NZ Commerce Commission Consultation Paper – Retail Payment System - Response

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1. Introduction

Consumers do not wake up in the morning wanting to make a payment. Likewise, merchants are focused on improving their business performance and payments are something that they do not wish, or should need to, think about. Both key stakeholders want quick, seamless, and secure payments.

Quick, seamless, and secure payment creates value for both merchants and consumers. Merchants benefit from selling a good or service, not having to provide credit to the consumer, or having to handle cash. Consumers benefit from being able to purchase an item without having to carry large amounts of cash and bear the risks associated with this.

Whilst electronic payments benefit a large number of people, it is not a social good. The ease with which we are able to pay today is based on hundreds of millions of dollars invested by card schemes, banks, and acquirers. It is based on thousands of hours of innovation, testing and learning. Organizations involved in the provision of payment services should be allowed to make a financial return to enable the continued evolution of payments. Rather than having poorly educated politicians and regulators distort market forces which have delivered the seamless experiences we have today. One of the roles of regulation is to solve for market failure. In this work, the NZ Commerce Commission, and previously MBIE, have failed to identify and articulate any market failure in the New Zealand payments ecosystem.

Some New Zealanders will refer to EFTPOS as the benchmark, but in the 21st century EFTPOS is a failed state. It is the dial-up modem of payments. It was groundbreaking in its day, but it is well surpassed now. The reason for its failure to evolve or innovate is that there is no revenue in the business model to fund innovation and evolution.

EFTPOS is no longer an appropriate reference point for a modern cards payment system in the 21st century.

When considering further reducing issuer interchange, the NZ Commerce Commission need to take a step back and understand the role that payments plays in the lives of merchants and consumers. They also need to take a step back and understand their fundamental responsibilities as a regulator and is this proposed action consistent with those? In my view, it is not.

Rather than reducing issuer interchange further and hoping for a better outcome, they should take responsibility for what is not working right now (merchant confusion and excessive surcharging) and focus their efforts there. These are the execution failures from the initial round of regulation.

Response structure: The structure of this response is based on the Consultation Paper, with commentary provided against the points of note.

2. **The cost of card payments**
    i. What are interchange fees?
        1. 2.8 "This paper is mainly focused on interchange fees"
            a. *It is helpful that the paper is transparent in it's focus, however continuing to focus solely on (reducing) interchange fees is unlikely to solve for the issues that have resulted from the initial interchange regulation that came into effect in November 2022. The leading challenge that resulted from the rollout of the work conducted by MBIE was the "explosion" of surcharging. Surcharging payments was allowed prior to the regulation coming into force; however, the regulation effectively codified it. The growth in surcharging has created the perception in consumers' minds that card acceptance was expensive when in fact the cost to merchants had come down, and is at or below the cost of accepting cash.*
            b. *What needs to be fully recognized and understood is that there are a number of "for profit" organizations*

that sit in the value change between where issuer interchange creates value and the consumer. Reducing interchange in isolation without acting further downstream means that the impact of the action may not fully translate to better consumer outcomes.

2. 2.10. The rationale for interchange weakens now that the four party networks are well established
    a. *The support for this statement is not included in the main body of the consultation paper. It is a bold statement and shows a clear lack of understanding of how card payments work.*
    b. *Whilst there is a set of fixed costs in establishing card payments functionality, there is a material number of variable costs associated with each transaction. Interchange has proven to be an effective mechanism in delivering revenue back to the issuer to cover these operational costs. It is also the primary basis for the establishment of the merchant service fee which has been an effective mechanism to distribute value been acquirers and issuers. To arbitrarily state that interchange is less important in an environment where four party card payments are mature displays a clear lack of understanding by the Commission.*

ii. Card payments other than Mastercard or Visa
1. EFTPOS Network
    a. *EFTPOS was a great step forward for electronic payments in NZ in the twentieth century, however it has been steadily in decline since the advent of chip cards and subsequently contactless. EFTPOS is now the equivalent of the dial-up modem. NZ should stop using it as a reference point as it is now a failed state. It is a failed state for the same reason people put it on a pedestal. The fact that it does not generate any income for the issuer because it is free to the merchant results in no revenue for reinvestment into innovation (like chip cards, contactless etc.).*
    b. *EFTPOS is not the benchmark that other payment options should be measured against.*

c. *It is interesting that the consultation paper notes that despite most countries having an electronic domestic payments network, none made it free to the merchant. I wonder if they avoided that approach, because they viewed it as an unsustainable approach*

2. AMEX

a. *I will comment on this on page 11 of this response*

iii. Open Banking providing an innovative alternative to Mastercard and Visa

a. *Do not assume that a reduction in interchange will incentivize the movement towards open banking. You may as well assume that it will incentivize banks to invest in EFTPOS – which it will definitely not. Whilst Open Banking will enable account to account payments, banks look at investments on a standalone basis. The real risk in reducing interchange is that it reduces the payments price point and makes it even more difficult to justify an investment in open banking.*

3. Potential problems with card payments

a. An overview of the problem and how it could be addressed

i. "Costs for businesses to accept Mastercard and Visa card payments are high and too complex"

a. *'High' is a relative term and is defined by the comparison set. Interchange is higher than the EU, similar to Australia, but also below Singapore.*

b. *Singapore should not be discounted as a market for learning. Singapore has a similar population and a similar penetration of electronic payments (90%+). In Singapore, interchange remains unregulated and is set higher than the EU, Australia, and NZ. This has not detrimentally impacted the growth of electronic payments. Card payments have grown, innovation has been encouraged, and alternative methods of payment have thrived as there is a revenue pool to be accessed*

ii. 3.2.1 - "Surcharges can be excessive"

a. *This is the consumer problem to be solved. Direct action needs to be taken to ensure that surcharging reflects the cost incurred by the merchant for card acceptance. An arbitrary cap will create more challenges than it solves, so engagement with acquirers and terminal providers is required to find a practical solution.*

iii. 3.2.1 - "Costs are complex for merchants"

a. *This is the merchant problem that needs to be solved. Engagement with acquirers and card schemes is required, as simplification is also a complicated exercise. Card schemes still need the ability to expand electronic payment acceptance by opening up new interchange categories.*

iv. 3.3 – "In the short term we see a further opportunity for regulatory intervention to improve the efficiency of the costs faced by merchants and consumers..."

a. *Merchants – an opportunity to deliver simplification. Payments is not something that merchants want to spend time thinking about. However, just arbitrarily reducing interchange within the existing construct is unlikely to change anything.*

b. *Consumers – There is no evidence globally that interchange regulation reduces consumer prices. Please point to evidence to the contrary. Merchants will bank the financial benefit of reduced interchange if they are able to.*

b. How interchange fees are currently impacting merchants and consumers

i. 3.12 – "...the average surcharge imposed by merchants is approximately 2% but the average merchant service fee is approximately 1%"

a. *This data point provided by the Commission is a perfect example of how consumers are being ripped off because of lax execution of the current regulation. This is a material failure that needs to be addressed.*

4. Considering further interchange fee regulation and the impact of this

a. Why we are considering further regulation of interchange fees in New Zealand

i. 4.4 – "…it would encourage existing and potential issuers of payment instruments to innovate outside of Mastercard and Visa ecosystem"

   a. *Can you provide the logic behind this statement. Reducing interchange potentially reduces the incentive as it reduces the space (and revenue) available for new players to enter*

b. Why interchange fees are regulated around the world

   i. 4.9 – "interchange fee is a form of horizontal agreement between rivals, it clearly risks breaching competition law"

      a. *This evocative statement is a direct copy and paste from Dr Fletchers paper (P3). Neither of which are provided with any supporting information for the statement. It is extremely irresponsible of the Commerce Commission to insert a highly inflammatory remark with no support.*

   ii. 4.10 – "the real policy concern… was not just the collective price-setting but that the jointly set fee was too high"

      a. *This evocative statement is a direct copy and paste from Dr Fletchers paper (P3). Neither of which are provided with any supporting information for the statement. It is extremely irresponsible of the Commerce Commission to insert a highly inflammatory remark with no support.*

   iii. 4.12 – "… merchants will tend to incorporate the higher card acceptance fees into overall prices"

      a. *It should be noted that independent studies across many countries have identified the cost of cash to be between 2 – 3% of the cost of a transaction. This is a level at or above the current card pricing and is a merchant cost which is already incorporated into the cost of the good given that surcharging for cash acceptance is not apparent in NZ.*

      b. *Incorporating costs into the price of a good should not be viewed as a negative*

c. Approaches to interchange fee regulation

   i. Economic literature

      1. 4.17 - "…assuming issuers set their margins optimally,… this would equate to an interchange fee level of 0.20%"

         a. *This assertion appears to be based on one study from Canada. This is the perfect example of the NZ*

Commerce Commission cherry picking information to support a narrative. Dr Flecther's work contains references to tens of studies. Basing a recommendation on only one study is highly irresponsible.

ii. Other regulators

iii. Benchmarking

1. 4.21 – "setting zero interchange fees on Mastercard and Visa networks may hinder further investment by challenger providers"
    a. *It is positive that the Commission understand that this approach would have significantly negative consequences for the NZ payments ecosystem*

d. Considering interchange fee cap methodology for New Zealand

i. 4.24 – "concern that payment providers are able to earn revenue from the payment service to support ongoing investment."

ii. 4.25.1 –

1. "not all costs are true costs"
2. "the choice of issuers on how to spend interchange fee revenue could be viewed as independent of the level of interchange fee"
    a. What is this assertion based on?
        i. *As someone with 20+ years of payments experience this assertion is not accurate in my experience. All issuers run a cards P&L and each organization typically has return on equity targets. Revenue from cards is applied directly to costs of providing the service. This comment from the NZ Commerce Commission is provided with no support and appears to not reflect market operation.*

iii. 4.25.2 –

1. "We consider payment providers should have incentive to invest in fraud reduction techniques so being potentially compensated for fraud losses through interchange fees may reduce this incentive"
    a. What is this opinion based on?
        i. *As someone with 20+ years of payments experience this assertion is not accurate in my experience. All banks are incentivized to minimize fraud and invest in technology to do*

this. Fraud losses are a direct bottom line expense, so irrespective of whether these losses are offset by revenue in the cards P&L, issuers are highly motivated to reduce fraud losses. Again, the NZ Commerce Commission has provided an assertion with no support which does not reflect market operation.

e. Determining a possible benchmark for interchange fee caps
    i. Breadth of current regulation and possible regulation
        1. Should the coverage be extended to commercial credit, prepaid, and foreign-issued cards
            a. *Extending interchange regulation to commercial credit effectively hands this portion of the cards market to one party, AMEX, effectively reducing competition not enhancing it. Issuers in the commercial credit card market utilize financial rebates, funded by interchange, as a primary incentive to encourage corporates to choose them as their provider. This is how competition in this market segment is based. Reducing interchange will effectively minimize issuing bank's ability to compete against non-regulated issuers (i.e. Amex). This would take market competition from 5+ competitors to one, an action which would seem counter-intuitive to the NZ Commerce Commission's core principles.*
    ii. Current regulation and possible new caps
    iii. Understanding the rationale for variation between interchange fee rates
        1. 4.34 – "there should be no difference between the interchange fees for credit and debit"
            a. *This again is another statement by the NZ Commerce Commission that is unsupported and frankly embarrasses the Commission. It highlights the clear lack of fundamental understanding of how the debit and credit products operate. The operational costs to provide the products are different, with cost of funds and credit losses being the two material costs ignored in the NZ Commerce Commission statement. Cost of funds is typically*

the largest operational cost associated with the provision of credit cards. Issuers can reimburse merchants for the transaction up to 55 days before they recoup funds from the cardholder. This is a direct cost to the bank. Likewise, credit losses are a direct cost to the bank incurred on credit cards but not on debit cards.

2. 4.36 – "it is not clear why the cost of credit should be borne by the merchant"
    - i. *The merchant is a direct beneficiary of the purchaser's ability to access credit*
    - ii. *The original purpose of credit cards was to take the burden and cost of account management off merchants.*
    - iii. *There is a good argument to share the cost between the two direct beneficiaries, the purchaser and the merchant, however including it in the MSF is more effective as the cost is typically ad valorem so is aligned to the purchase price. As the card operation cost and the credit risk sit with the issuer, issuer interchange is an effective approach to covering these costs.*
3. 4.39 – "innovations such as stronger customer authentication are likely to further reduce the incidence of successful fraud"
    - i. *This is an incredibly naïve view if you think that fraud does not require on-going investment. The good vs. evil battle over fraud will be eternal. As an example, fraudsters can access AI tools like issuers can. Fraud will only now become increasingly sophisticated requiring further investment from issuers.*
4. 4.47.1 – "businesses treated differently with different merchant rates"
    - i. *The low fixed price interchange rates enjoyed by a limited number of large merchants reflects the market power of these large merchants rather than a rate that could feasibly be applied to all. Issuers will lose*

money on these fixed price interchange transactions.

f. Ensuring any change to current interchange fee regulation has the intended impact

    i. Ensuring a reduction in merchant service fees

        1. 4.55 – "we want to ensure interchange fee savings are passed through to merchants in the form of lower merchant service fees and to consumers in the form of lower and more accurate surcharging"

            a. *How does the NZ Commerce Commission propose to solve for the second half of this sentence? Does the Commission understand that there are multiple steps and numerous variables that sit in between reducing interchange and lower surcharges for consumers? No insight is provided for how the Commission may approach this.*

    ii. Ensuring a reduction in surcharging

        1. 4.58 – "Consumers realise the benefits of interchange fee regulation through merchants passing on savings due to lower merchant service fees"

                i. *What is the basis for this assumption by the NZ Commerce Commission? Most merchants are "for profit" entities. If they have the opportunity to increase margins as a result of a reduction of merchant service fees, then they will likely do it. There is no evidence globally that reduced interchange results in lower prices for goods and services for consumers.*

        2. Hoping that pricing simplification will solve for surcharging, not willing to regulate surcharging as it will involve "costs"

            a. "not easy for the ComCom to monitor"

                i. *It appears that the NZ Commerce Commission are only willing to do work which is easy, however it is also unlikely that it will deliver the outcome they are seeking.*

g. How further interchange fee regulation could change the way consumers pay?

    i. 4.68 – "Further interchange fee regulation has potential to significantly change the way consumers choose to pay"

1. A shift to contactless payments
    a. 4.71 – "in 2023, 57% of all in-person card payments were contactless, an increase of 28% from 2019"
        i. *The change in % was primarily due to COVID and the convenience of contactless. The Commission fails to identify any consumer behaviour change as a result of the 2022 regulation.*
        ii. *Reducing interchange in isolation of taking any other action is again unlikely to deliver any consumer behaviour change.*
2. A shift to American Express
    a. 4.73 – "we note it's recent growth in NZ"
    b. 4.74 – "we are not considering any recommendation to designate the American Express network at this stage"
        i. *So, is the NZ Commerce Commission fine for transactions to move to a higher cost network? Isn't this counter to the stated intent of lowering costs to merchants and (fingers-crossed) consumers?*
3. Potential impact on innovation within the payment system
    a. 4.77 – "A reduction in interchange fee revenue for issuers could result in a relative change to banks' incentives to invest in open banking payments. We also recognize the potential for reduced interchange fees to dampen interest from merchants and consumers in new alternative payment methods"
    b. 4.78 – "New products and services should be able to compete on their own merits"
        i. *Reducing the pool of revenue for payments will provide a disincentive for businesses to invest in alternative methods*

5. Conclusion

The Consultation Paper is a truly disappointing effort from the NZ Commerce Commission. It is loaded with unsubstantiated and sometimes contradictory statements, many of which show very little understanding of how payments operate.

Reducing issuer interchange is a relatively easy exercise to undertake, but without follow through with acquirers and terminal providers, and enforcement of reasonable surcharging, it will solve little. It will result in a theoretical number which the NZ Commerce Commission (and politicians) will point to as value creation, however NZ consumers are likely to see little or no benefit flowing through in the form of reduced process for goods and services.

An additional benefit which the Commission is seeking, which is greater innovation in alternative payment options, is also unlikely to materialize as a reduction in payments pool revenue will act as a disincentive for new players.

I would hope that the Commission listens to all feedback and does selectively cherry-picks commentary that supports their thinking. The Commission needs to look at the results of the previous round of regulation. Understand what worked and what did not and focus on those areas that were not effective. These failures are at the merchant end of the value chain, with their inability to understand how they are charged by banks and their subsequent inability to surcharge correctly.