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

SUBMISSION ON RETAIL PAYMENTS SYSTEMS IN NEW ZEALAND

EXECUTIVE SUMMARY

Mitre 10 (New Zealand) Ltd is a New Zealand owned business operating as a co-operative model under which the owners of our stores are shareholders in Mitre 10 ("Members"). The payment system, its cost, innovation and regulation are something of high interest and importance to our business. We always look for ways to improve the efficiency of payment processes. However, minimising the ever-rising costs of running their businesses is important for our Members.

The paper presented by the Ministry of Business, Innovation and Employment (MBIE) provides a new level of insight for us with regards to retail payments systems.

This summary aims to present a high level overview on the issues identified by MBIE. It will be followed by our responses to the questions posed throughout the Issues Paper.

Issue 1: Economic inefficiency in the credit card market.

We consider this to be one of the key issues in the current credit card market. Economic inefficiency is driven by the parties who can influence the pricing of processing credit cards – schemes, banks and strategic (large) merchants. The interchange model benefits them the most, with small merchants having to bear the costs through increasing merchant service fees (MSFs) which reduces competition in the market.

Another aspect of the interchange model is that some foreign-owned local merchants are able to use the power of the much bigger group located in other jurisdictions to obtain better interchange rates and minimise MSFs. This further reduces the competitiveness of New Zealand merchants who cannot compete on the same scale with businesses that are run with international interests and can negotiate better rates.

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

Due to the limited information available to us, we cannot assert the assumption that higher-income consumers benefiting from rewards. However, this hypothesis has been referred to throughout various analysis of payment system efficiency. On its own, this is not a unique situation in the market. In the retail space for example, there is a product price differentiation between consumer and business/ trade customers. However, such differentiation is a business choice through assessing the volume and cost to service business and trade customers. What is changing currently is the dynamic of business customer behavior where they now want to use credit card to pay for the outstanding account balance to obtain card scheme rewards. The cost of processing this kind of payment is high and leads to a decline in profitability.

Further, we disagree that prices are rising for all consumers. In the competitive retail market space it is very hard to pass on cost increases to consumers as they tend to shop around before they make a decision to buy. Having higher prices due to the rising cost of processing the payment may well be a competitive disadvantage depending on the approach taken by others involved in the market space.

Issue 3: Emerging inefficiency in the debit card market.

Introduction of contactless technology and online debit options means customers are switching from traditional EFTPOS to scheme debit with contactless technology. As a result our stores are experiencing high demand for contactless payment acceptance. For the merchant this means changing from cash and EFTPOS transactions to more expensive scheme type payment, leading to increases in MSFs. In our market, the competition is strong and increase in cost of processing a payment does not translate into an increase in price. This affects the profitability of stores while banks, schemes and issuers are benefiting from the increased uptake. Eventually, this type of inefficiency will be predominant in the debit card market as much as it is currently in the credit card market.

Issue 4: Barriers to entry in the debit market

While we cannot provide full insight into the barriers to entry in the debit market, it would be worth noting that the current debt schemes offered in the New Zealand market are well established globally. They have significant technology and products to create fierce competition if anyone attempted to enter the debit market space.

Another barrier is likely to be the small size of the New Zealand market compared to other parts of the world. It is likely to be uneconomic for new entrants to the debit market to obtain market share as they would have to offer issuers a competitive deal that is better than what current schemes can offer. If they can do so, they are likely to incur significant costs which will have to be managed by passing those costs through to merchants or consumers. This could lead to low acceptance and low usage which might force the new entrant out of the market.

Issue 5: Impact on small business

Small businesses are significantly impacted by the current state of the retail payment industry. This is mostly driven by smaller merchants' inability to negotiate with the schemes and banks to obtain strategic rates. This means the cost of processing scheme transactions is significantly higher which creates a major competitive disadvantage.

Non-strategic rates for the banks is a way to fund rewards to increase market share in the debit and credit card space. Strategic rates reduce interchange revenue for issuers and subsequently put the pressure on non-strategic rates to produce the desired level of revenue. This means that small businesses are forced to accept the higher cost of payment processing due to a lack of bargaining power, which then funds the competitive advantage of large merchants on strategic rates.

Further, through industry programs such as government, petroleum, telecommunications, and strategic merchants (e.g. groceries) which have special interchange rates, consumers are growing accustomed to the new types of payments technology and demand the same level of service from smaller merchants who are likely incurring higher MSF rates than the larger strategic merchants. Even though smaller merchants have an option to mitigate MSF rate increases through surcharging and steering, these methods are perceived as a competitive disadvantage and may lead to loss of customers and reduction in sales levels.

RECOMMENDATION:

We believe that intervention through regulation of the payment industry is required in order to improve the efficiency of the payments industry and the competitive environment for all merchants and consumers.

Next Section will answer specific questions asked by the MBIE in the Issues Paper.

QUESTIONS – Mitre 10 RESPONSE

Section 1 – Introduction

1. **Are these objectives for retail payment systems appropriate?**

   Overall, we believe that the objectives are appropriate. We are inclined to note that the 3rd objective is key to allow for 1st and 2nd objectives to evolve. That is, if the costs are distributed fairly then there will be more new and innovative payment products that are valued by customers with greater acceptance by merchants. The current state of the system shows that the costs of accepting new types of payments demanded by customers (e.g. contactless) are getting higher for smaller merchants which hinders acceptance. As a result, it obstructs the objectives of the payment system.

Section 2 – Payments systems in NZ

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

   There are two other payments methods that we would like to add to the list that can potentially affect the market:

   - **Invapay**: A business to business payment solution based in the cloud that facilitates a payment process. Communicates between purchaser and supplier regarding order, approval and shipment and then instructs the bank to pay once all checks are complete (www.invapay.com).

     This solution will likely to be based on a different arrangement to the interchange model as it is a direct debit type of payment rather than acquirer/issuer relationship. It will likely to create competition to the recurring payment type solutions offered by schemes.

- **Bitcoin**: digital currency payment option that removes the banks altogether. The uptake by merchants is likely to be slow due to complexity and lack of product representation tailored to retailers. Nevertheless, it could be another disruptor on the market given the rapid move to digital space across the retail industry.

<u>Section 3 – Market Business Models and resource costs</u>

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

   Firstly, to drive the consumer uptake, the marketing and advertising generated by schemes and issuers around promoting credit card use is based on functionality such as payment convenience (e.g. contactless technology, online and international payments, etc.) and to obtain rewards. These benefits are promoted more than the actual use of credit facility. Provided that these customers do not need a credit facility to fund their purchases, they will pay off the balance on time without attracting interest. Increase in such behaviour will cause the revolving ratio to decrease.

   Moreover, it is in the interest of issuers to promote credit card use as it increases their market share and subsequently interchange revenue. Use of the credit facility by customers which subsequently generates interest revenue seems to be secondary and additional value rather than being the primary revenue generating unit.

   Additionally, the cost of switching banks for a consumer credit card is low or non-existent, especially for customers who use credit cards for rewards. This means that the customer will be inclined to take out a credit card with the banks who will offer the most value for them in rewards. This behaviour will also drive the revolve ratio to decrease.

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

   While we generally agree with the rationale for interchange, we do not agree that merchants are less price sensitive. Merchants, especially retailers, are sensitive to cost increases in the business and will look for ways to minimise these costs. This is evident through some merchants surcharging for accepting credit cards and/or steering to a certain method of payment (e.g.“no paywave” sign on EFTPOS terminals).

   Further, the interchange model is intended to benefit schemes and banks the most. Schemes have the power to set interchange rates which will affect banks' revenue. Banks have the power to accept/decline schemes' products which will affect consumer uptake, as well as schemes' market share revenue. Both of these groups have significant powers to influence each other and subsequently the interchange fees. There is little power for consumers to see the true price signals and for merchants to negotiate their MSFs.

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

   We agree with the incentives outlined for acquirer and issuer. However, we would disagree with the assumption that merchants are able to pass on the cost increase into the price for consumers. This will not be true for strategic merchants as their cost of accepting schemes' payment options is significantly lower, which means there is no need to pass the cost to consumers. This may be true for large retailers who are able to distribute the cost over large volumes so that the increase is insignificant for the consumer. For SMEs the situation is different and in the highly competitive retail market place an increase in prices will likely to lead to a decrease in sales as customers tend to shop around for the best deal.

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

   Using increased interchange rates, the issuers are able to attract customers to use credit cards through funding rewards and other benefits. This leads to increase in interchange fees for the banks' acquiring department. To compensate for such increase, acquirers are increasing MSF rates for the merchants. Overall, it looks like consumers are paid to use cards through rewards and extended credit terms but are not necessarily seeing any increase in prices they pay for goods and services. In turn, banks are turning to merchants to fund the ever continuing war for consumer market share through increases in MSFs.

   Also, larger merchants have more bargaining power with schemes due to the large uptake of day-to-day payments through scheme cards such as food and petrol. These merchants are used by the schemes to test and drive new technology uptake and promote the use of debit/credit cards. Once consumers are enticed into using their card and new technology through those merchants and it becomes valuable to them, then the behaviour will drive demand for acceptance by other merchants. It is the scale that the larger merchants can offer to schemes that will help them distribute payment products in the market. As a result, these large merchants are able to negotiate with schemes directly and receive strategic rates. Even though the number of these strategic merchants is low, it would cover a large part of total transactional volume compared to the rest of the retail market.

   On the other hand, SMEs do not have the same bargaining power and visibility over the cost of the payment options they accept to be able to negotiate strategic rates. Overall, the lack of transparency around the payment system makes it difficult and costly to get the information required to make more informed assessments of merchant fees charged and to engage in discussions with schemes and banks.

   Further, from the banks' point of view, existence of strategic rates for larger merchants leads to interchange revenue reduction. To fund the difference, the ordinary interchange rates are set twice as high for non-strategic merchants. From the retail industry perspective this means that smaller merchants are disadvantaged as their ability to be price competitive is eroded.

7. **Is the resource cost data robust? Is the Australian data likely to over-state or under-state the costs of running New Zealand payment systems?**

   Without full visibility in the cost of running a payment system, we are unable to comment.

Section 4 – Issues Identified

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

   Overall we agree with the logic. However, we would disagree that the increase in MSFs results in the overall increased prices for consumers. This is very unlikely for SMEs who operate at a disadvantage to large strategic merchants in a very competitive retail market.

   There is also the issue that along with lack of information available to consumers, the merchants are faced with the same problem which hinders the ability to understand and negotiate the cost of accepting various payment options.

9. **Do you agree with the logic underpinning our assessment that there are regressive cross-subsidies in the credit card market?**

   We disagree that consumers face higher overall prices. This point assumes that all merchants put their prices up as the cost of accepting payment options rises which will not be true in the highly competitive retail market.

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

    We agree. Self-acquirers will likely cause prices to increase due to technology investment required to become one.

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

    Unless you have a deal with schemes for a strategic rate or your volumes are that of a large merchant, banks will tend to increase your MSFs. This is especially evident for banks with lower market share where their off-us interchange exceeds on-us interchange.

    Further, new technology that is being introduced to the market through larger retailers who have strategic rates in place is driving consumer demand, e.g. contactless uptake. The trend is not as strong at the moment but it is on the rise and merchants will end up activating contactless at their terminals in order to meet consumer demands and subsequently retain and/or increase sales.

    Moreover, a lack of transparency around the cost of accepting different payment options means retailer’s negotiating power is reduced.

12. **Do you think that the issues in the credit card market are of a scale that warrants intervention? If not, do you think that the size of the issue is likely to grow over time?**

We believe that intervention is required. This is due to the current state of the payment system that allows schemes and banks to influence interchange and MSFs, as they have the largest stakeholder interest in the payment system for revenue and market share generating activities.

We have recently observed changes in rewards programs around various credit cards which may have been facilitated by increased interchange rates. As a result, this would likely lead to increase in MSFs but not necessarily to increase in prices for consumers.

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

Overall, we agree with the assessment.

In addition, it is worth noting that the increase in uptake for contactless will see merchants having to offer this payment option regardless of cost/benefit implications.

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

We agree. Scheme debit cards provide the security and functionality beyond what EFTPOS can offer at the moment. A significant investment is required to ensure EFTPOS can compete with scheme debit and become a value proposition for consumers. This investment would have to be recovered either through consumer fees or merchant fees or both. Hence, this might push EFTPOS to cease being 'free' to merchants.

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

We believe that uncertainty exists whether schemes will impose interchange on swiped/ inserted scheme debit transactions.

On the one hand, there is no regulated measure in place to prevent them from doing so.

On the other hand, the contactless technology uptake will supersede the need to swipe/ insert scheme debit cards which means that schemes will not have to worry about interchange on swiped/inserted debit transactions.

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

The issue is not that there is a charge, the issue is at what rate that charge is set, who sets such charge and how it is regulated.

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

    In the existence of 'free' to merchant EFTPOS, the shift to contactless debit is not cost-effective given it increases the cost of accepting a card payment option. In addition, while the interchange rates are set by the schemes and influenced by banks through the ability to offer rewards and encourage uptake, the interchange model involved in accepting contactless debit will be inefficient in the same ways as credit card interchange model.

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?**

    Yes, we agree.

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

    Yes, we agree. Currently schemes will be looking for various ways to encourage product uptake. Once the required threshold is reached the price will go up unless regulated.

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

    We agree. This is driven by the main players of payment system – banks and schemes - who have the most power to influence this model.

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

    - **The level of uptake of contactless payment through mobile phones such as Apple Pay**

      The level of uptake will continue to increase. This will be driven by technology evolution in the new generation who grew up with fast technology changes and who will switch to contactless much faster.

      This will also be driven through issuer's marketing, aimed at encouraging a new generation to take out debit cards due to better functionality (use of contactless and online payment technology).

    - **Whether new interchange-based payment options enter the market**

      It is possible for new players to enter the market. However, it is likely that new players will be utilising current schemes' networks in order to provide in-app payments, such as Amazon Shop, Apple Pay, Android Pay, etc.

    - **Whether non-interchange-based payment options enter the market**

      This is unlikely as the interchange model serves as a means of generating revenue to attract customers through funding rewards and benefits offered.

- **Whether proprietary EFTPOS exits the market altogether**

  Unless there is significant investment made to increase security and functionality of the current state of EFTPOS technology, there is a high chance that it will exit the market due to a decline in uptake.

- **Whether merchants start to steer and surcharge more**

  Current pressure to take on contactless will only increase going forward. This is driven by day-to-day merchants such as petrol stations and supermarkets that promote the technology, as they face lower costs of accepting this technology through strategic interchange rates. This makes it harder for smaller merchants to push back the demand driven by the consumer to accept contactless. Introduction of a surcharge and steering will likely create a significant competitive disadvantage, especially if your direct competitors do not surcharge or steer.

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

No, the current model effectively means that small merchants are paying more to the banks to subsidise the interchange revenue they forgone as a result of large strategic merchants being on lower interchange rates.

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

Yes, we agree.

<u>Section 5 - Possible Next Steps</u>

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

We agree that greater transparency will provide merchants with an improved understanding of the payment industry to make informed decisions.

The efficiency issue in the market is unlikely to be improved with greater visibility for the following reasons:

- Unless merchants have the volume, they are not going to be able to negotiate with the schemes to place downward pressure on the MSFs. The retailers with bargaining power might reduce the MSFs for their businesses. However, consideration should be given to the impact this could have on the pressure to increase MSF fees for the smaller merchants to offset this revenue lost by the issuing banks.
- Options such as surcharging in a competitive retail market are not always viable. These options might work for hotels, airlines or niche retailers.

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

In short term this might help. However, it is possible that if EFTPOS completely disappears schemes can apply the interchange model to the debit swiped/ inserted transactions. The justification might be driven by various factors such as improvement to security or other investment recovery measures. Unless the market has viable options, being aware of the intentions of the schemes in advance would be of marginal benefit.

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

The benefits of regulation will exceed the costs. While the blended MSF rates might decrease for merchants, without regulation the overall costs to merchants are still likely to rise with the shift to scheme debit cards and new technology payment platforms.

27. What unintended consequences could arise from interchange regulation?

Excessively harsh regulation can slow down innovation.

Furthermore, regulation would likely impact the rewards programs offered by issuers. However in other regulated markets the schemes and banks continue to provide innovative products, rewards schemes and development in the infrastructure.

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

It should be regulated now to avoid similar issues that arise in the credit card market.

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

Another barrier imposed by the interchange business model could be the small size of the New Zealand market. It could be uneconomical for the new entrants in the debt market to compete with well-established schemes that are currently operating here.

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

Risk exists in the payment industry and should require barriers for entry to ensure the market is secure from fraud. The industry should also ensure that infrastructure is configured to accept payments from international consumers visiting New Zealand.

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

If we look at contactless as an example, a number of merchants have not activated this technology due to the costs involved. If the barrier of cost was mitigated, then the market could move towards full implementation of a technology that is used internationally.

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

Yes.

33. Have we missed any options?

It is difficult to comment from our perspective.