

18 August 2016

Ms Fei Wu
A/g Senior Analyst Adjudication
Australian Competition & Consumer Commission
Level 35, 360 Elizabeth Street
MELBOURNE VIC 3000

Dear Ms Wu

Applications A91546 & A91547 – interested party consultation

Heritage Bank Limited [**Heritage Bank**] is headquartered in Toowoomba in regional Queensland and is Australia's largest mutual bank. Heritage Bank offers savings and transaction accounts, term deposits, credit cards, personal loans and mortgages, along with other, primarily retail, products and services.

Heritage Bank's customers are able to access their accounts through a variety of channels, including a proprietary mobile banking app. Since July 2015, customers with NFC enabled Android mobile phones have been able to make contactless payments at point of sale by downloading Heritage MobilePay and adding their Heritage Bank Visa Debit or Visa Credit cards to their eligible mobile phone.

Heritage Bank is also the biggest issuer of prepaid (stored value) payment products in Australia, including the MasterCard Cash Passport, Qantas Cash and Australia Post Load & Go prepaid payment products amongst others and together with a SIM based mobile payment stored value facility on NFC enabled Android phones. Given Heritage Bank's significant industry role in payments including mobile payments, Heritage Bank has a strong interest in the application currently before the Commission.

With regard to the factors that the ACCC wishes to assess concerning the substantive authorisation;

Likely future without

1. *Please comment on how contactless payments are likely to develop in Australia over the next five years.*

It is generally accepted that Australian consumers are already amongst the highest users of contactless payments in the world. When contactless EMV chip cards were first introduced in Australia, the high rate of take-up by Australian consumers was unexpected because commentators at the time could not identify a significant enough benefit over inserting the card at the terminal. However, once the four big banks and two large supermarket chains had upgraded their cards and merchant terminals to accept contactless transactions, consumers quickly adopted the new payment method in ever increasing numbers.

Australia also has a high proportion of the population with smartphones, with typically short upgrade periods resulting in the availability of new technology across smartphone users relatively quickly. This means that mobile phones with in-built NFC technology are likely to be pervasive amongst Australians within the next couple of years, if not sooner. While the use of mobile phones to make contactless transactions is still in its infancy in Australia, the likely growth path once infrastructure is ubiquitous can be guessed by the growth in the use of contactless cards.

Like contactless cards, the benefits of using a mobile phone over a card to make a transaction is unlikely to be recognised by consumers until they actually experience it. Unlike "dumb plastic", mobile payment applications can provide an interactive experience, allowing consumers to see their balances and transaction history in real time in their hand. Merchants, issuers and wallet providers can enhance the experience with rewards and incentives, apps showing spending patterns and budgeting tools etc.

The driver of growth of contactless payments in Australia appears in part to be due to the concentrated nature of banking and retailing compared with, say, the United States. Once Australia's four largest banks began issuing contactless cards to their customers and upgrading their merchant terminals to support contactless payments, a high proportion of the market had the ability to access the contactless payment functionality. The proliferation of contactless payments also occurred due to Australia's largest supermarket chains accepting contactless transactions as a means of payment.

Heritage believes that there is a clear trend of payments with physical cards being replaced with virtual payment methods.

However, without issuers and wallet providers having open access to mobile phone operating systems and device hardware (in the way that all issuers' scheme cards work on all acquirers' merchant terminals) the growth of mobile payments in Australia (and the consumers' ability to access such new innovations) will continue to be hindered. In contrast, open access to mobile phone operating systems and hardware will promote effective competition and give consumers the right to have choice regarding the wallet or wallets they wish to use for mobile payments (including Apple Pay).

In addition, the standardisation of security of mobile payments systems within the existing industry framework will further enhance growth by providing confidence in this payments method.

The New Payments Platform is also due to be introduced in 2017 for real time person-to-person mobile payments and is likely to further enhance mobile phones as a core payment tool.

2. *Absent the proposed collective negotiations, do you see the use of Apple Pay becoming widespread in Australia? For example, are banks likely to accept the terms offered by Apple?*

The terms currently offered by Apple appear to be unattractive to issuers for a number of reasons including the access and security issues mentioned above and the fee restrictions Apple seeks to impose. A bank's lack of desire to "sign up" to the Apple terms primarily relates to the additional cost involved where income is already modest, the possibility of constraints on the ability to recoup that cost from users of the service and the potential for control over which of the bank's products can be offered with the service.

Heritage Bank has no insights regarding the likelihood of any of the banks accepting Apple's terms for offering Apple Pay, but since one large bank has already done so, it is possible that more would join them.

The problem is that as a result of Apple's share of the mobile phone market in Australia more banks may decide to support Apple Pay. To remain competitive banks such as Heritage Bank will be forced to offer Apple Pay as well, irrespective of the cost of doing so (see below). Given that the cost of Apple Pay transactions may not be able to be passed on to users, banks will either have to recoup them from increased fees elsewhere (cross subsidisation) or accept a negative impact on profit. For a mutual ADI like Heritage Bank, the primary source of capital is retained earnings, so reduced profitability makes it more difficult to be competitive and continue to provide maximum benefits to our customers.

3. *How would the situation be different with the collective bargaining/boycott?*

While ultimately the negotiations may not result in a change to the status quo, the benefit of the collective boycott is that the status quo will not change until the negotiations are completed. Collective bargaining will provide the opportunity for a level playing field for all participants in negotiations with a company the size of Apple. As a minimum, such arrangement will address issues of information asymmetry within the market and will allow all participants to receive the benefits associated with such an arrangement that may not have been the case had each participant entered negotiations alone.

Areas of competition

4. *Please provide any comments regarding the area(s) of competition that may be affected by the collective bargaining/boycott.*

It is clear that taking account of the size and revenue of the likely participants in such arrangements in the Australian market, the ability to collectively bargain reduces the disadvantages that would be experienced if a participant was to negotiate alone with a company of the size and market power of Apple.

Without such arrangements, outcomes in other jurisdictions suggest that participants in the Australian market would never achieve better terms than those offered by Apple.

It is noted that the ACCC's view is that collective arrangements may be in the public interest, for example, when smaller businesses can face challenges negotiating with larger businesses. The collective bargaining arrangements are consequently of great significance to a smaller participant like Heritage Bank in seeking more beneficial outcomes for its business and its customers. We agree that the ACCC's view is also instructive for large businesses negotiating with even larger businesses.

While the collective bargaining still may not achieve better terms, the process will allow the issue of information asymmetry to be addressed and each participant will at least know the terms offered during the process are the same as those available to the other participants.

The collective boycott ensures that parties can negotiate in good faith the important industry-wide principles set out in the application in the knowledge that their competitors are supportive. Alternatively, any participant can choose to stand aside from the collective arrangements and negotiate separately for their own terms, just as they can today.

Apple is one of the most powerful companies in the world, with over \$100 billion in free cash resources. Apple is seeking to conduct negotiations with issuers one-on-one in strict secrecy. Apple controls both the hardware and software chosen by a large (if not majority) proportion of each issuer's customers so has considerable power relative to issuers, as demonstrated by outcomes of negotiations conducted with banks everywhere else in the world.

Without the collective bargaining arrangements, it is likely that issuers will continue to be disadvantaged by negotiating alone and under conditions of secrecy that leave issuers vulnerable to accepting terms to their own detriment and to that of their customers as a result of not knowing the terms being offered relative to other issuers.

Importantly, it is noted that the issues sought to be negotiated collectively (non-exclusivity, industry standards and the efficiency and transparency of fees) are likely to strengthen competition if the negotiations are successful.

Public benefits and detriments

5. *To what extent do consumers value Apple Pay and expect their bank to offer payments via Apple Pay?*

Apple Pay is a product offered by Apple to facilitate payments using an iPhone with NFC. It is not an account used for mobile payments, rather it draws on a customer's account established with their bank.

Heritage Bank believes that iPhone users looking to make contactless payments from their bank account or credit card using their mobile phone are simply seeking the enablement of their mobile phone to make contactless payments rather than Apple Pay per se.

Many iPhone owners love Apple and believe that it is the banks that are refusing to offer mobile payments on iPhones. In fact, unlike the US, mobile payments have been widely available in Australia for some time. Heritage Bank has offered a SIM based mobile (stored value) payment facility since November 2014 and a mobile wallet to our customers since June 2015. Apple introduced Apple Pay in Australia in 2015, and iPhones did not have NFC until the launch of the iPhone 6 late in the previous year. Issuers like Heritage Bank, who are pioneers in mobile payments in Australia, looked forward to the release of NFC enabled iPhones to ensure that consumers were given the maximum benefits and choice in the mobile payment market. Unfortunately, when NFC was introduced with the iPhone 6 in late 2014, mobile payments to iPhone customers were limited to Apple Pay and only to card issuers that accepted Apple's terms and conditions.

In summary, it is Heritage's view that customers with iPhones who want to make mobile payments simply want to pay from their bank account using their phones, as distinct from actively wanting Apple Pay. Unfortunately, this view cannot be tested under the existing arrangements.

6. *The Applicants submit that the negotiations will relate to:*

- a. enabling card issuers to participate in any mobile payment/wallet services (e.g. on Apple devices)*
- b. standards regarding fraud and security (such as the APCA Third Party Digital Wallet Security Industry Guidelines)*
- c. the ability of issuers to pass on fees imposed by third party wallet providers.*

Do you consider that these issues are important in the context of mobile payments? Do you expect that collective negotiations with Apple in relation to these issues will be successful?

For the reasons set out above, Heritage Bank believes that the resolution of these issues is important to the growth of mobile payments in Australia. There was some immediate resistance to Apple Pay when it was announced in late 2014 on the grounds of loss of control of customers to Apple. This was also discussed at Heritage Bank. However, Heritage Bank ultimately took the

view that the critical thing was to offer our customers a seamless experience without compromising on security and customer value irrespective of which operating system their mobile phone had.

These issues are not dissimilar to those faced by issuers in relation to merchant terminals where terminals (like the operating system and hardware in mobile payments) are provided by third parties. The critical thing for Heritage Bank is that merchant terminals always work effectively and securely for our customers at an appropriate cost. Irrespective of which merchants or payment methods (including mobile payments) are used by customers the source of truth remains Heritage's consolidated account information available through mobile and online banking.

We agree that the three issues raised by the applicants are impediments to progress discussions with Apple. Given that these are industry issues, Heritage Bank takes the view that collective bargaining is the best way for issuers to address them with wallet providers.

7. Please comment on the bargaining power of the Applicants and of Apple.

There are no issuers in the Australian market that can match Apple's size or revenue. It is noted that Apple is more than twice the size of the combined Applicants by market capitalisation and by global revenues. Each of the Applicants alone would have much less bargaining power in negotiations with Apple than as a collective bargaining group.

Apple has demonstrated an apparent high degree of market power in negotiations in other jurisdictions, where initial resistance to Apple Pay has eventually folded under pressure from competitor acceptance and Apple customers. ANZ is offering Apple Pay to their customers and according to their CEO, is attracting significant new business as a result¹. This puts pressure on other issuers.

Given that it is likely that the combined bargaining group will issue a significant proportion of the cards issued in Australia and control the availability of such cards on Apple Pay, the combined bargaining group would be regarded as collectively having significant power as well. Bargaining collectively will place them on more equal footing with Apple (who control outright access to Apple phones) since they can negotiate essentially industry based terms on a competitively neutral basis.

8. Please comment on the proposed collective boycott conduct.

Heritage notes that the ACCC has requested further information from the Applicants regarding the proposed operation of the collective boycott. Heritage Bank views the collective boycott as a mechanism to assist in the management of the collective negotiations by ensuring the position of those negotiating could not be maintained if breakaway issuers negotiated separate terms. Given the issues for negotiation will, in our submission, be most effective from a competition point of view if there is industry wide acceptance of negotiated terms, a collective boycott seems necessary and supports the collective negotiations.

9. To what extent do other providers of digital wallets constrain Apple/Apple Pay?

Apple Pay is an integrated offering by Apple on iPhones and Apple watches with NFC. As far as Heritage Bank is aware, Apple Pay is not available on phones other than iPhones due to Apple's proprietary requirements for its products to only be available on Apple iPhones rather than because of restrictions imposed by Google and Android handset manufacturers such as Samsung.

¹ Sydney Morning Herald, 10 May 2016

For a consumer to be able to use Apple Pay, the consumer's card needs to be of a type capable of being added to the Apple Pay functionality on the consumer's iPhone. This requires the card issuer to 'sign-up' to Apple's terms and conditions. To the extent that an issuer does not wish to accept the terms offered by Apple, this reluctance can constrain Apple Pay. However with the substantial segment of the market using iPhones, this is not likely to be a long term outcome, as discussed above.

10. *The Applicants submit that transaction fees for Apple Pay overseas are in the vicinity of 0.07% and 0.25%. Please comment on the size of these fees.*

The Payment Systems Board of the Reserve Bank of Australia (RBA) has imposed caps on interchange in Australia. The weighted-average benchmark for credit cards is 0.50 per cent of the transaction value, while the benchmark for debit cards is 8 cents per transaction. These levels are much lower than those in the US where Apple Pay was first launched. Assuming the Apple Pay fee is at the mid-point of the higher and lower fees quoted above (i.e., 0.16%), Apple Pay fees on debit card transactions greater than \$50 will cost issuers more than the interchange received. The point at which debit card interchange is less than Apple Pay fees if the fee is at the lower end of the range is transactions with a value above \$114.29.

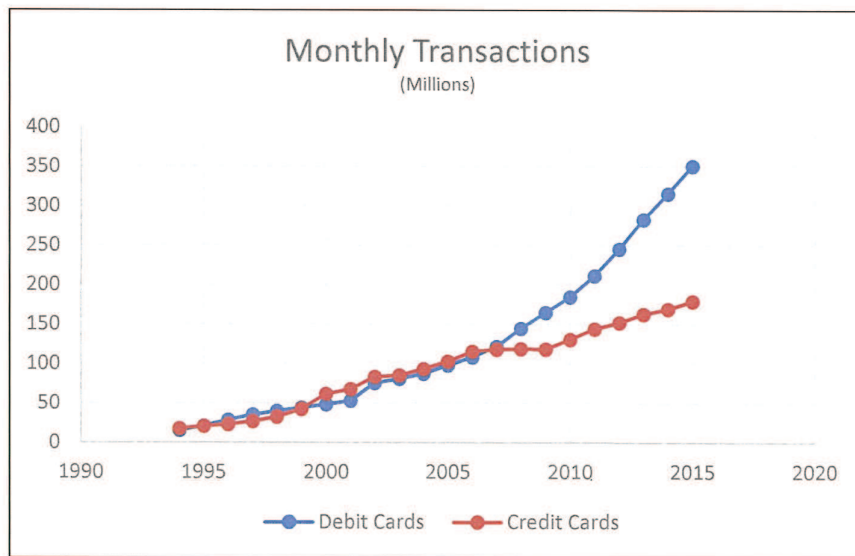
Given that issuers also have to pay all of the costs of each transaction, including scheme costs and processing costs, the point at which debit transactions conducted using Apple Pay will cost issuers more than the interchange received is going to be much lower than a transaction with a value of \$50 after other costs. The Australian Payments Clearing Association (APCA) provides payments data from the RBA. APCA data regarding the number and total value of debit transactions in Australia suggests that the average value of debit transactions in 2015 was \$56.47.²

While the weighted-average benchmark of 8 cents for debit card transactions is calculated at a scheme level across all transactions, the reality is that many transactions occur at large merchant chains that pay strategic interchange rates which are lower than the weighted average. The interchange an issuer such as Heritage actually receives on our customers' debit card transactions will depend on the mix of merchants where cards are used and would be significantly less than 8 cents if a significant proportion were conducted at large merchants.

The chart below, sourced from APCA data³, shows how transactions in Australia have moved dramatically from credit cards to debit cards, especially since the introduction of contactless cards.

² <http://www.apca.com.au/payment-statistics/transaction-statistics/cards>

³ <http://www.apca.com.au/payment-statistics/transaction-statistics/cards>



Consequently, not only is there little interchange to be shared with Apple on debit card transactions, but the use of debit cards is far higher than credit cards and the difference is increasing. Issuers could address this issue if Apple Pay costs could be passed through to consumers, which is one of the issues for negotiation that was raised by the Applicants. Being able to limit Apple Pay to higher interchange products would also help this situation, but it would not remove the impost of additional Apple Pay fees.

11. *Please provide any other comments regarding the public benefits claimed by the Applicants or other public benefits of the proposed collective bargaining/boycott.*

Heritage Bank's experience in negotiating with the Third Party Wallet Providers reflects that described by the Applicants in their submission. The three issues which the Applicants wish to address through collective bargaining are also Heritage's primary concerns arising from the negotiations to date with Third Party Wallet Providers.

Successful negotiations are likely to result in greater customer choice with regard to the wallet used to make mobile payments irrespective of whether their mobile phone uses an Android or an IOS operating system. This also will not preclude customers choosing to use the wallet provided by Google or Apple or Samsung instead of the wallet provided by their bank. In fact, some banks may choose to offer their customers Android Pay and Apple Pay rather than manufacturing and maintaining their own mobile wallet. However, if negotiations regarding the fees charged (able to be passed through to customers) are not successful, the cost of third party wallets will need to be cross-subsidised by the bank's other customers.

12. *Please provide any other comments regarding the public detriments claimed by the Applicants or other public detriments arising from the collective bargaining/boycott.*

No further comments.

Period of authorisation

The Applicants have sought authorisation for a period of three years. Please provide any comments on the period of authorisation.

The application proposes that the negotiations and boycott would last 12 months, unless extended by agreement of the negotiating group, with a maximum duration of three years. Given the length that a

participant could potentially be bound by a collective boycott and the likelihood that the marketplace will change over that period, Heritage Bank expects that participants would have the ability to opt out if an extension of the boycott term is being sought by the negotiating group.

Heritage Bank appreciates the opportunity to make this submission and can be contacted for further information if required.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Peter Lock', with a stylized, flowing script.

Peter Lock

Chief Executive Officer