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5 December, 2016

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

Dear Sir/Madam

Re: "Retail payment systems in New Zealand"

We are pleased to have the opportunity to respond to some aspects of the above Paper and do so generally in the order in which they are presented in the Paper.

Industry Metrics

Debit cards are performing stronger than indicated in the Statistics NZ data.
The growth in credit card spending over the last 10 years has been modest at best with inflation adjusted CAGR in spend per account of just 1.0%.

We note that Annex 4 refers to the misclassification by Statistics NZ of debit as credit transactions. This specifically results from the incorrect classification of contactless scheme debit as credit by Paymark. The impact of this misclassification is that the Statistics NZ data for the 12 months to March 2016 reports debit with a share of value of 54.7% and credit with 45.3%. We note that your estimate in point 6 shows debit at 58% (proprietary at 36% and scheme at 22%) with credit at 42%. The differential between the data reported by Statistics NZ with the actual numbers is now increasing at an accelerating rate as contactless debit gains traction.

Your note 8 to Figure 2 states that, "*The slight upward trend in credit card usage in the last two years is misleading and represents the miscategorisation of contactless debit transactions as credit transactions...*". In fact, the reported upward trend over the past two years has been considerably more than slight with the share of value of credit reported as firstly decreasing from 42.4% in the 12 months to March 2011 to 42.1% in the 12 months to March 2013 before then growing to 43.1% in the 12 months to March 2014, 43.7% in the 12 months to March 2015, 45.3% in the 12 months to March 2016 and now to 46.5% in the 12 months to October 2016. The misclassification extends to volume where the share of transaction numbers on credit is incorrectly reported as having leapt from 22% in 2012 to now be at 30.8% in the twelve months to October 2016. It has in fact increased only slightly to 23%. This incorrect data is erroneously indicating a growth in credit when in fact that market is experiencing only modest growth.

Adding to the confusion resulting from incorrect segment data being published by Statistics NZ is your point 113. It states in part, *"In fact, in the year to February 2016, domestic spending on credit cards increased by 13.6% on the year before."* The February 2016 MWE New Zealand Cards Report is cited as the source in note 12. Page 6 of the MWE New Zealand Cards Report shows the annual

growth rate in domestic credit card spend for the 12 months to February 2016 was actually 7.2%. The rate of 13.6% shown on page 3 of the MWE report shows that figure to be the month of February 2016 on the month of February 2015, not the underlying annual rate of growth.

We also suggest that it is misleading to describe growth in inflation-adjusted credit card spending of almost six-fold over the last 23 years without also pointing out that it has slowed markedly over the last ten years. Total credit card spend as reported by the RBNZ increased by 60.7% from $24,424 million in the 12 months to March 2006 to $39,256 million in the 12 months ended March 2016. Adjusted for inflation, this represents a total growth over this ten year period of about 31.8%. When we look at spend per credit card account over this ten year period the increase has been 34.8% from $10,631 to $14,332 or 10.6% adjusted for inflation. The New Zealand market has not of late and is not now experiencing significant growth in credit card spend. The CAGR in credit card spend (adjusted for inflation) over the 10 years to March 2016 was 2.8% per annum with the CAGR for spend per account at just 1.0% per annum. This is more accurately described as very modest growth.

EFTPOS fees in Australia are significantly higher than indicated in Annex 1.

Annex 1 shows average merchant fees in NZ, Australia and the UK. There appears to be an inconsistent use of data with the MBIE analysis based upon a comparison of the total Australian credit card fees inclusive of other fees but excluding other EFTPOS fees.

Segment	Month	RBA			MBIE Paper
		MCI & Visa MSF	Other fees	Total Fees	
Credit Cards	Dec2013	0.79%	0.04%	0.83%	0.83%
	Dec 2014	0.77%	0.05%	0.82%	0.82%
	Dec 2015	0.73%	0.05%	0.78%	0.78%
EFTPOS	Dec2013	$0.1038	$0.0578	$0.1616	$0.10
	Dec 2014	$0.1011	$0.0580	$0.1591	$0.10
	Dec 2015	$0.0907	$0.0593	$0.1500	$0.09

Executive Summary

Analysis should consider benefits as well as costs

Issues 1 and 2 raise concerns with economic inefficiency in the credit card market with increased prices and cross-subsidisation. Issue 1 estimates that at least $45 million additional costs are borne by the economy as a result of current incentives. The principal incentives used by credit card marketers are reward programs that provide benefits for cardholders at various merchants. To the extent that these rewards are redeemed at these merchants, we ask if the flow-on benefits to those merchants have been factored in?

The majority (not "around half") of payment card transactions in NZ are at no cost to merchants and this needs to be factored into any assessment of individual segment card fees .
Analysis indicates that New Zealand merchants pay less per card transaction (debit plus credit) than in a regulated market such as Australia.

Point 16 states that merchants in New Zealand appear to pay higher fees to accept payment via credit cards than in some overseas countries. It also notes that *"The overall higher cost of electronic*

transactions may be offset to some extent because no charges are applied to EFTPOS and swiped /inserted scheme debit transactions, which currently account for around half of all card transactions." The Paper in point 65 refers to data from a NZ switch that indicates about 46% of transactions are proprietary debit and Figure 3 shows that the total switch to issuer (proprietary debit and swiped/inserted scheme debit) is close to 65% of the overall volume. Regardless of whether half or two-thirds of all debit and credit transactions are being processed without interchange costs and fees to merchants, it seems to us that to suggest that credit card costs *"...may be offset to some extent..."* fails to grasp the impact of the magnitude of the no-cost card segment in the New Zealand market. We suggest that it would be of more relevance to ask whether merchants in New Zealand are paying more or less or the equivalent charges for not just credit but for the overall payment cards business. A preliminary assessment indicates that they pay less.

Scheme Debit is not solely replacing proprietary debit

Issue 3 describes emerging inefficiencies in the debit card market as a result of the growth of scheme debit. At the outset, the paper refers to the growth of scheme debit in place of proprietary debit but we question if the impact that scheme debit has had on the credit card market has similarly been taken into account? The profound uncertainties that accompanied the GFC led to an increased propensity for (particularly among the younger demographics) debit over credit. Segments such as Gen X and Gen Y were increasingly debt averse and wanted the control offered by using their own funds. However, they also travel and are prolific e-commerce users. Whilst there has not been a large migration from credit to scheme debit, the lower growth rates experienced in credit in recent years do suggest that there has been growth in debit that in earlier years could have been expected to have gone to credit or to cash. Given that the ability to use scheme debit for online transactions has been noted in the Paper, we also ask if the benefits of huge growth in online purchases accorded to virtual merchants has been similarly considered?

EFTPOS should (as a minimum) be assigned an imputed value.

Issue 3 also states *"...we are concerned that the competitive constraint on fees to merchants currently provided by proprietary EFTPOS will reduce."* Our view is that any review of card fees in the New Zealand market should recognise that the provision of a large scale payments network at no cost to merchants is not a viable long-term proposition. To use EFTPOS as a benchmark for fees is unrealistic as the current scenario (as indicated in the Paper) provides little or no incentive for its providers to sustain or enhance its capabilities.

Issue 4 considers the barriers to entry in the debit market. The barriers are probably similar across all payment options but particularly challenging with debit when EFTPOS carries no interchange in the New Zealand market. We suggest that the principal barrier to entry in this market is the relatively small size. This characteristic means that the financial drivers need to be established such that a reasonable return on funds employed is achieved in a small-scale operation. This might indeed be interchange but the reality is that whether it is interchange or account fees or transaction fees or some other charge, a potential player will require confidence that an investment can reasonably be expected to deliver an adequate return.

Issue 5 looks at the disparity between card fees paid by smaller and larger merchants. In part this will be determined by whether merchants are charged on a bundled rate that might protect them (or otherwise) from changes in the product mix, or on an interchange plus basis. Merchants eligible for strategic rates will generally be those that deliver substantial volume as well as meet the acceptance and other criteria such as fraud prevention that are determined by the card schemes. To some extent, strategic rates result from the concentration in the merchant market with this giving

the very large merchants considerable bargaining capacity. The question is whether the differential between the strategic rate and a bundled rate that encompasses all interchange segments can be rationalised on a cost basis? Question 22 asks this later in the Paper. Our view is that the networks require the presence of these very large merchants to be successful. Their absence would jeopardise one of the essential requirements for a payments product and that is universal acceptance. So not only are the strategic merchants leveraging their volume in an absolute sense but also in the strategic value they deliver to the network. Smaller merchants are unable to do this. We have therefore no philosophical argument against the differential but are not in a position to determine whether it is "reasonable".

Payment systems in New Zealand

Credit cards are not primarily a vehicle to bring forward future expenditure.
The cost of cash is real and should not be dismissed as fixed until all cash is removed.

Box 1 (page 16) presents some suggested benefits flowing to merchants through the use of credit cards as a payment option. These include the higher average transaction value of credit cards together with the cost of payment by cash. The Paper challenges both, arguing that credit cards are simply bringing forward future consumer purchases and that the costs associated with cash payments are *"....unlikely to disappear without a complete withdrawal of cash from circulation."* We have difficulty with the logic of both arguments.

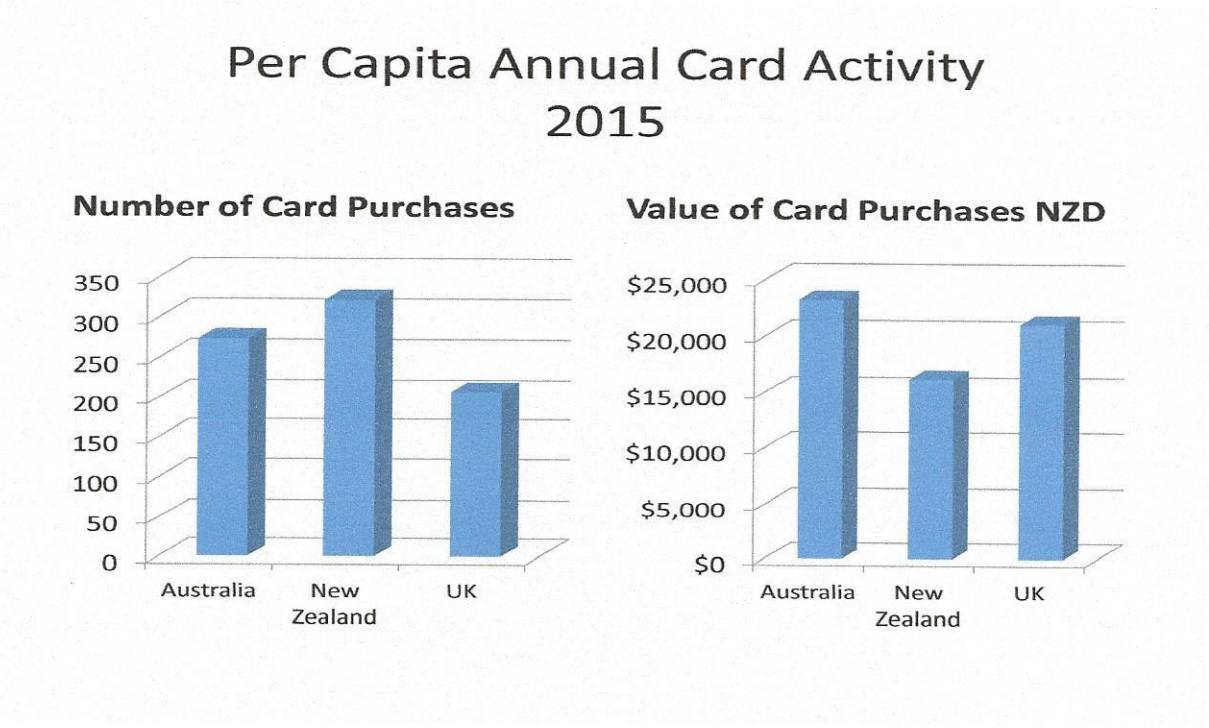
Firstly, the average transaction size of credit card transactions does indeed have a correlation with income but as importantly, there is a correlation with the value of a transaction and the payment type. Cash has its place in <$10 transactions whilst debit (average $38) is typically used for everyday commodity transactions with credit (reported as $76 but believed closer to $85) used for higher value discretionary spend. It is true that there will be some use of credit cards where they are used to facilitate transactions that otherwise would not have taken place until a later date. This was indeed quite typical when credit cards were introduced 40 years ago but their use has changed markedly as illustrated by the altering spend to balance ratio and revolve rates. As can be seen later in this letter, the metrics indicate that credit card purchases are increasingly for current use rather than the financing of purchases that have been brought forward.

Secondly, we struggle with the proposition that the cost of cash is unlikely to disappear unless its use disappears. One could indeed say the same for credit or debit or cheques or accounts but this fails to recognise that there is indeed a cost for each. This was recognised by the Paper "Payment Costs in Australia" issued by the Reserve Bank Australia in November 2007.

The disproportionately high volume of low value card transactions in the New Zealand market imposes commercial issues not equally seen in other markets

Points 60 and 61 correctly describe the high international ranking of New Zealand when it comes to the use of payment cards, particularly for low value transactions. In support of this, we include the following graph prepared by us. It shows clearly the ranking of the New Zealand market compared to Australia and the United Kingdom. In comparison to both of those sophisticated and mature markets as far as card use is concerned, the New Zealand market leads when it comes to the number of annual per capita purchases. However, when it comes to the value of those purchases, the rankings

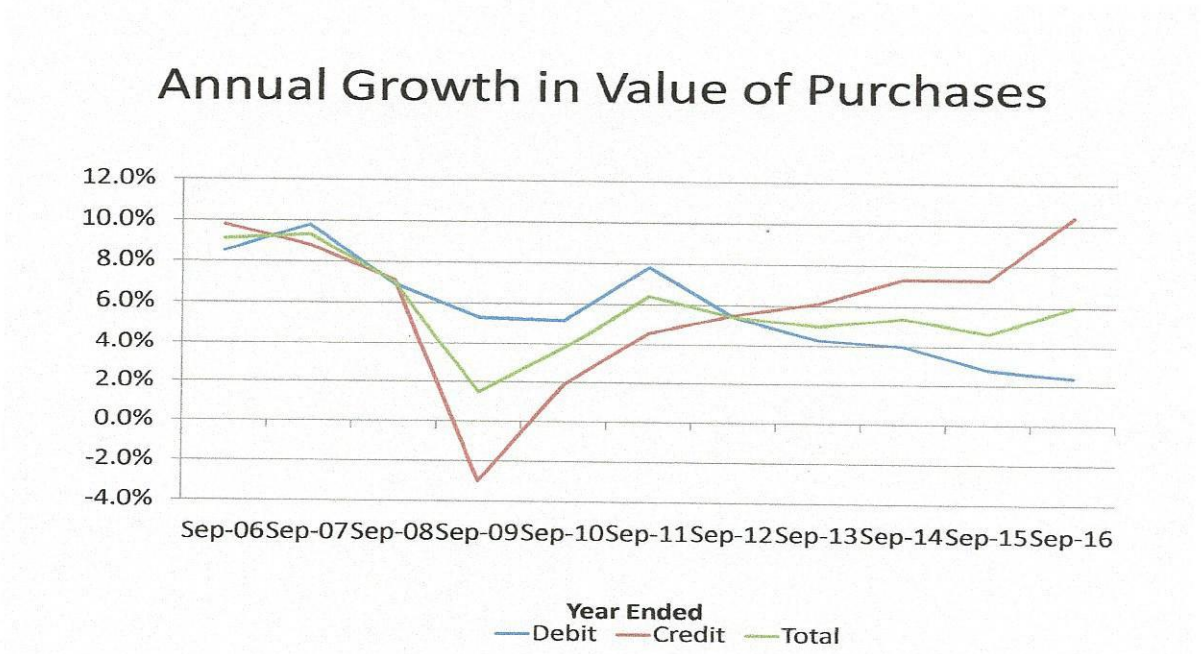
are different. The per capita use in 2015 was 17.6% higher in New Zealand than Australia but the total value of those transactions was 30% lower here than in Australia. An average card transaction in New Zealand was $50.53 compared to $84.90 in Australia. We suggest these metrics need to be recognised in any review of the New Zealand market with, for example, any changes to credit card regulations cognisant of the large volume of cost free proprietary debit and swiped scheme debit.



Market business models and resource costs

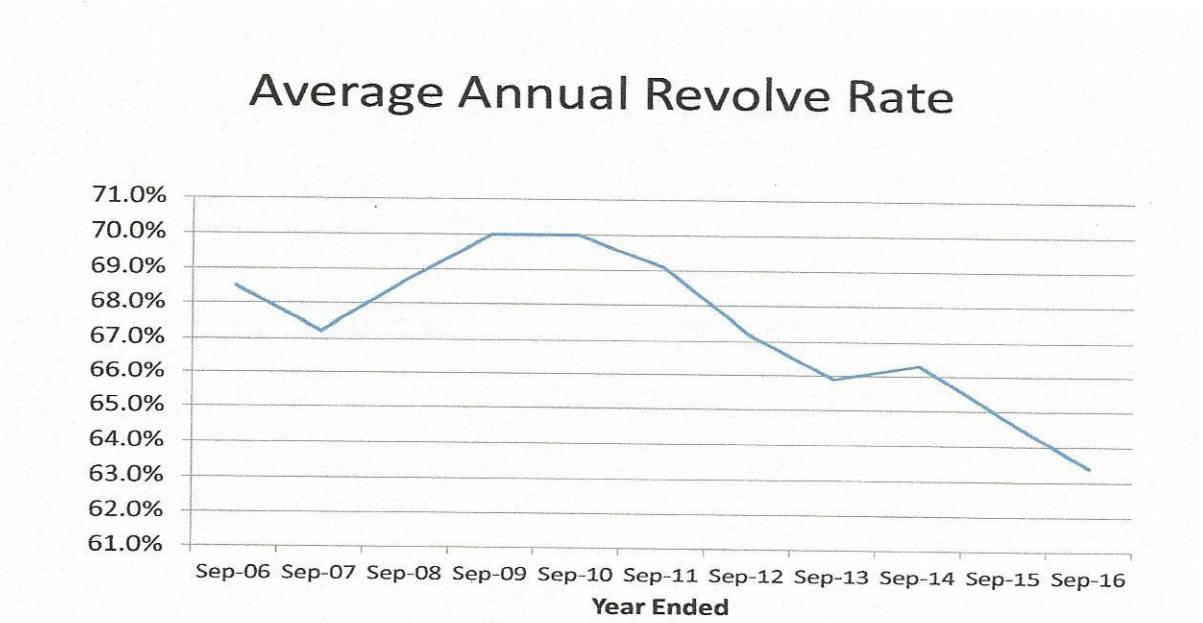
Debit has gained a small share of transaction numbers since data commenced in 2002. As is the case in Australia, debit transactions are much more stable than credit which is more prone to impacts from external factors.

Point 114 states, *"....the share of credit card transactions as a proportion of all electronic card transactions has remained relatively constant since 2002 (when records began) indicating that there has been a similar growth in the level of transactions carried out on debit cards over this period."* Growth has been "similar" although the share of transactions (volume) has increased slightly for debit which has increased from 74% in 2002 to 77% in 2015.We do think it is relevant to point out that there has been a significantly more volatile pattern with growth in credit card spend than debit card spend. We need to qualify the following graph by again pointing out that data over the past few years has increasingly been distorted by the misclassification of contactless debit as credit. The growth rates for debit and credit were indeed similar for the first few years of the last ten but growth in credit card spend then crashed to the extent that it became negative as a result of the GFC. This volatility in credit versus debit in part emanates from their typically differing uses as described earlier in this letter.



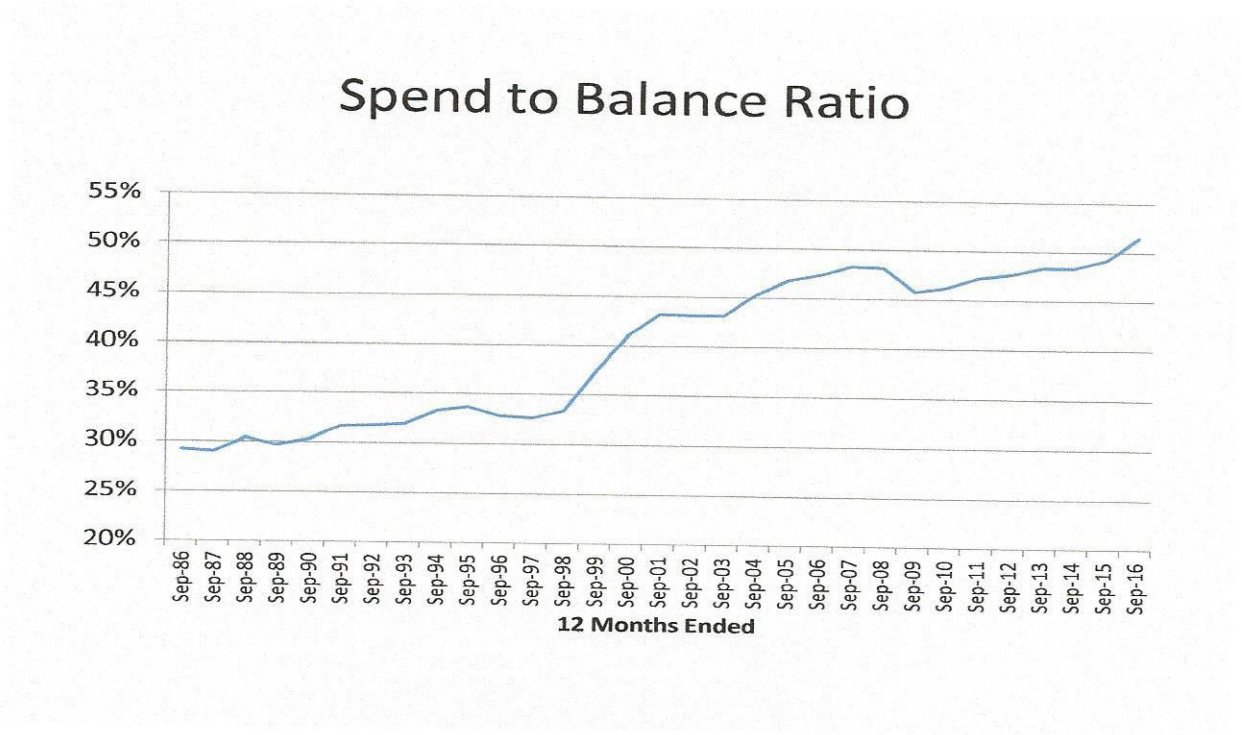
The decline in the Revolve Rate is not a single causal outcome

Point 115 in the Paper notes the decline in the revolve rate. The Paper hypothesises that *"...credit card usage may be increasing for reasons other than consumers needing credit."* This indeed is the point we made earlier in commenting on Box 1. Credit cards have increasingly been perceived as a legitimate payment option as distinct from a form of unsecured lending to facilitate purchases earlier than might otherwise have been the case. We consider it is however not logical to then assume, *"....that consumers may be being induced to use credit more than they otherwise would."* We suggest that the decline in the revolve rate has more to do with factors (in addition to the before mentioned altered positioning of credit cards) such as consumer sentiment, economic volatility and employment rates. We point out the significant decline in the revolve rate since the GFC as an indicator of a change in consumer behaviour as regards the management of card balances rather than a change in credit card use.



Reward Programs are not the sole driver of an increased Spend to Balance ratio

Point 116 correctly indicates an underlying increase in the ratio of card spend to balances. In essence, this means that the growth in card spend is exceeding the growth in card balances. Many would say that this is an indication of prudential behaviour by cardholders who seek to take advantage of the cash flow benefits afforded by the interest free period without incurring interest payments. We are not aware that there has been any significant shift in the 40:40:20 mix that refers to 40% of cardholders often paying interest; 40% rarely paying interest; and 20% moving in or out of either segment. In practice, this is in line with the bank assertion included in the Paper that *"...around half of credit card customers use their card primarily for the credit functionality."* However, as with the revolve rate, we suggest that factors apart from rewards are at play, noting that the 3 most significant interruptions to the increase in the spend to balance ratio followed major corrections in the equities markets in 1997 (Asian Financial Crisis), 2002 (911 Impact) and 2008 (GFC).



Interchange has broader applications than funding reward programs

Point 117 talks of interchange income and describes is as *"....used to pay for rewards.....which are tied to the value of spending on a card." "Interchange income may also cover scheme fees and the cost of fraud, meaning that not all interchange income necessarily flows to cardholders."* We will leave it to others better placed to describe interchange but we do think it relevant to point out that interchange paid by credit card acquirers to card issuers preceded the introduction of reward programs in New Zealand by about 20 years. The fundamentals of interchange were not to deliver a benefit to cardholders via reward programs but to deliver a revenue stream to issuers to offset costs associated with credit card issuing.

Issues Identified

On what basis was the assumption made that international cardholders are unlikely to be motivated by rewards?

Question 8 seeks views on the Paper's logic regarding inefficiency in the credit card market. It seems to us that the central tenet is that higher interchange related to premium cards with associated reward programs results in additional fees to merchants that result in higher overall priced goods and services with this price premium disproportionately allocated across differing socio-economic groups. We believe there is some basis for this conclusion but suggest that this simplistic interpretation and regulatory approach would be inappropriate. As an example of our questioning, we refer to the Paper's note 33 to point 192 which states, *"...that around 20% of credit card transactions are made by business or international cardholders, and have removed these from the analysis on the basis these transactions are unlikely to have been induced by rewards."* We agree that about 20% (but significantly less of the transactions) of the $40 billion spent annually on credit cards at New Zealand merchants is on international and commercial cards but fail to understand the hypothesis that international credit card users are motivated differently to New Zealand credit cardholders? Having argued that New Zealand credit cardholders are primarily motivated by rewards

as distinct from a line of credit, we don't understand, given the nature of the credit card markets in most major sources of visitors to New Zealand, why they would be any different? If they indeed are differently motivated, that seems to us to raise doubts about a key platform of the logic underpinning this assessment of inefficiency.

Rewards are just one of many factors that determine card selection and use.

We also have reservations about the methodology used in determining the added cost at $45 million. It is premised on the assumption that 40% of cardholders use the card primarily for the associated reward program. As indicated earlier in our letter, it is our understanding that following the introduction of reward programs in New Zealand in the late 1990's there was not a fundamental shift in the 40:40:20 split of transactors, receivers and cardholders moving between the 2 segments. We would argue that the 40% (or thereabouts) of cardholders that are described as transactors are indeed often attracted by rewards. But they were transactors before reward programs, having been motivated by the interest free period, international functionality, enhanced security, online capability etc. These factors continue to influence card selection and use with rewards driving card spend and to some extent, account tenure. Rewards have influenced card use but we would not agree with point 193 which states *"Put another way, 40 per cent of credit card users have no need for credit; they have sufficient funds in their accounts to pay for the purchases. However, they use their cards because they are incentivised to do so through rewards and do not face the full cost of doing so, since surcharging is uncommon."* We believe rewards have altered some aspects of the card use of this group but they have not been the sole causal factor.

Question 9 asks if reward schemes result in higher overall prices and cross-subsidies. Given that the presence of interchange preceded the introduction of associated reward programs, we would argue that it is not reward programs per se that place pressure on card costs but the extent and manner in which credit card issuers use pricing to fund those reward programs. To the extent that Standard or Electronic or Premium interchange rates are used (in part or in full) to fund reward programs, then we would agree that these result in higher card fees to merchants. We point out however, that it is no more possible to conclude that these specific costs result in overall higher retail prices with any more conviction than saying that higher marketing costs, distribution costs, or utility costs lead directly to higher retail prices.

We also point out that these interchange rate flows have historically, and now, continue to fund costs besides reward programs with these related to general portfolio costs such as funding and fraud or specific product costs such as travel insurance or concierge services. To the extent that higher interchange rates are used specifically to fund reward programs, we would agree that merchants not able to access strategic interchange rates would face additional card acceptance costs. We are however, unable to determine if any or all of these costs are passed on to customers in the form of higher prices.

Point 197 in the Paper estimates the cross-subsidy allegedly occurring between users of low-cost cards and high-cost cards. Attached to this point is note 34. Included in this note is the assumption that 10% of credit card transactions are made by international cardholders and these have been removed from the analysis. We raise this as an example of data integrity that does not appear to be completely robust. The C13 table published by the RBNZ enables this metric to be quantified and the share of spend at merchants in New Zealand has moved as follows:

12 months to Sep 2013 10.5%
12 months to Sep 2014 10.9%
12 months to Sep 2015 11.6%
12 months to Sep 2016 12.4%

The result would be an over-estimation of any cross-subsidy and we question therefore whether other data used in the economic evaluations are similarly inaccurate?

We consider it economically and practically incorrect to suggest that credit card pricing is too high without conceding that EFTPOS is correspondingly too low.

Box 2 (page 50) asks if the alleged cross-subsidies on credit cards are more pervasive than other cross-subsidies and then implies that they are. We disagree. Credit cards are widely used (even if their growth of late has been very much less than implied in the Paper) as they have become an inherent component of the payments system. This is due to the benefits that flow to both cardholders and merchants. To suggest that all costs must be apportioned equally across all users seems simplistic and naïve; how to regard any coffee shop that offered regular users a free cup after 5 or 10- visits? or the airline that offers upgrades to its best customers? Credit cards have costs but the benefits should not be discounted. Some businesses (such as e-commerce) could barely survive without them or would face added costs if credit cards were unavailable. Associated with this is the issue peculiar to New Zealand where the use of proprietary debit and swiped or inserted scheme debit is cost free to merchants. It appears to us that any attempt to adjust credit card pricing must include the establishment of EFTPOS pricing that recognises the value it delivers to New Zealand merchants and cardholders.

The interchange rates on scheme debit in NZ do not appear high in comparison to a regulated market such as Australia.

Point 4.3 addresses inefficiencies that could develop in the debit market as a result of growth in switch-to-acquirer transactions. We have difficulty reconciling an impending inefficiency issue with the following comments in the Paper: *"The share of contactless transactions will continue to grow as more merchants start accepting contactless debit payment."* and *"There are real benefits associated with contactless technology for both consumers and merchants."* We understand that there is a body of discontent among New Zealand retailers about the presence of fees on contactless debit. But although not having any empirical evidence, we feel this view stems from the fee-free nature of EFTPOS and swiped/inserted scheme debit as distinct from a considered view about the fees themselves. We note that the interchange rates for scheme debit in New Zealand appear to be comparable to the Australian market where a) rates have been regulated and b) the acceptance rates of contactless cards are at internationally high levels. Whilst the average debit transaction is currently reported at $38.70, we believe the median is likely to be lower. If we assume it is closer to $20, a typical interchange fee (as distinct from the total fee to the merchant) would be around 6 to 8 cents with an interchange fee from MasterCard for transactions <$15 of just $0.004. Given the noted benefits to both sides of the market, we do not see these interchange levels as being a cause for concern.

We fail to see that the current proprietary debit model can be sustained and developed in the long term without the introduction of a revenue stream.

Question 14 asks if there is any incentive to invest in proprietary EFTPOS. Our view is that from a rational financial perspective, the short answer is no. Proprietary debit not only delivers nil income to issuers or acquirers but it lacks competitive product functionality. EFTPOS did originally have negative interchange in New Zealand but that was terminated many years ago. Until that occurred, there was an incentive for acquirers to build, develop and maintain the network. Not surprisingly, merchants embraced the no fee service and cardholders recognised the widespread network that offered a secure, convenient and safe alternative to cash for relatively low ticket purchases.

However, as in any two sided network, long term success requires a balance of risk and reward. The emergence of scheme debit satisfies the needs of consumers who can use it online and overseas as well as delivering a commercial platform for issuers and acquirers. It begs the question, why would the banks commit capital to develop the proprietary debit network without a revenue stream when an alternative is available?

Question 15 seeks views on the likelihood or otherwise of interchange on swiped/inserted scheme debit. Our view is that in the current climate, such a move is unlikely. But we think the broader perspective needs to be considered. An absence of EFTPOS interchange has become a well established feature of the New Zealand payments market. Other elements of this market have developed with this characteristic recognised as a major feature. Should the financial drivers of the non-EFTPOS payment card market be substantially constrained, then we could envisage a scenario in which interchange on all scheme debit would be considered essential. Whilst, as we indicated earlier in this letter, there are some underlying differences in the manner in which debit and credit are used, the two are not mutually exclusive so that changes to one may well flow into the other.

Any analysis needs to consider benefits as well as costs.

Point 220 analyses the financial impact to merchants should contactless scheme debit reach a 60% share of card present debit. In determining the financial impact, we ask if the benefits of contactless technology were factored in? The following is taken from "Payment Costs in Australia" issued by the RBA in 2008; *"The weighted-average cost to merchants of the average EFTPOS transaction, at $0.34, is a little higher than that for the average cash transaction. This is due to the longer average tender time, with other payment-related costs being lower than for cash transactions."* The report also shows that of the total weighted average coast of $0.34, the tender time accounted for $0.24. Contactless scheme debit will add costs when compared to the fee free EFTPOS system but to the extent that it replaces cash and to the extent that it reduces the processing time at the point of sale, it will deliver financial benefits to retailers and this should be recognised in any overall analysis.

Our view on question 16 is that it is the absence of interchange and fees on proprietary debit that is the issue. We recognise it has been pivotal in positioning New Zealand as a global leader in payment card use but question the long-term viability of such a model.

Factors apart from interchange impose barriers to entry

Question 20 seeks input on the view that the interchange model imposes significant barriers to entry in the debit market. We do not feel that it is specifically interchange that poses barriers but a) the small size of the New Zealand market; b) the presence of a no fee competitor; and c) the massive challenge of establishing a network in which acceptance is ubiquitous and cardholders in a mature market will require a performance or pricing incentive to switch.

Merchant pricing does need to be transparent.

Box 7 looks at the clarity of merchant pricing. The increase in number of interchange rates and card products over the years has led to a more complex environment. We support the proposition that merchant fees should be clear and transparent although it is our understanding that many smaller merchants do prefer the simplicity of a bundled rate. That notwithstanding, merchants should have the ability to understand what influences they can exercise over the costs of card acceptance.

Conclusion

In summary, we believe that any proposed changes to the credit card model in New Zealand should recognise that the cost to a merchant of an average payment card transaction compares favourably to international markets such as Australia. Contactless technology delivers benefits to cardholders and merchants. Its pricing should not be constrained by the presence of a fee-free proprietary debit model. We feel that to the extent that some review of the higher interchange rates on premium card segments is considered warranted, it should not be in isolation to consideration of the broader payments card arena and in particular, consideration of a small interchange fee on proprietary debit.

Yours sincerely

Michael Ebstein
Director
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