willingness to accept cards and their low sensitivity to price changes with higher merchant service fees effectively passed on to consumers in the retail prices they pay. This allows the issuers to charge higher interchange fee, which provides the inducements to cardholders.

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

We agree that reward schemes result in higher interchange fees. The consequence of bank and scheme promoted reward cards is that customers are incentivized to use a form of payment that results in higher costs to the merchant. Merchants have no choice but to accept these costs.

There are rich public policy veins in this analysis. The critical one is the overall economic inefficiency resulting from higher costs that do not deliver a higher quality services

As the paper notes, these issues are not like other inefficiencies that naturally occur in the economy and that there is little chance of remedy to this public policy failure using market mechanisms.

In addition, Paymark (which processes around 80% of transactions) is for sale and appears most likely to be sold to an offshore investor – from current ownership by domestic banks. The current bank ownership is unique globally and provided an unusually low cost and efficient payments system (more so than Australia, for example), but suffered from too little incentive (profitability) to invest and develop. If Paymark is treated as a network utility by the new owners, there is high likelihood of significant increases in the cost of processing domestic payments and potentially even greater incentive to limit access.

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

We agree that self-acquirers are unlikely to place downward pressure on interchange. Countdown has not realised any significant commercial benefit from its self-acquiring infrastructure network due to the changes made by the Scheme to remove any pricing differential shortly after Countdown became a self acquirer.

The market power wielded by banks and schemes, without any regulated access rules, and the cost of setting up as a self-acquirer means that self-acquirers are unlikely to be a big feature of the New Zealand market and will not place downward pressure on interchange fees.

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

Merchants have very limited negotiating power. Large merchants have some scope, but the extent is limited. We summarised this in response to question 6 above.

Merchants are forced to offer multiple payment options, but the customer does not have to have more than one. If the customers preferred method of payment is not available, they can go elsewhere. Surcharges are uncommon and they turn off customers.

Near saturation of card use in New Zealand and rapid conversion to scheme cards, customer affinity for rewards schemes, emerging technologies like Apple Pay/Android Pay and a lack of consumer understanding of the cost of electronic payments means that merchants must accept most forms of payment or risk alienating their customers. The competition for customers, particularly those who spend more per transaction, leaves merchants in a weak negotiating position.

12. Do you think the issues in the credit card market are of a scale that warrants intervention?

We believe there is currently a strong case for government intervention, and this will likely grow over time, particularly with the growing use of contactless scheme debit cards .

The 2009 Commerce Commission investigation documented significant issues in the credit card market which lead to economic inefficiencies, perverse competitive models that lead to higher prices, inducements that lead to private gains but public costs (inequities) and new technologies that are likely to further increase the uptake of scheme cards and amplify the issues we are experiencing today.

The Commerce Commission noted that "if the trend back towards higher interchange fees continues then something other than noncompliance with the Commerce Act is likely to be the cause of the lack of competition. The Commission is not able to address anything other than breaches of the Commerce Act and so alternative regulatory intervention may be required".

This raises the very real question of what those alternative interventions may be and the overall oversight regime for the payments system and the governance principles that underpin it. We would suggest there are five broad governance principles of:

- Transparency
- coherence with international standards
- effective powers and capacity
- consistency with other settlement systems
- cooperation with other authorities.

This would oversee the regulator's objectives that encompass:

- Promote competition in, and the efficient and reliable operation of, electronic payment systems for the long-term benefit of consumers.

Specific interventions should focus on the key problem areas:

- Transparency – there is simply not enough information available to know the best course of immediate action. Requiring greater transparency in a consistent manner would pave the way for a measured approach.
- High interchange fees – explore international best practice on determining interchange fees. New Zealand faces high fees but no better service than jurisdictions with regulated fees (usually caps).
- System resilience and access – a domestic payments system, like EFTPOS, is being created in Australia. New Zealand needs to explore the public policy arguments on whether there is a model for a sovereign payment system as being built in Australia, to allow open access and thus encourages innovation.

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

We agree.

We expect a repeat of what we have seen with credit cards.

There are similarly two groups driving contactless debit – schemes and issuing banks. Schemes incentivise issuing banks and issuing banks are moving their customers from EFTPOS and scheme debit to contactless scheme debit cards.

Issuers will offer inducements to encourage uptake of scheme debit contactless cards. Schemes already use a variety of financial incentives to induce both issuers and larger retailers to accept contactless debit cards.

As consumers switch, they will expect merchants to accept those payment methods. Merchants who may have not accepted contactless in the past, will have to accept them once customer penetration rates increase sufficiently.

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

We agree.

The current fee structure and the ownership model means than there is no financial incentive to invest in EFTPOS.

EFTPOS is a secure, viable and safe domestic payment system. It once was world leading technology. But changes in the market and pricing structure means that acquirers and issuers can no longer profit from EFTPOS. There is no incentive to invest.

Similar issues echo in other countries too. Australia and Canada have invested in a sovereign controlled domestic payment system. The sovereign control element is deemed important for resilience and stability reasons.

PEL also wishes to emphasise that consumers and merchants benefit from EFTPOS yet there is no regulatory body to uphold their interests in the face of the rising substitution of EFTPOS with new technology debit cards. Perhaps the bigger concern here should be the loss of a national, New Zealand owned and operated – safe, secure and reliable –system leading to loss of domestic control of a home grown payment system

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

There is no binding undertaking by either schemes or issuer, nor an **empowered and independent regulatory body** with effective powers and capacity to hold any such undertaking to account. As such the current pricing structure simply reflects the inertia of history.

However, as EFTPOS use continues to diminish and is replaced by scheme based cards to a critical mass, the market dynamics would shift dramatically. In the absence of regulation and competition from an EFTPOS network, it is entirely plausible that interchange fees will spread from credit and contactless debit cards to swiped or inserted scheme debit transactions.

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

We agree in principle that a fee on a user pays basis is not an issue in and of itself. However, as you have noted in the issues paper, the challenge is the asymmetric nature of the market and negotiating or pricing power. Another challenge is how to overcome merchants' resistance or inability to pass on the charges, to steer customers to lower costs of payment, should they choose.

Another challenge is that the impact will be felt unevenly by merchants. Merchants with small transactions (for example a coffee shop) will be very differently impacted than a furniture shop. There may be ongoing equity issues that have not been fully understood.

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

We are not yet sure. Currently, contactless debit uses the existing EFTPOS system to debit the users cheque account in all instances (there is no credit extended). The service in effect is the same as EFTPOS, except for the convenience of contactless, but higher fees. There seems little justification for the additional cost.

We do not have sufficient information on the cost to improve the quality of EFTPOS to a comparable level to compete with contactless. As such there is no firm basis to compare the efficiency of the contactless pricing model.

This lack of information or **transparency** hinders much of the analysis in emerging technologies and further highlights the needs for a co-ordinated and holistic approach to oversight and supervision of the payment system.

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?

We agree.

The debit card market faces the same issues as the credit card market. There is no effective way to signal price to users. Surcharges and other methods are simply too cumbersome for most retailers and customers. The well documented inefficiencies and inequities that are generated in the credit card market are likely to emerge in the debit card market.

The lack of price signals and the capture of merchants (they need to accept cards) mean that they have very low negotiating power. This would amplify as EFTPOS use continues to decline. With concentrated market power, we could see a repeat of the pattern seen in credit card interchange.

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

Yes, we expect and are very much concerned that merchant service fees will increase once acceptance reaches a critical level. It is unclear what that level is, but the key factor will be merchants' willingness to accept cards. International experience shows that this is the case, hence the move by several jurisdictions to regulate.

Whether there is an alternative method, such as EFTPOS, will matter a great deal. Without EFTPOS the market will effectively become a "price taker" to whatever fee the schemes might set and issuers may charge.

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

Yes, the interchange model is a significant barrier to entry.

The market is dominated by the issuing bank that controls the consumer account, and Visa and MasterCard predominantly provide the product and incentivise issuers to promote the interchange model. It is in all the current players' interest to keep the interchange model. In a bank-based payment system, it is also in banks' interest to limit access to customers' accounts to inhibit competition from other providers.

Innovation in blockchain and other technology may sit completely outside the interchange and bank model. So far these methods have not yet been developed to a level to compete with banks or the interchange model.

To our knowledge the Reserve Bank has not taken ownership of or sponsored an assessment/study into the potential benefits such new technologies might bring to New Zealanders or whether they would help change the current competitive landscape.

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

We expect a strong Visa-MasterCard duopoly to continue to strengthen in the credit card market to extend to the debit market.

Banks will have no incentive to facilitate other players entering the market - Apple Pay in Australia is a good example.

It is entirely foreseeable that new interchange-based-contactless and other interchange-based payment methods will emerge. This is likely to be supported by issuer banks, who increasingly are forced to accept Fintech innovation as a complementary development. So, it is likely most new technologies will be forced to co-opt into the current bank and scheme driven-interchange model.

Non-interchange methods would probably be driven by non-bank issuers, such as telecommunication companies, service providers, social media or peer to peer payment providers.

EFTPOS is likely to decline in the face of these trends, unless there is a broader sovereign interest and stake such as in Australia, Canada, Germany and other nations. Decline of EFTPOS will be replaced by forms of payment that are revenue generating and economically inefficient.

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

We do not consider the difference to be justified, given the payments system is an essentially fixed cost infrastructure.

International comparison shows that New Zealand merchants are charged more than in other countries and the gap is wide. For example and in strict confidence, Countdown faces costs of around compared section 9(2)(b)(ii) to Woolworths at section 9(2)(b)(ii) in Australia.

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

We agree with your analysis. Some extensions follow in the table below:

Market	Innovation	Efficiency	Fair costs
CREDIT	New Zealand is unable to influence product innovation in the payment cards market and will always be driven by the schemes due to scale and ubiquity of use issues	We remain concerned that current payment systems are inherently inefficient	We know that inequity exists in unconstrained systems. New Zealand being an unregulated payments market means costs are inequitably distributed whilst unjustified cross subsidies exist
DEBIT	We remain very concerned that the interchange model will impose barriers to new non-scheme and non-bank entrants. There might be a very limited play by other non-bank/scheme players in the future	It is entirely foreseeable that debit systems will follow the same costs structure of credit	The future development is unclear given what might happen with domestic EFTPOS

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

We believe that transparency is a necessary but not sufficient condition to improve the payments system. Transparency is a crucial first step to ensure that there is an accurate understanding of the issues facing the payments system, the systemic implications and the individual implications. The current level of disclosure makes these assessments impossible.

Whilst greater transparency might be helpful it is unlikely this alone will provide merchants with the ability to negotiate effectively better merchant service fees. We believe there is room to regulate in this space. However, there is currently no empowered and independent regulatory body with the breadth necessary to do so.

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

We do not believe clarifying intentions by schemes would be sufficient in New Zealand's light touch regulatory environment. There is no governance body with effective powers and capacity to monitor and implement such an undertaking.

The use of similar methods in EU falls under the scope of very different regulatory settings, where the schemes can be held to account.

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

Early evidence from overseas regulators (such as Australia) seems to suggest such intervention has been cost effective for the market as a whole.

We believe greater oversight, regulation and transparency is a lot more important than simply signalling of intent.

The Australian experience is a helpful contrast, detailed in a supporting Appendix in Section 3 of this submission. At the time the Payments System Board was established, the Australian government also provided the RBA with specific powers to regulate payment systems to implement the Board's policies. The most relevant powers in the context of the card payment reforms are those set out in the Payment Systems (Regulation) Act 1998. Under this Act, the Bank not only has the powers as described above but also sets out the matters that the Bank must consider when using these powers, including the desirability of payment systems:

- being financially safe for use by participants
- efficient and competitive
- and not materially causing or contributing to increased risk to the financial system.

The PSB has sought to improve the efficiency of the overall payments system and to promote competition in the system by:

- increasing the transparency of the system;

- requiring the removal or modification of restrictions imposed on merchants that hinder competitive forces being (no-surcharge rules, honour-all cards rules, and no-steering rules);
- liberalising access arrangements to both the debit and credit card systems;
- and promoting more appropriate price signals to consumers by reducing interchange fees in the debit and credit card systems and requiring the removal of restrictions on merchants.

27. What unintended consequences could arise from interchange regulation?

There is always a cost of regulating. Heavy handed regulation may stifle innovation and may perversely lead to even costlier payments system. This is why we do not promote a hasty move to a definitive regulatory approach. A first step should be to set up the infrastructure that is empowered to collect information in this market and analyse and monitor patterns. We would also expect a detailed regulatory impact statement and exhaustive consultation period which would flesh out the risks of any potential unintended consequences and their mitigation.

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

Under the same conditions as credit when they are known to be excessive causing economic inefficiency.

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

The critical issue to promote innovation and competition is access. The three key aspects for a new debit payment are:

- Clearly defined and guaranteed access rules
- Clearly defined pricing for access
- Specified timeframes to provision access

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

The regulatory challenge is to find the balance between stability and safety of the system, and innovation. Innovation through new entrants and competition cannot occur, if the financial cost or access is prohibitive.

The regulator needs to ensure that safety and security of the payments system is maintained, but at a hurdle that is sufficiently low to encourage innovation. New entrants need guaranteed, cost effective and timely access. The experience in New Zealand is a case in point. VeriFone to date has been forced to route all its debit transactions through Paymark at the behest of Paymark and its shareholder banks who will not allow VeriFone to build new access infrastructure between them. That constitutes a systemic infrastructure risk and lack of competition.

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

We believe a consistent institutional response is required. It does not necessarily mean regulatory intervention, but the first step is to provide full coverage of payments supervision in one body, and complementary statutory powers. We propose that Australia, which is a global leader in payments system supervision and regulation, is used as the template for New Zealand. The most important achievement is the unification of responsibilities in one body with the appropriate statutory authority to regulate if the need arises to ensure efficiency, resilience and equity.

Allow this body to monitor, investigate and intervene with just cause (and detailed Regulatory Impact Statements, as is normal practice in the New Zealand public service).

- transparency of system
- Price signals
- Liberalised access arrangements

Please also refer to our answer to Question 12.

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

We recommend this workstream be developed under an oversight group spanning representative market participants.

33. Have we missed any options?

We would emphasise the need for a coherent oversight and regulatory approach. Please refer to our answers to questions 12 and 31.

3. Appendix: The Reserve Bank of Australia (RBA) and its regulatory framework

Most central banks have some type of broad responsibility for oversight of the payments system. In New Zealand this is the RBNZ, however its powers are limited despite its oversight role in payment systems. Mostly this responsibility is coupled with regulatory powers relating to high-value payments.

If we look to the reforms carried out by the Reserve Bank of Australia (RBA), those encompassed the efficiency and competitiveness of the payments system as a whole, including retail payments.

This responsibility was given to the RBA following the wide-ranging Wallis committee enquiry into the structure of financial regulation in the mid 1990s. This enquiry recommended that bank supervision be moved from the Reserve Bank to a stand-alone prudential regulator today known as the Australian Prudential Regulation Authority (APRA) – but also recommended that the RBA be given responsibility for the overall efficiency of the payments system.

This recommendation reflected, in part, recognition of the fact that the RBA was already highly enmeshed in the payments system and had considerable expertise in what are often highly technical matters. This as you know led to the establishment of a second board within the Reserve Bank – the Payments System Board (PSB).

The PSB is charged with controlling risk in the payments system and promoting efficiency and competition. Its key powers and responsibilities are:

- Ability to formally designate payment systems
- Set standards
- Determine an access regime
- Provide enforceable directions to participants in the payment system

At the time the PSB was established, the Australian government also provided the RBA with specific powers to regulate payment systems in order to implement the Board's policies. The most relevant powers in the context of the card payment reforms are those set out in the *Payment Systems (Regulation) Act 1998*. Under this Act, the Bank not only has the powers as described above but also sets out the matters that the Bank must take into account when using these powers, including the desirability of payment systems: being financially safe for use by participants, efficient and competitive; and not materially causing or contributing to increased risk to the financial system. The PSB has sought to improve the efficiency of the overall payments system and to promote competition in the system by:

- increasing the transparency of the system;
- requiring the removal or modification of restrictions imposed on merchants that hinder competitive forces (no-surcharge rules, honour-all cards rules, and no-steering rules);
- liberalising access arrangements to both the debit and credit card systems;

- promoting more appropriate price signals to consumers by reducing interchange fees in the debit and credit card systems and requiring the removal of restrictions on merchants.

The RBA is seen as a world's best practice on payments systems governance and its regulatory framework is worthy of consideration. Some of the key reforms conducted by the PSB to date are:

- INTERCHANGE FEES
    - **Credit Cards:** Weighted-average interchange fees in the MasterCard and Visa schemes must not exceed 0.50 per cent of the value of transactions. MasterCard and Visa must publish their actual credit card interchange fees
    - **Visa Debit:** The weighted-average interchange fee for Visa Debit transactions must not exceed 12 cents per transaction. Visa must publish its actual debit card interchange fees.
    - **Eftpos:** EFTPOS interchange fees for transactions that do not involve cash out component must be between 4 and 5 cents per transaction.

- MERCHANT RESTRICTIONS
    - Honour All Cards Rule: Visa is not permitted to require a merchant to accept Visa Debit cards as a condition of accepting Visa credit cards, or *vice versa*. Visa Debit cards must be visually and electronically identifiable as debit cards, and acquirers must provide merchants with information required to electronically distinguish Visa Debit and Visa credit card transactions.
    - Surcharges: The card schemes must not prohibit a merchant from imposing a surcharge for MasterCard or Visa credit card transactions, or for Visa Debit card transactions.

- ACCESS REGIMES
    - Credit cards and Visa Debit
        - Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit-taking institutions (ADIs).
        - A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or *vice versa*.
        - Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.

- Eftpos/Domestic debit
  - The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently $78,000 (ex GST). An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).

In particular, the PSB has focused particular attention on two interrelated aspects of the current competitive environment that have the potential to impair efficiency and competition in the overall system. These are:

- the difficulty that merchants can have in exerting downward pressure on interchange fees
- the difficulties arising from the current structure and governance of the domestic debit card system (the EFTPOS system), which potentially limit its ability to compete with the international card schemes.

The second, and related, issue is the competitive dynamics in the debit card systems. For many years, Australia has benefited from having a widely used, low-cost debit card system (the EFTPOS system) which, to some extent, operates in competition with the payment systems operated by the international card schemes. The RBA ensured through a cross-industry working group that new access standards were developed to lower the high barriers to entry and the establishment of Eftpos Australia Ltd (ePAL) as a national scheme with 14 members institutions including 2 large retailers for the domestic debit network. With RBA oversight, ePAL has embarked for the first time on an ambitious product development roadmap introducing - chip security and infrastructure to enable contactless/digital payments

1. Benefits already achieved in Australia

In Australia, Woolworths commenced the self-acquiring of debit card transactions, and direct processing to key issuers of credit card transactions in 2007. Bilateral "On- Us Transactions Processing Agreements" govern these card transactions. The Woolworths switching infrastructure was developed and deployed with the following key objectives:

- **Control and flexibility over a significant cost of doing business**: Card acceptance fees are universally the 3rd highest cost of doing business for most retailers after wages and rent. Achieved through bilateral negotiations of interchange and processing fees, direct negotiations with schemes to fund scheme mandates and ability to undertake lowest cost network selection for processing of cards.
- **Significant reduction in costs**: This allowed Woolworths to be more price competitive as a result of achieving substantial cost savings. These savings were achieved through Woolworths taking on the role of a Self Acquirer and routing credit and debit card transactions directly to the Issuing bank thus bypassing international card schemes (Visa, MasterCard and American Express). The removal of the card schemes and a bank acquirer allowed Woolworths' "off-us" processing costs to be removed/reduced thus creating the savings mentioned.

Section 9(2)(b)(ii)

PROGRESSIVE ENTERPRISES

SENSE PARTNERS

DATA LOGIC ACTION