

Ministry of Business, Innovation & Employment – Retail payment systems in New Zealand

Paymark's response

Introduction

1. Paymark Limited ("**Paymark**" or the "**Company**") welcomes the opportunity to respond to the Ministry of Business, Innovation & Employment's ("**MBIE**") Retail payment systems in New Zealand Issues Paper dated October 2016 (the "**Issues Paper**").
2. Paymark's board has authorised the Company and its independent chairman to make this submission. Neither Paymark's shareholders, nor their shareholder appointed directors, have been involved with preparing this submission and the views expressed in this submission do not necessarily reflect the views of all or any of them.
3. This submission contains commercially sensitive information. We therefore request that MBIE engages with Paymark before this submission is made public or released under the Official Information Act 1982 so that any necessary redactions can be made.
4. Paymark agrees that MBIE's objectives as set out in the Issues Paper are appropriate. Paymark has not responded to each specific question posed, however this submission contains Paymark's view on the issues raised. If required by MBIE, Paymark would welcome the opportunity to provide further clarification.
5. Paymark has attached an Appendix which includes a comment on data and reporting, and brief descriptions of the Paymark products referred to in this submission.

Executive summary

6. Paymark is involved in delivering effective competition and innovation in the retail payment system in New Zealand. Since its inception in the 1980s, Paymark has played a key role in confining the cost of safe and secure payment processing services for New Zealanders.
7. As MBIE observes in the Issues Paper, the low cost to consumers and merchants for proprietary eftpos transactions is the key competition in retail payments. The international card schemes (the “**Schemes**”) cannot price their services without regard to this lower cost alternative.
8. The unique feature of Paymark (internationally) has been its position as an instrument of collaboration for banks, merchants and technology providers in retail payments in New Zealand. Paymark can continue to counter the efficiency concerns raised in the Issues Paper through, for example, innovation and industry collaboration.
9. New Zealanders will continue to receive from Paymark a cost-effective alternative to Scheme-provided services. Paymark is investing to ensure that merchants can avoid Scheme charges without material functionality disadvantages. Paymark will help small and medium businesses redress their bargaining power imbalance and help alleviate the barriers that have stalled the use of available contactless functions for many of them.
10. In addition to effective competition and efficiency, Paymark provides standard-setting leadership on other matters described in the Issues Paper, including; security, reliability of services and systems, access, education and transparency.

The threat seen in the issues paper is real

11. The Issues Paper identifies some threats to proprietary eftpos. The consequence for proprietary eftpos could be a spiral. Loss of scale economies could result in increasing charges for the remaining transactions. It could stop, not merely limit, investment in technology, both for continued reliability and to maintain comparable functionality with Scheme services. It could prevent entry of innovations and technology not sponsored or provided by Schemes or international challengers, such as Apple, that are associated with Schemes.
12. Paymark experiences directly the operation of incentives that may be rational for individual decision-makers but which may result in sub-optimal or inefficient outcomes for New Zealanders collectively. Paymark foresees the rapidly increasing proportion of Scheme cards in use reaching a tipping point where too few merchants will be able to steer transactions away from those that attract interchange fees.
13. However, Paymark does not believe that the demise of proprietary eftpos is an inevitable progression to the scenario outlined in the Issues Paper. Paymark does not need to be supplanted. Paymark's proprietary eftpos service will prosper in an efficient market. Paymark can ensure that merchants retain a viable alternative to Scheme products.
14. As described elsewhere in this submission, Paymark is already investing to ensure it has all the functionalities (including contactless and card-not-present capability) to compete successfully. In order for these innovations to be successful, market developments are needed to counter the adverse market dynamics described in the Issues Paper.

Continued relevance of Paymark

15. Paymark is a low cost, efficient, reliable payments service provider and a key component of the retail payment system infrastructure in New Zealand. Continued support of Paymark's services ensures that New Zealand retains a player with enough scale to sustain expertise and investment in deployment, development and integration, in an arcane area. Paymark believes it remains an important aspect of national resilience.

16. Paymark has maintained low costs for New Zealanders over many years since eftpos gained substantial use. Paymark's owner banks were willing to bear the investment risk of early inception (in international terms) to achieve cash and cheque handling savings. At the time, those savings were estimated to be potentially NZD \$300m per year. The low resource costs of the processing network enabled by bank collaboration supported an 'efficient low cost utility' business model. Trivial transaction charges were enabled by standardisation and savings on links and other interconnection costs. The unique collaboration generated world leading cashlessness.

17. The low cost of proprietary eftpos is the combined effect of:
 - a) scale efficiencies (from world leading penetration following unparalleled reliability) despite New Zealand's small market;
 - b) standardisation and universal acceptance;
 - c) low transaction fees for issuers;
 - d) low charges to merchants enabled by that scale and efficiency, expressed in:
 - i) no interchange fees;
 - ii) monthly terminal rental in a very competitive terminal market; and
 - iii) low merchant connection fees charged by Paymark.

18. The proprietary eftpos service continues to protect New Zealanders from paying much above the resource cost of payment services. The Issues Paper offers an estimate of NZD \$45 million per annum in current excess cost through the use of Scheme mechanisms instead of proprietary eftpos (after allowing for higher functionality). Paymark does not take a view on reliability of that estimate. Nor does Paymark enter into debate on whether the additional costs anticipated by the paper are correctly described as inefficiencies.
19. For the year September 2015 to September 2016, Paymark switched approximately [section 9\(2\)\(b\)\(ii\)](#) retail electronic payment transactions in New Zealand with a value of approximately [section 9\(2\)\(b\)\(ii\)](#)
20. Of the transactions switched by Paymark during that period approximately:
- 36% were switch-to-acquirer transactions (Scheme credit, Scheme contactless debit and Scheme debit online);
 - 54% were switch-to-issuer transactions (proprietary eftpos and swiped or inserted Scheme debit);
 - 10% were other products such as loyalty.
21. Paymark therefore estimates that consumers, via merchants, have avoided paying interchange fees on transactions which had a total value of approximately [section 9\(2\)\(b\)\(ii\)](#)
22. Paymark has not lost the scale needed for operational and capital economies. The tipping point has not been reached whereby the Schemes can dominate and eliminate proprietary eftpos.
23. Paymark submits that the only significant advantages of Scheme products over proprietary eftpos products for domestic transactions within New Zealand at present are:

- a) online or card-not-present transaction capacity; and
 - b) contactless capability.
24. Both of those advantages are readily matched. The problem that needs countering is the absence of a measurable and attributed return to issuers to reflect the efficiency of proprietary eftpos.
25. Paymark believes that New Zealand's proprietary eftpos service will be maintained and that Paymark's processing and acceptance services will be enhanced for the reasonably foreseeable future. Those services will continue to provide an effective alternative to Scheme services, enabling merchants to avoid inefficient Scheme charges and limiting the adverse outcomes postulated in the Issues Paper.
26. Paymark is well positioned to drive the critical mass necessary for ubiquitous acceptance, consistent and frictionless customer experience, and future innovation. This will allow front-end disruptors the capability to innovate outside of the Schemes.

Paymark and innovation

Card-not-present

27. Paymark recently launched Online Eftpos, a fully developed card-not-present solution. Online Eftpos is a payment method that allows consumers to pay for online purchases directly from their bank account. Users enter their mobile phone number at the online checkout and approve the payment within their mobile banking application (“**app**”). Paymark believes that compared to other direct-from-account products available in the New Zealand market, Online Eftpos operates in a more secure and reliable manner.

28. Paymark developed an API-based platform that securely connects to bank APIs and allows participating merchants to send consumer initiated payment requests directly to the consumer's mobile banking app for approval and authorisation.
29. Online Eftpos consists of the following components:
- a) Merchant API - allows merchants to generate payment requests and to receive authorisation from banks;
 - b) Bank API - allows banks to receive payment requests and to send an authorisation response to merchants; and
 - c) Settlement system - settles funds to merchants overnight via Payment New Zealand's Settlement Before Interchange.
30. To ensure Online Eftpos achieves critical mass adoption more support is required from the banking divisions that are vested in customer accounts and merchant uptake must increase. Presently one major bank and a small number of merchants are using it. One smaller bank has commenced the necessary integration work. However, for this product to be successful at least three major retail banks are required. Merchant's have expressed interest in, and support of, Online Eftpos but merchant uptake is limited for so long as there is only one major retail bank offering the solution to their mobile banking app users.

Contactless and issuer tokenisation

31. Paymark will provide support for innovation in the payments market by adding key infrastructure such as contactless and issuer tokenisation. Many merchants have contactless capable terminals but they have disabled the contactless function because of concerns about interchange fees. Paymark plans to make contactless transactions appeal to those merchants and to level the playing field between payment instruments. Paymark

intends to provide a form agnostic (card, mobile, app) acceptance mechanism and an issuer tokenisation processing service for contactless transactions. Such platform would be available on a nation-wide basis and it is Paymark's intention that the issuer tokenisation service will be capable of being accepted on any payment device.

Access

32. Retail payment systems require scale and therefore it is in Paymark's interest to work with as many industry participants as possible, including banks, the payment arms of retailers and mobile phone operators, to reach the widest number of consumers and merchants so they are able to make and accept payments via any device or any channel. Paymark's API infrastructure can be used to simplify integration and encourage innovation between the banking networks and the retail and technological innovators. APIs provide a low cost and secure way of accessing systems and delivering data.

33. For Paymark's digital expense app, Paypr, Paymark and Xero collaborated and connected via API to enable real-time data messaging from the point-of-sale to integrate with Xero's accounting software. Via its APIs, Paymark can facilitate front-end innovation for emerging players. This will allow innovators to innovate while Paymark remains a secure conduit and facilitator between them and the banks.

Data, transparency and education

34. Paymark welcomes the opportunity to assist in providing information to merchants and other industry bodies. Paymark can assist with education and transparency for merchants on costs of different payment types as well as provide industry reporting. Paymark can enable greater transparency for merchants, and is already capable of doing so, through its Paymark Insights solution – a real-time transaction data dashboard. With acquirer bank support,

Paymark Insights could be expanded to include tools and methods whereby merchants can be educated not only on card types and spend but also the fees those cards attract.

Rebalancing

35. Market changes must: (i) mitigate against the growing market barriers to entry perpetuated by the interchange model; and (ii) limit the disadvantages of the bargaining power imbalance faced by small and medium sized business.

36. The Issues Paper sees a comparative lack in functionality of ‘free’ proprietary eftpos as being behind the advance of Scheme penetration and replacement of zero interchange transactions with fee attracting Scheme transactions. While Paymark sees that as a factor, it does not believe it is material in comparison with the drivers operating within issuers.

37. Paymark believes that revenue from interchange fees is easily identified and routinely reported as part of assessment of performance by internal bank decision-makers. In contrast, Paymark believes that the savings to banks from cashless transaction levels do not appear in issuer budgets or targets. As banks have separate issuing and acquiring divisions, the return to acquirers from Paymark and merchants are not likely to be visible to issuer decision-makers.

38. Paymark believes that its bank customers are aware that Schemes have been effectively able to ‘divide and rule’ even within banks. To Paymark it appears the Schemes have exploited specialisation (separation of issuing and acquiring) in banks. By directing rebates and interchange revenue through the budget lines of issuer executives, those executives become strong advocates for Scheme dominance and the issue of Scheme cards.

39. Paymark considers that bank divisions that benefit from cashlessness or from having a low cost service available to merchants, have no positive revenue reflection of changes in those parameters. What is not measured is not influential. Even if overall bank returns and costs are adversely affected by Scheme intervention between the bank, the merchant and the cardholder, that may not be measured or influential in bank decision-making.
40. Paymark considers that some rebalancing may be required by the market in order to counter the adverse issuer incentives described in the Issues Paper. The rebalancing could include:
- a) Ensuring enough new revenue to incentivise issuers to issue proprietary debit (in any desired form factor).
 - b) Reassurance for issuers that they will not pointlessly cannibalise revenue they would otherwise receive from Schemes. To that end it is likely that:
 - i) issuers need certainty and confidence that they will not be deprived of fair returns on investment in proprietary debit;
 - ii) issuers need assurance that competition among them will not exacerbate the consumer and bank trends and incentives the Issues Paper describes that could be collectively perverse though individually rational; and
 - iii) express issuer collective agreements and exchanges of information may be required (the kind of pro-competitive collaboration arrangements foreshadowed in an amendment to the Commerce Act awaiting passage) possibly including provisions for constraining rewards and interchange fees.
 - c) Ensuring the new revenues generated for issuers have limited impact on merchant acceptance of debit and ensure cash handling costs do not rise.
 - d) Ensuring critical mass because, as with most network services, take-up depends on confidence that enough necessary players will participate to generate usage levels that will enable a return on investment.

- e) Reasonable assurance for issuers and merchants of achieving a return on their investment on any integration costs to use new proprietary debit functionalities provided by Paymark.
 - f) Customer (including bank) acceptance of a merchant-facing per transaction charge for proprietary eftpos that they are not presently paying. Paymark would likely pay or rebate some or all of that to issuers. Paymark expects those fees to be less than current Scheme interchange fees.
 - g) Resetting merchant willingness and expectations may be assisted by:
 - i) the availability of contactless functionality;
 - ii) better merchant understanding of the trade-offs and consequences of 'free' eftpos; and
 - iii) the industry-wide solution described below.
41. There is no material technological or financial obstacle to stop proprietary debit from matching or surpassing the contactless and card-not-present functionality of Scheme products.
42. Paymark has already delivered card-not-present solutions with Online Eftpos and the payment gateway product Click. Both these products were developed with a view to simplify merchant integration.
43. The obstacles to full market-wide deployment of these products are entirely commercial and consist of:
- a) the competing incentives of issuers;
 - b) the reluctance of merchants to incur integration (set up) costs until there is a critical mass of issuers and cards issued; and

- c) the up-front cost of integration for banks, when there is not enough certainty that enough other banks will join to ensure critical mass.

44. Paymark can enable contactless transaction functionality for proprietary debit for merchants. The investment is within its capacity and not a constraint. Nor is capability, or availability of software, licences or hardware a constraint. The constraint is again commercial. As Paymark perceives, issuers have little incentive presently to issue proprietary eftpos cards, or other form factors, with contactless functionality because issuers think it will reduce the likelihood of Scheme-derived revenue from interchange fees or processing rebates.
45. Paymark has other exciting innovations. Some are in deployment, like Paypr and Paymark Insights, and others are in the pipeline. With Paypr, Paymark delivered a world-first for real-time data messaging from the point-of-sale to a consumer's mobile phone. These innovations depend on enough of the payments industry choosing to support and maintain the extraordinary system resilience and economy of Paymark's centralised switching service.
46. The constraints on preserving and strengthening domestic competition with Schemes all rely on overcoming the trends described in the Issues Paper. Paymark has outlined changes that would need to be supported to maintain the current scale economies and capabilities. Bluntly, that means ensuring that Paymark can offer enough to ensure that the Scheme incentives to issuers and cardholders do not outweigh the perceived benefits of its product to issuers, merchants and consumers. This is achievable.

A voluntary collaborative initiative

47. New Zealand, with Paymark at its core, is a world leader in electronic payments and this has been achieved without government intervention to date. Paymark and Payments New

Zealand are both examples of industry collaboration and show that industry participants can successfully work together voluntarily. Paymark believes that many of the concerns raised by the Issues Paper could be addressed by collaborative arrangements made among the relevant payments stakeholders.

48. New Zealand acquired its world leading eftpos capability and penetration when competitors suspended their usual mutual suspicion to achieve together what it would not have been economic to do separately. New Zealanders can overcome small scale disadvantages with unusual mutual trust and defined cooperation among competitors. The unique ownership and institutional architecture of Paymark was developed to manage conflicts of interest without destroying competitive confidences. Paymark sees this as substantial institutional capital.
49. Paymark requires some level of consensus from the payments industry. The industry must work together to preserve and enhance proprietary eftpos. Paymark needs the support to maintain its market share and significance to counter the feared increase in inefficiencies. Paymark believes that a rational collaboration would sustain New Zealand's world leading efficiencies. Obviously that would require relevant competition law issues to be dealt with using appropriate channels.
50. Industry can develop the necessary agreements and assurances. There remains scope for the collaborative, mutually beneficial "New Zealand Inc" spirit represented by Paymark to counter what appears to Paymark to be individually rational incentives for issuers to by-pass low cost mechanisms.
51. Paymark's solution to the commercial obstacle may require issuers to reconsider their competitive focus on card rewards. It may involve educating merchants about interchange

fees generally. Paymark, banks and merchants may need to test a range of solutions to ensure that there are no unintended consequences. For example, to ensure that any proposed cap on interchange does not have unintended consequences, particularly for smaller merchants which lack bargaining power with respect to interchange fees.

52. In Paymark's view, if suitable collective arrangements are facilitated, the issuers can recognise better the overall impact and counter the perverse incentives to greater collective cost, probably without long term loss to themselves.
53. Paymark thinks it is feasible to design, and get agreement on, an arrangement that:
- a) preserves competitive tension;
 - b) does not block new technologies or new entrants;
 - c) offers neutral utility terms of trade assurances to parties anxious about the market power that could attach to a comprehensive agreement; and
 - d) enables New Zealand institutions to bargain effectively with the Schemes.
54. Paymark is willing to prepare a package to obtain the necessary commitment of issuers to justify the developments outlined above. That package may contain proposals for an industry-wide solution to limit interchange and rewards. Paymark may develop such a package in its own commercial interests, but Commerce Commission blessing of the discussions and procedures involving banks, which could be needed to complete that package, is likely to be necessary.
55. Paymark is ready to strengthen and sustain low cost efficient proprietary debit technologies and capable of maintaining strong domestically controlled protective competition for offshore Scheme services.

Unintended consequences of regulatory intervention

56. There are numerous international examples where well intended regulatory intervention in the cards payment market has resulted in detrimental consequences. It is common that market players who lose revenue as a result of regulatory intervention look for new revenue sources, potentially to the detriment of consumers.
57. Regulatory intervention in Spain and Australia resulted in a transfer of costs from retailers to consumers. Retailers' costs fell as they paid lower merchant service charges, but this cost reduction was not passed on to consumers in the form of lower retail prices. Consumers ended up paying higher cardholder fees and interest charges as issuers sought to make up for reduced revenues. As a result, there was a marked increase in the use of cash. A reversion to cash use could harm the New Zealand economy as electronic payments overall cost less than cash. Furthermore, electronic payments provide transparency and traceability of payments, which in turn discourages the shadow economy.

APPENDIX

Paymark products

Paymark Product	Description
Click	Click is an e-commerce gateway that enables merchants to accept Scheme products for digital payments via websites or smartphone apps. Click can also have Online Eftpos built in, so consumers can either make a payment with a Scheme product or eftpos via their mobile banking app.
Online Eftpos	Online Eftpos is an online acceptance solution that enables consumers to buy online directly from their mobile banking app. Rather than entering sensitive credit card information at checkout, users enter their mobile phone number and approve the payment directly from their mobile phone banking app.
Paymark Insights	Paymark Insights is a recently developed and soon to be launched dashboard that reports directly from any Paymark connected terminal. It gives merchants an insight into their store's performance and their customer loyalty in real-time.
Paypr	Paypr is an Android and iOS app for expense management developed in collaboration with Xero. When a subscribed customer makes a purchase at a merchant on the Paymark network a digital copy of the receipt is automatically sent straight to their mobile phone app, ready to code and send to Xero.

Additional comment on data and reporting

The Issues Paper included a footnote on page 21 which states that information on credit card usage in the last two years is misleading and represents miscategorisation of

contactless debit and credit transactions. The data Paymark provides is sourced from the Paymark processing switch. Transactions received from the merchant are switched in one of two ways depending on the card used, to either the: 1) issuing bank; or 2) acquiring bank. Traditionally, and prior to contactless Scheme debit, all debit (proprietary eftpos debit and scheme debit) transactions were switched to the issuer and Scheme credit transactions only were switched to the acquirer. When contactless Scheme debit was introduced to New Zealand, it was agreed by the relevant stakeholders that these transactions were to be switched to the acquirer rather than switched to the issuer. The Paymark switch simply provides data according to where the transactions are switched which means that contactless Scheme debit transaction data is included with the Scheme credit transaction data. For the purposes of the Issues Paper, it is accurate to include contactless debit in Scheme/switch to acquirer transactions as those transactions are sent via the Scheme 'rails' and attract interchange fees.