MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HIKINA WHAKATUTUKI

Issues paper

Regulating to reduce Merchant Service Fees

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Submissions process

The Ministry of Business, Innovation and Employment (MBIE) seeks written submissions on the issues raised in this document by 10 am on **19 February 2021**.

Your submission may respond to any or all of these issues. Where possible, please include evidence to support your views, for example references to independent research, facts and figures, or relevant examples.

Please use the relevant submission template provided at: ***https://www.mbie.govt.nz/have-your-say/regulating-to-reduce-merchant-service-fees***. This will help us to collate submissions and ensure that your views are fully considered. Please also include your name and (if applicable) the name of your organisation in your submission.

Please include your contact details in the cover letter or e-mail accompanying your submission.

You can make your submission by:

- sending your submission as a Microsoft Word document to ***competition.policy@mbie.govt.nz***.
- mailing your submission to:

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

Please direct any questions that you have in relation to the submissions process to the Team by also emailing: ***competition.policy@mbie.govt.nz***.

Use of information

The information provided in submissions will be used to inform MBIE's policy development process, and will inform advice to Ministers. We may contact submitters directly if we require clarification of any matters in submissions.

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Executive summary

The Ministry of Business, Innovation & Employment (**MBIE**) is consulting with interested parties to test our understanding of the issues related to high merchant service fees in New Zealand. This consultation will also gather information about possible options to remedy these issues, should our understanding hold. This will inform our advice to the Government on regulations to reduce merchant service fees.

Merchant service fees are charged to merchants by their bank for accepting some types of card payments. Scheme (MasterCard and Visa) credit card transactions, and contactless and online scheme debit card transactions, cost merchants more to accept than swiped or inserted debit card transactions. These higher cost payment methods have been growing as a share of transactions in New Zealand. Domestic EFTPOS provides price competition for some scheme debit products, but its use is declining.

While there is innovation occurring in the payments system in New Zealand, many new products are operating over the top of the scheme debit and credit cards and therefore add further costs to merchants and consumers. Barriers to competition for new payment cards and methods also remain, although there are moves to introduce 'open banking' and to facilitate alternative forms of payment.

Merchant service fees, including interchange fees (which usually are the main component of merchant service fees), are unregulated in New Zealand. Over the years a complex pricing system has evolved, with multiple fees depending on the product and merchant. Other than for debit cards (swiped or inserted), weighted average merchant service fees are high relative to international comparisons. This remains the case even after changes by the schemes and participating banks to restructure their merchant service fees and increase transparency to provide better deals.

We invite feedback on our understanding of the following issues with merchant service fees in New Zealand:

a. Consumers/cardholders do not face the full costs in choosing their payment methods and may have incentives to use higher cost methods creating additional costs for merchants.

b. Many merchants pass on the costs of the payment system by charging higher prices for goods and services. These higher prices are incurred by all consumers, but only those consumers using the higher cost payment methods receive any off-setting benefit.

c. There are limited competitive constraints on the setting of interchange fees. In fact, competition between issuers of payment cards may lead to higher interchange fees, as the issuers increase rewards and inducements to encourage more customers to use their cards.

d. Most merchants lack bargaining power with their banks and have limited ability to steer consumers or surcharge without risking losing sales. Small business merchants are particularly affected.

e. There is no clear regulatory governance to oversee the retail payments system.

Overseas jurisdictions have taken a variety of interventions to reduce merchant services fees. Many have relied on generic competition law remedies to remove restraints that limit competition. However, this has had limited success in reducing merchant service fee levels. Of those jurisdictions that have pursued regulatory options, they have generally regulated the interchange fee component of the merchant service fee and relied on other factors in the system to keep downward pressure on the other components of the merchant service fee.

We consider that it is important to take a 'systems' approach to effectively reduce merchant service fees. Alongside direct regulation of interchange fees, we invite interested parties to comment on the impacts, benefits and costs of supplementary options alongside suggesting any other feasible options for us to explore further. A full list of questions for submissions is included in chapter 7. Written submissions are sought by 10 am on Friday, 19 February 2021.

1 Introduction

Purpose of this issues paper and context

2. MBIE is seeking information from interested parties to enable us to advise the Government on the most appropriate approach for regulating merchant service fees payable by retailers for debit and credit card transactions.

3. This project is a result of the Government's pre-election commitment to support small businesses by regulating merchant service fees, and was subsequently confirmed as a Government priority in the Speech from the Throne. This project responds to concerns that merchant service fees are high relative to overseas jurisdictions, resulting in New Zealand merchants paying nearly twice as much as their Australian counterparts for some transaction types.

4. MBIE first initiated a review of New Zealand's retail payments system in 2016, which identified a number of issues. Since then successive Ministers have engaged with the card schemes and banks on a voluntary basis seeking to get better outcomes for businesses and consumers.

5. COVID-19 has increased the use of higher cost payment methods (i.e. online and contactless payments), at the same time as businesses and consumers are facing financial pressures, thus making the efficient operation of the retail payments system more important than ever.

6. MBIE recently consulted on options for establishing a consumer data right in New Zealand, which may assist in addressing some of the issues outlined in this paper through increased competition. That work is ongoing and is complementary to this project.

What does this issues paper do?

7. This project will advise on regulating to promote fair and efficient merchant service fees with a focus on debit and credit card transactions. It will consider these products and fees in the context of a dynamic and innovative retail payment environment in New Zealand.

8. This issues paper sets out an overview of the retail payments system in New Zealand and seeks feedback on:

   a. our understanding of the issues of concern with the retail payments system

   b. the objectives for the retail payments system

   c. the likely impacts of direct regulation of interchange fees

   d. other supplementary options for intervention in the retail payments system to address the issues of concern.

9. **Annex 1** includes a brief overview of public authority interventions in retail payments systems in other comparative jurisdictions.

Process and timeline

10. The release of this issues paper is the first step of the project. Interested parties are invited to make written submissions by 10 am on Friday, 19 February 2021. We may also follow up with some parties to test the information with them.

11. Following consideration of submissions and further analysis, we intend to undertake further targeted consultation to assess in more depth one or more options to address the issues of concern.

2 Our approach to regulation

12. The Government has committed to regulating to reduce merchant service fees. MBIE's approach to advising on regulatory proposals takes into account the Government's expectations for good regulatory practice and the requirements for regulatory impact analysis.

Identify the problem and objectives

13. A starting point for our advice is a clear articulation of the nature and extent of the problem, or opportunity, to be addressed and the objectives that are sought to be achieved.

14. As part of defining the problem, we develop one or more theories of harm and then test whether this is supported by the evidence. The focus should be on the underlying causes of the harm rather than its symptoms. We also assess the size of the problem, or the extent of harm caused, and attempt to quantify this where practicable.

15. Another element of defining a problem is to consider what would happen without any intervention (i.e. the counterfactual). The counterfactual forms a baseline to enable us to assess different options.

16. This project is building on the outcomes of the MBIE 2016/17 study into retail payments and our subsequent monitoring of developments. We set out our assessment of the issues or problem in chapter 4. Submissions to this issues paper will update our assessment of the nature and extent of the problem and allow us to further test our thinking.

Identify the range of feasible options

17. A further step is to identify feasible options to address the problem and meet the objectives. These options may be standalone or form a package, and may include a mix of the following:

    a. direct regulation, where the government regulates to achieve the objectives of the regime

    b. co-regulation, which is generally regulation that also confers a regulatory role for third parties to give effect to the regime

    c. self-regulation, such as voluntary industry codes

    d. non-regulation, such as education campaigns or funding of new services.

18. In identifying options we will consider such things as:

    a. consistency with relevant international standards and practices to maximise the benefits from trade and from cross border flows of people, capital and ideas (except when this would compromise important domestic objectives and values)

b. alignment with existing requirements in related or supporting regulatory systems, with a view to minimising unintended gaps or overlaps and inconsistent or duplicative requirements

c. conformance with established legal and constitutional principles.

19. We set out some preliminary advice on options to regulate interchange fees in this paper. However, we seek submissions on these and other interventions that may further constrain merchant service fees and best achieve the objectives.

20. Submissions on this paper will help us to identify the full range of feasible options for intervention, the direct and indirect impacts of those interventions, and some of the associated benefits and costs.

Analyse the options and provide advice

21. Following consideration of submissions, we propose to carry out a further round of consultation setting out one or more options in more detail. We will analyse the advantages/benefits and disadvantages/costs of the options relative to the counterfactual.

22. This further analysis will look at how each option (or the preferred option if there is one) addresses the problem and how it achieves the objective. The analysis should consider the full range of impacts of the option and identify the parties that are impacted. In particular, we seek to assess the magnitude and incidence of compliance or regulatory costs and benefits.

23. Following consultation on the detail of the options, we will prepare advice to the Minister of Commerce and Consumer Affairs, and Government.

24. Any analysis of options involves assumptions and judgements, such that reasonable people can form different views. In order to promote transparency, and enable Ministers to make informed decisions, we will prepare a regulatory impact assessment in accordance with Cabinet requirements which sets out our reasoning and assumptions.

25. In making recommendations to Ministers, we will consider which option best delivers net benefits for New Zealanders. Ideally it would achieve the objectives with the least costs, and consistent with good regulatory principles.

The role of consultation

26. Consultation with interested parties is key throughout this process. It enables us to gather evidence to inform the analysis and to test its accuracy, completeness and workability. It also adds to the legitimacy of the process and its outcomes.

1	Do you have any feedback on our proposed approach to this project?

3 Retail payments system

What is the retail payments system?

27. A payments system is the arrangement that allow consumers, businesses and other organisations to transfer funds by facilitating the movement of cash, electronic payments and other payment instruments. The technical infrastructure, standards and participants ensure that funds can move from accounts at one financial institution to another.

28. This paper considers the retail payments system only. The retail payments system transmits, clears and settles financial transactions between consumers and merchants in return for goods and services. This project focuses primarily on debit and credit card payment schemes, but other products – including potential emerging disruptors – are considered to the extent they provide competition in this system.

29. The retail payments system is a form of two-sided market. Two-sided markets are different to traditional markets where buyers and sellers transact directly. Rather the retail payments system requires an intermediary or platform to coordinate the interface between the two-sides, being the customer and merchant. In this case, the intermediaries are the financial institutions that participate in the card schemes, such as the Visa or MasterCard schemes and the Electronic Funds Transfer at Point of Sale (**EFTPOS**) system.

30. The two sides of the market are closely related as they create 'network effects'. That is, consumers prefer a payment method that is widely accepted by merchants, and merchants prefer cards that are widely used by consumers. The wider the use and acceptance of a card, the more efficient the retail payments system is. With two sided markets, such as this, the revenue mix for the intermediaries comes from a combination of the two sides. For example, the source of revenue may be heavily skewed to one side of the market in order to attract users on the other side of the market.

Parties in the retail payments system

31. There are a number of parties involved in any card-based transaction. The parties involved and the interactions between them will depend on the payment product. In general, the key parties are:

    a. **Cardholder/customer/consumer**: Buys goods and services from merchants in exchange for payment.

    b. **Merchant**: A party that provides goods or services in return for payment. Includes retailers, wholesalers, utilities companies, and central and local government.

    c. **Issuer**: An organisation, typically a bank, which issues cards and provides debit and/or credit services to consumers.

d. **Acquirer**: An organisation, typically a bank, which provides access to the payments system on behalf of merchants for the clearing and settlement of funds in a transaction. An acquirer may, or may not, also be the bank that provides other services to a merchant (such as lending and deposits).

e. **Scheme**: Includes Visa, MasterCard, American Express and Diners Club. Schemes develop technology and base product features, and set the commercial model and card system rules. They may issue cards and attract merchants through banks (open system – Visa and MasterCard) or directly (closed system – American Express, Diners Club, etc.).

f. **Switch**: Infrastructure that sends the transaction information to the correct card issuer or acquirer (depending on the type of transaction) so the funds can be taken from the consumer's account and delivered to the merchant's account. Switching functions can be performed by various parties, including stand-alone switches (most notably Paymark), schemes, and vertically-integrated terminal providers and customer gateways (such as Verifone and Windcave).

g. **Customer interface**: Either the terminal hardware and software (for card-present transactions) or digital customer gateway (for card-not-present transactions) through which the customer makes a payment to a merchant.

Main business models for retail payments

32. There are two main business models for retail payments in New Zealand, being switch-to-issuer (i.e. the EFTPOS rails) and switch-to-acquirer (i.e. the scheme rails).

Switch-to-issuer transactions

33. Introduced in 1984, New Zealand's EFTPOS system established the switch-to-issuer business model.

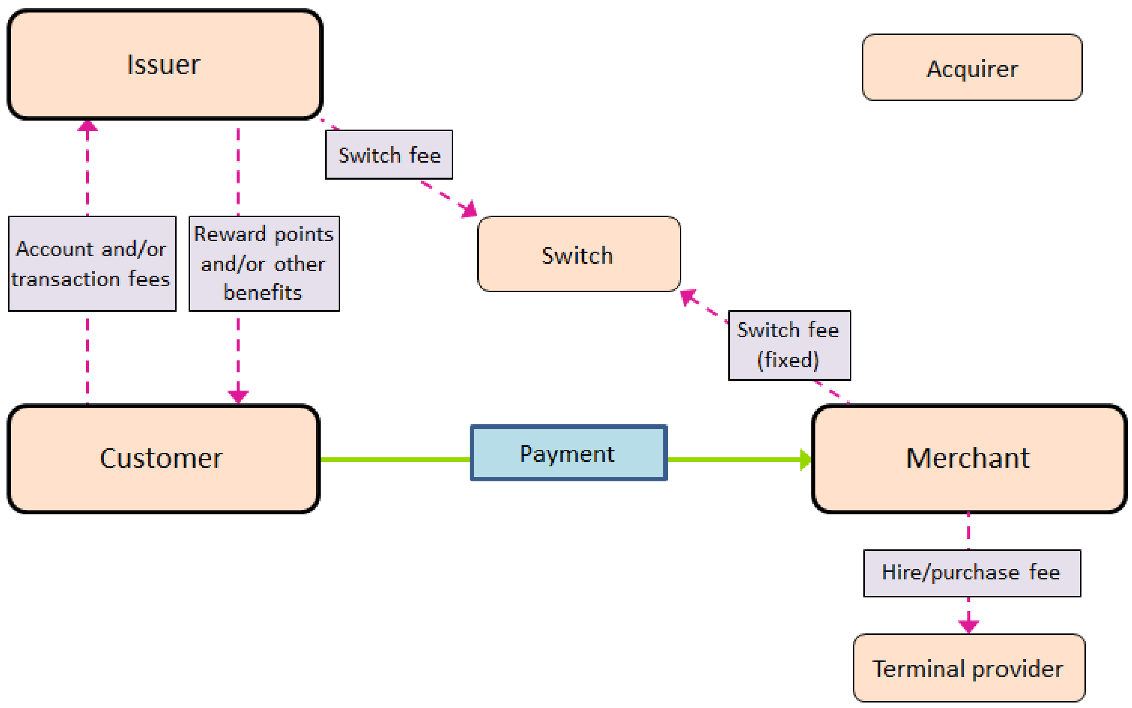
34. Figure 1 sets out this model and the possible flow of fees and inducements depending on the card type (e.g. an EFTPOS card or some scheme debit cards).

35. Under this business model, when the customer swipes or inserts the card at the merchant's point of sale, the payment instruction is sent by the 'switch' directly to the issuer (i.e. the customer's bank) and payment is made to the merchant. The switch-to-issuer model does not pass through a scheme (i.e. does not operate on 'scheme rails') even if a scheme debit card is used for the transaction.

36. In general, under this business model, the issuer incurs the costs of these transactions and any charges imposed on customers do not fully offset these. However, the issuer may recover these costs through other means such as reduced interest payments to customers on debit balances. In most cases, the merchant either incurs no or relatively low fixed service fees for each transaction, but that depends on the card type.

37. In New Zealand, the schemes and banks have agreed to route scheme debit cards that are swiped or inserted through the switch-to-issuer route. This no-merchant service fee model for such scheme debit cards is unusual internationally.

Figure 1: Fees and inducements in switch-to-issuer transactions



Switch-to-acquirer transactions

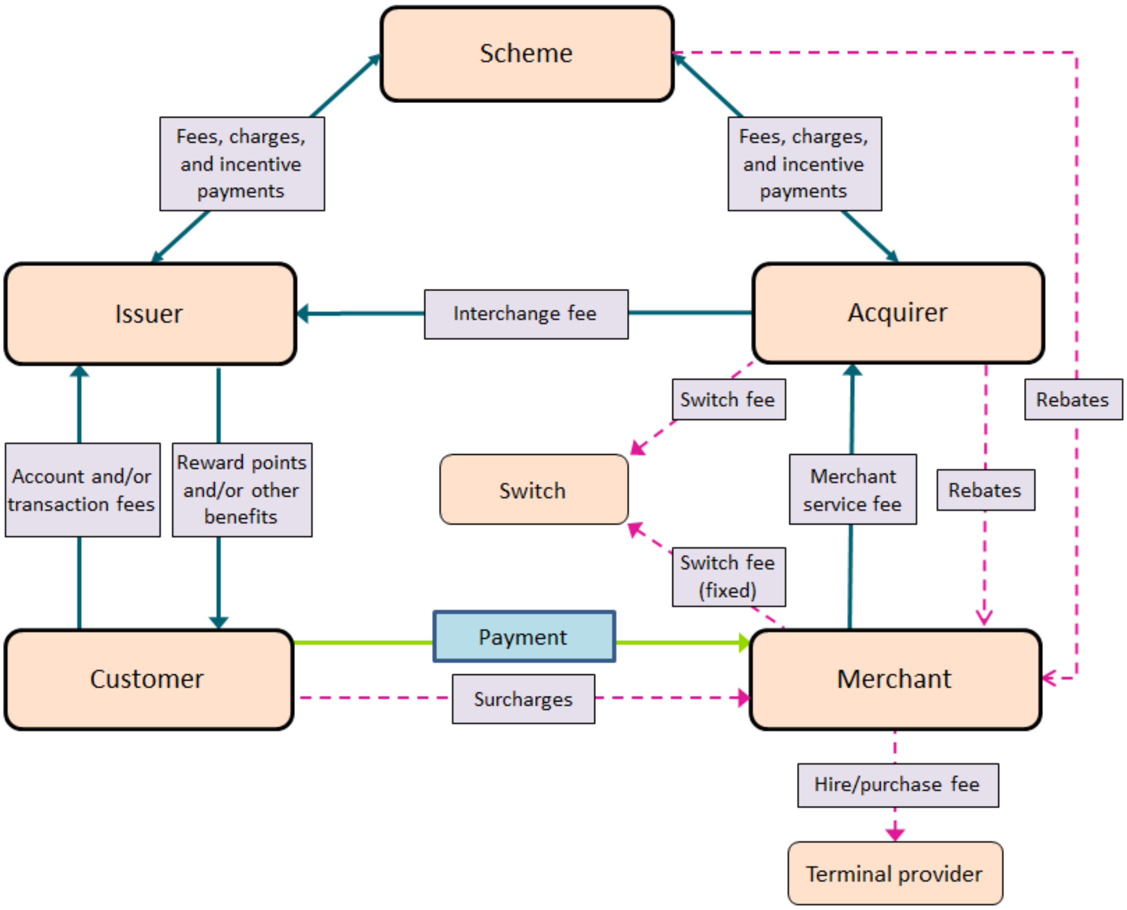
38. The other main business model is the switch-to-acquirer model, which is used by the schemes for credit cards used in-store (swiped, inserted and contactless), in-store contactless debit cards, and online credit and debit cards.

39. Figure 2 sets out this model for a typical open four-party scheme and the possible flow of fees and inducements.

40. Under this business model, when the customer uses the card at the merchant's point of sale, the payment instruction is sent by the 'switch' to the acquirer (i.e. the merchant's bank). The acquirer then sends the payment instruction to the issuer for clearance, but in return is also charged an 'interchange fee' and a 'scheme fee'. In general, under this business model the acquirer incurs the costs of the transaction and fully recovers this cost from the merchant through a 'merchant service fee'.

41. The issuer uses the interchange fee to cover any rewards or inducements, such as Airpoints, that the consumer may receive for using the card, the costs of any credit that is offered, and the costs of any fraud.

Figure 2: Fees and inducements in switch-to-acquirer transactions



Variations on these business models

42. There are a number of variations to these two models including cases where:

    a. the terminal provider also acts as the switch

    b. the transaction bypasses a stand-alone switch to be switched purely by a scheme

    c. a transaction is processed by a self-acquirer.

43. There are also closed three party systems, such as American Express and Diners Club, where the scheme acts as both issuer and acquirer of payment cards, and is the provider of credit to a consumer. In this case, there is no interchange fee, and the scheme sets the merchant service fee directly.

44. There is also an increasing use of other payment methods such as digital wallets. Examples include Apple Pay, Google Pay, PayPal and 'Buy Now, Pay Later' products such as Afterpay. However, many of these new digital wallets still operate over scheme rails. That means that a scheme debit or credit card is still required for payment. The merchant service fee in this circumstance may include an additional margin to cover the costs of the digital wallet provider.

45. Other electronic payment methods that do not rely on existing scheme rails include:

a. **direct entry** to a consumers' bank account, otherwise known as a bank-to-bank transfer.

b. **purchased payment platforms** that hold stored value for a person that can be used for payment to participating merchants, such as 'smart cards' (e.g. Snapper) or mobile payments platforms (e.g. Alipay).

c. **digital currencies**, such as Bitcoin, also continue to develop and find new applications.

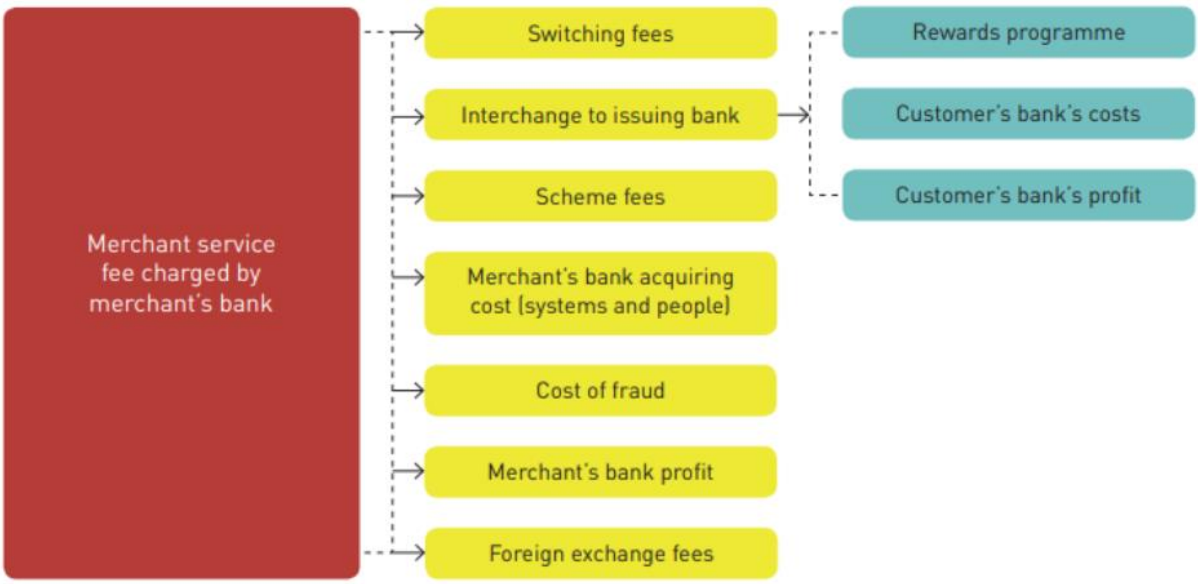
46. Many of the emerging scheme-based payment methods utilise what is known as 'tokenisation'. This supports greater security, as only the scheme and the issuer have information about both the person and the transaction. In other countries, EFTPOS-like cards have also been tokenised, which allows for 'switch-to-issuer' type transactions for online debit card purchases among other things.

47. Importantly, other than switch-to-issuer transactions, there are currently no mainstream electronic payment methods in New Zealand that facilitate direct entry for in-store transactions. Application programme interfaces (or **APIs**) that would enable bypassing of scheme infrastructure are being explored through work by Payments NZ and others.

Merchant service fees

48. Merchant service fees are payments made by a merchant each time certain payment transactions are processed. The fee may be fixed or as a percentage of the sales transactions value. Figure 3 shows the components of a merchant service fee payable under the typical switch-to-acquirer business model.

Figure 3: Components of a merchant service fee (switch-to-acquirer)



Source: Retail NZ

For most transactions the main component is the interchange fee

49. The interchange fee is generally the largest component of the merchant service fee – particularly with credit card transactions where it can be around 70-80 per cent of the merchant service fee. It is typically set as a percentage of the transaction value.

50. The interchange fee is the charge payable by the acquirer (the merchant's bank) to the issuer (the consumer's bank) to recoup the costs of processing payments, a profit margin, and in the case of credit card transactions, an additional margin to fund inducements or rewards (e.g. Airpoints) for customers and the credit supplied.

51. Card schemes (e.g. Visa and MasterCard) do not directly receive revenue from the interchange fee. Instead they receive scheme fees for the use of their cards from both the issuer and the acquirer. The card schemes set a complex range of interchange fee caps that issuer banks can charge acquiring banks. The interchange fee cap depends on the merchant type and the form of card used, to balance incentives for higher use and acceptance of cards on both sides of the platform. For example, the schemes set a lower interchange cap for strategic merchants, usually being the largest merchants such as supermarkets and fuel chains.

52. The participating issuers may set lower interchange fees, through bilateral negotiations with acquirers, but generally target the scheme caps. This enables the issuer to set higher inducements to attract customers to use their cards over their competitors, and in doing so, increases incentives on consumers to use credit cards over other payment methods, such as EFTPOS.

The structure of merchant service fees

53. Following a Commerce Commission enforcement action which resulted in a 2009 settlement[1], acquirers are required to offer merchants choice in the structure of their merchant service fees. The choices are:

    a. **A 'blended' rate**, which averages out the cost of accepting payment types into a fixed percentage per transaction regardless of the mix of products used in a particular month. These blended merchant service fee percentages are fixed for a given period of time.

    b. **Unblended rates**, which are separate fees for each of the scheme's (i.e. Visa, MasterCard) transactions, thereby enabling the merchant to see the cost of accepting each scheme's cards.

    c. **Unbundled rates**, which are separate fees for all types of scheme's transactions, enabling the merchant to see the cost of accepting each type of product. In practice, the acquirer may only separate credit and debit fees, or classes of products. Unbundling is generally known as cost-plus pricing, in that acquirers pass along the interchange fee that they are charged plus a margin.

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[1] ***https://comcom.govt.nz/case-register/case-register-entries/visa-international-service-association,-and-others*** . Note the settlement expired in 2013, but has continued to shape commercial arrangements.

54. Some of the major merchants may also directly negotiate with the schemes (or their acquirer) to obtain an additional rebate off their merchant service fees. As a consequence, merchant service fees can vary substantially. They are complex to unpick and are often specific to each merchant.

Passing on of merchant service fees

55. For many merchants, the merchant service fee is treated as a cost to be recovered through the price for goods and services sold. However, also as a consequence of the Commerce Commission's 2009 enforcement action, merchants may influence consumers in their choice of payment through:

    a. **Steering**, whereby the merchant refuses to accept or discourages some forms of payment either generally or in specified circumstances (such as in the case of low value transactions). For example, some merchants have signs saying they don't accept credit or contactless payments, or don't accept cards from particular schemes such as Diners Club. However, the schemes and acquirers may still require merchants to 'honour-all-cards' of a particular type. That is, if the merchant accepts a scheme's credit cards, it cannot steer between standard or premium credit cards for that scheme.

    b. **Surcharging**, whereby the merchant adds an additional charge on the price of goods or services sold for accepting some forms of payment and classes of card. In such cases, the additional charge should be no more than the merchant service fee. Surcharging is particularly used by some sectors, such as airlines and utilities providers.

What actions have been taken to date

2016/2017 MBIE study into retail payment systems

56. In 2016, the Minister of Finance and the Minister of Commerce and Consumer Affairs at that time commissioned a study into retail payment systems. The study was motivated primarily by concerns expressed by merchants about increasing costs for processing electronic transactions, in the context of new technologies and regulatory developments overseas.

57. MBIE initiated the study by releasing an issues paper: *Retail payment systems in New Zealand*[2]. The paper sought feedback on whether New Zealand's retail payment systems – particularly our EFTPOS, credit, and debit card networks – were delivering good outcomes for consumers, merchants, and the New Zealand economy as a whole.

58. The issues paper identified a range of potential issues in the payments system. These mostly centred on interchange fees and their impacts on innovation, efficiency, and the distribution of costs between consumers and businesses. The paper sought feedback on these issues, as well as potential options for reform, such as regulation of interchange fees.

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[2] MBIE. (2016). *Retail payment systems in New Zealand: Issues Paper.* Retrieved from: ***https://www.mbie.govt.nz/assets/3f6cff197b/retail-payment-systems-issues-paper.pdf***

59. Submissions from 46 parties were received, representing views from card schemes, banks, merchants, consumer representatives, and other industry representatives.[3] We also met with key stakeholders to discuss their submissions in more depth.

60. MBIE concluded that New Zealand's retail payments were not functioning as well as they could, confirming that many of the issues identified were problems. However, there were also some promising developments including some industry-led initiatives that could go some way to address the issues:

    a. The banks (through the New Zealand Bankers' Association) undertook to provide greater transparency of fees to merchants. This had the potential to help merchants' decision-making and, in a small way, improve merchants' bargaining power when negotiating fees with banks and schemes.

    b. Payments New Zealand (Payments NZ), the industry body that oversees and manages the rules for most of the core payments systems in New Zealand, outlined its intention to work on initiatives that could allow for new entrants and enhanced payment methods (e.g. direct entry or open banking). Similar projects, at a much larger scale, were also underway in Australia and the United Kingdom at that time. This had the potential to facilitate competitive alternatives to existing retail payment systems.

61. In 2017, the then Minister of Commerce and Consumer Affairs, reported to Cabinet on the outcomes of the study. The Government agreed to continue monitoring and encouraging industry-led solutions, while noting that further regulation could be an option if this did not achieve the Government's objectives.

Promotion of open banking

62. In early 2018, following a letter from the then Minister of Commerce and Consumer Affairs, Payments NZ formally began work to facilitate the development of a shared API framework to support new and improved methods of payment and easier, standardised ways of sharing banking data. This is sometimes referred to as industry-led 'open banking', and culminated in the launch of the Payments NZ API Centre in May 2019. Open banking is expected to, amongst other things, provide competition through new payment options for consumers and merchants which may be less expensive.

63. In August 2020, MBIE released a discussion document seeking feedback on options for establishing a consumer data right in New Zealand. This was in response to the then-Minister of Commerce and Consumer Affair's dissatisfaction at the speed at which open banking was progressing. A consumer data right could help with some of the frameworks required for the development of open banking in New Zealand.

64. Submissions were received from 59 parties which range from businesses and individuals. MBIE is reviewing feedback received and developing advice for the Minister of Commerce and

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[3] The submissions are available on MBIE's website here: ***https://www.mbie.govt.nz/have-your-say/retail-payment-systems-issues-paper/***

Consumer Affairs to help inform the Government on the development of a potential consumer data right.

MBIE monitoring of fees

65. Since 2017, MBIE has been monitoring the interchange fees of the card schemes. We estimate that weighted average credit and debit interchange fees have decreased over that time by around 11 per cent. Whilst during this time the share of retail payments transactions processed through the 'switch-to-acquirer' model has increased.

66. We have limited visibility of the overall merchant service fees. There is significant variation in rates between products and merchants, leading to some complexity.

67. There have been positive moves from the banks on merchant service fees for contactless debit card merchant service fees. Recently many of the banks have announced that merchants will not be charged more than 0.7 per cent to process contactless debit card transactions. This will be a reduction for some smaller merchants from merchant service fees that were previously close to 3 per cent.

2	Have we described the retail payments system accurately? Is there any additional information that you would like to provide?

4 Our understanding of the issues

Merchant service fees are high based on international comparisons

68. Retail NZ carried out an annual survey of members to better understand merchant service fees. Its 2019 Payment Survey showed a small reduction in weighted average merchant service fees from the previous year, but payments for contactless debit and credit card transactions remained higher than in Australia and the United Kingdom, where interchange fees are regulated.

TABLE 1: 2019 RETAIL NZ SURVEY OF MERCHANT SERVICE FEES WITH COMPARISON

COUNTRY	CONTACTLESS DEBIT	CREDIT
New Zealand	1.1%	1.5%
Australia	0.6%	0.8%
United Kingdom	0.3%	0.6%

Source Retail NZ

69. Retail NZ attributed the small reduction in weighted average merchant service fees as likely being due to Visa and MasterCard having earlier reduced some of the maximum interchange fees that applied in New Zealand. Our monitoring supports this and shows that participating banks followed suit with further reductions in their interchange fees. Also, as noted in chapter 3, since the Retail NZ survey, contactless debit card merchant service fees have seen reductions from a number of banks. Merchants should now be paying no more than 0.7 per cent in merchant service fees for accepting contactless debit card transactions, which would bring New Zealand closer to the 2019 Australian survey result.

70. A further positive trend identified by Retail NZ is the banks move to unbundle their merchant service fees offered to merchants. This had been slow to rollout to smaller merchants, possibly due to the complexity, but also due to some technology issues. The 2019 Retail NZ survey showed that merchants with an unbundled rate for contactless debit pay, on a weighted average basis, 0.1 per cent less than those on a bundled rate do. This ability to accept an unbundled rate will likely be a significant benefit to merchants that have a high share of contactless debit cards. It will also better support those merchants that surcharge for accepting higher cost payment options (e.g. swiped or inserted credit cards).

71. However, there are also some worrying trends, particularly as use of domestic EFTPOS declines with consumers transacting more with contactless cards or online payments. Unlike many overseas jurisdictions, scheme debit cards that are inserted or swiped are essentially fee-free for merchants in New Zealand. This has been attributed to this product needing to compete with domestic EFTPOS, which operates on a similar business model, but which is less profitable to banks as acquirers.

72. In addition, as the New Zealand payments system continues to evolve, there is a significant uptake of 'Buy Now, Pay Later' products, such as Afterpay, Zip, Laybuy and humm. But these new schemes push the vast majority of the costs to merchants whilst offering their services to consumers for limited direct costs. They charge fees to merchants that are often more than three times a credit card merchant service fee.

73. We are concerned that the retail payments system is not performing as well as it could. The reasons for this were canvassed in our 2016/17 market study. Similar concerns were discussed by the Australian Productivity Commission in its 2018 Inquiry Report into Competition in the Australian Financial System.[4] We discuss these issues below and seek your feedback.

3	Please provide information on your understanding of the levels of merchant service fees in New Zealand, any trends in relation to those fees, and how they compare to merchant service fees in overseas jurisdictions.

Consumers are incentivised to use higher cost methods and do not face the full costs of these choices

74. Consumers choose which payment method to use based on the costs and benefits that they face. The Australian Productivity Commission identified a range of factors as being relevant, including availability, convenience, security, cost and rewards. For example, credit cards can be convenient, but also come with a cost of annual fees or interest.

75. New Zealand has a very high uptake of debit and credit cards, including domestic EFTPOS, as methods of payment. Banks in New Zealand are the predominant issuers of these cards and, through Payments NZ, oversee domestic EFTPOS. They are also the main acquirers providing payment services to merchants. This means that banks largely determine the fees and inducements for debit and credit card schemes for both sides of the market within the scheme rules and caps. They use incentives to steer consumers to those payment systems where they make the highest return.

76. We consider that there are incentives in the system that encourage the use of higher cost payment methods, such as credit cards. These are:

    a. Offers of rewards and inducements which means that the marginal cost to the consumer of using this higher cost payment method could actually be negative when rewards and the provision of credit are factored in.

    b. Contactless payments and digital wallets are significantly more convenient for consumers over other lower cost payment methods. For example, they offer faster in-store payment and related public health benefits. However, many of these contactless transaction types (e.g. contactless debit card, Apple Pay) have higher merchant service fees than payments by cards that are swiped or inserted, but the cardholders, if not

[4] Australian Productivity Commission, Competition in the Australian Financial System, 2018. ***https://www.pc.gov.au/inquiries/completed/financial-system/report***

surcharged, do not directly incur these costs. This means that they may use them more than they would otherwise.

77. These incentives to use higher cost payment methods, which are also likely to be the payment methods that provide higher returns to banks, drives additional costs into the retail payments system.

4	What is your view on charges incurred by cardholders for the use of payment methods?
5	What impacts do you believe rewards and inducements have on the retail payments system?

Merchants risk losing consumer sales through steering or surcharging and lack countervailing bargaining power

78. Merchants choose which payment method to accept based on the costs and benefits that they face. However, whilst a consumer may make a direct decision at the point of sale, a merchant makes a longer-term business decision about which payment methods they are willing to accept across all transactions in the future.

79. Merchants may find it difficult to refuse to accept (or surcharge) for higher cost payment methods if that payment method is valued by consumers. To do so would risk them losing sales. In addition, a merchant is likely to face greater negative customer response to removing a particular payment method than never accepting the payment method in the first place. This likely means that the merchant's decision about whether or not to accept a payment method is less responsive than consumers' to changes in fees.

80. We consider that there are some features of the retail payments system that also make it difficult for merchants to steer or surcharge for higher cost payments. These are:

    a. For some merchants, accepting credit cards is likely to be essential for their business. If they accept credit cards from a scheme, the honour-all-cards rules mean that they are unable to steer customers away from high-cost cards, towards low-cost cards (e.g. from a platinum to a gold credit card, or from an overseas issued card to a domestic card).

    b. Some point of sale systems in conjunction with the terminal the merchant uses do not allow for automatic credit card or contactless card payment surcharges. This reduces the ability for some merchants to recoup the costs of higher cost payment types from those consumers.

    c. Consumers are increasingly using scheme debit cards, as these are issued by the banks in preference to domestic EFTPOS. These cards also have contactless functionality which is valued by many consumers given its speed of processing of transactions and, more recently, its public health benefits. However, if merchants wish to accept contactless debit card payments, currently payment terminals do not have the ability to distinguish between these and the higher cost contactless credit transactions. Unless the merchant is willing to manually check at the time of the sale, they have limited ability to just accept (or steer customers to) the lower cost contactless debit card payments.

81. Many merchants also have limited countervailing power with their acquirers. Moves by the banks to offer merchants unblended and unbundled merchant service fees have paved the way for merchants to have greater choice in the way their fees are structured. However, the range of fees by payment method creates considerable complexity for many merchants. It is also unclear how much merchants shop around to get the best deals on merchant services, particularly beyond the larger strategic merchants. As mentioned, the weighted-average merchant service fees in New Zealand remain relatively high.

6	What is your view on charges incurred by merchants for the use (acceptance) of payment methods?
7	Please provide your views on barriers to merchants steering consumers to lower cost payment methods and the extent that steering occurs?
8	Please provide your views on the barriers to merchants surcharging and the extent that surcharging occurs?

Costs are passed on to all consumers as higher prices for goods and services, while not all benefit

82. As outlined above, we consider that merchants face constraints to steering consumers to low cost payment methods or surcharging for high cost payment methods. This means that merchant service fees, where surcharging does not occur, may be treated simply as a cost that is included in the price of goods and services. As a consequence, all consumers, regardless of their payment method, pay these costs.

83. If surcharging occurred, merchants would not have to factor the cost of electronic transactions into the general prices because they would be recovered directly from each customer depending on payment method used in each case. However, we consider there is low prevalence of surcharging by merchants and an inability to easily, and accurately, surcharge for each product type.

84. The higher prices for all goods and services faced by consumers is offset for the holders of credit cards offering credit and rewards, who in some cases may receive rewards that greatly exceed the overall increase in price that they face. On the other hand, those who do not hold rewards-offering credit cards face an increase in price, with no corresponding benefit. This represents a wealth transfer from the users of low-cost payment options to users of high-cost cards.

85. This wealth transfer is strongly regressive. This is because users of high-cost credit cards are likely to be on high incomes due either to issuer rules (for example, the Air New Zealand American Express Platinum Card has a minimum income requirement of $65,000), or self-selection as a result of higher-annual fees (that nevertheless do not cover the full cost of rewards). In contrast, the cost that merchants face is passed on to all consumers, including those on low incomes.

9	What is your view of the wealth transfer by merchants passing on merchant service fees in the price of goods and services to all their consumers?

Small business merchants are particularly affected

86. Small business merchants are more likely to bear higher merchant service fees than other businesses. Many small businesses lack bargaining power with their acquirers, due to the small volumes and values of transactions that they deal with.

87. The retail payments system, for many, is complex and relatively opaque leading to knowledge and capability gaps among businesses. Businesses are able to choose from multiple suppliers of payment services and multiple payment product types. However, often small businesses will select a supplier of convenience, such as their bank that provides bank loan services, rather than splitting their custom and separately shopping around for the best deals for merchant services.

88. In addition, small businesses may also lack the information or capability to negotiate a merchant fee structure that is optimal for their business. Some businesses do engage with merchant service fee advisors to help negotiate better rates, but this is not common.

89. As a consequence, small business merchants may be at a competitive disadvantage, either because of the higher merchant service fees being passed through to their customers in higher prices for goods and services or due to them not accepting certain payment methods that are preferred by many consumers (i.e. contactless). This competitive disadvantage may impede small businesses ability to grow.

10	What barriers do small businesses face to obtaining competitive merchant service fees?
11	What information or assistance would assist small business to obtain better deals?
12	What cost differences are there for providing merchant services to small businesses compared with larger businesses?

Domestic EFTPOS provides price competition, but its use is declining

90. Introduced in 1984, domestic EFTPOS is the traditional debit payment card used in New Zealand. It was the result of collaboration between banks and while there is no ‘owner’ of the scheme as such, it is overseen by Payments NZ. The functionality of the EFTPOS system relies on a set of agreements between the banks.

91. Currently EFTPOS is providing downward pricing pressure on scheme debit products. As mentioned, the banks do not generally collect fees on EFTPOS transactions from consumers and merchants. Inserted and swiped scheme debit cards have become substitutes for EFTPOS transactions, with banks removing or reducing fees for consumers and merchants.

92. However, the market share of domestic EFTPOS is declining. The initial 'joint' ownership of the EFTPOS network by the banks provided weak commercial incentives to enhance its functionality. It is only in the last few years that Paymark has developed an online EFTPOS product, which also offers contactless functionality in-store. Some banks have not adopted this functionality limiting the use for consumers and merchants. This may be due to banks being reluctant to offer a product that would compete with the scheme debit and credit products on which they make profits. This can be seen by consumers increasingly being issued scheme debit cards rather than EFTPOS cards on renewal.

93. There is a risk that this downward pressure on contactless debit interchange fees will weaken if EFTPOS continues to lose market share. This means it is quite possible that acquirers could start charging merchants more for accepting the scheme debit cards. We expect the market will reach a tipping point where merchants that wish to receive electronic transactions (and not discourage customers) will have limited choice but to accept scheme debit products at the going price.

13	How much competitive discipline does EFTPOS provide on scheme debit card merchant service fees and are there any barriers to domestic EFTPOS providing more competitive discipline on merchant service fees?

Barriers to competition remain and innovation is generally over the scheme rails

94. New Zealand's debit and credit schemes are dominated by Visa and MasterCard. Concentration in a few card schemes is not unusual internationally, because of the significant network effects, but it has the effect of giving the established schemes a degree of market power.

95. The schemes and banks receive revenue from credit card usage through their ability to set interchange fees and scheme fees. The issuer and acquirer market in New Zealand is relatively concentrated, with few acquirers who are not also issuers. This means that competitive disciplines on interchange fee setting are relatively weak.

96. Entry for a new card scheme is difficult, because of the need to achieve the critical mass for merchants and consumers to adopt their systems. High interchange fees and rewards to cardholders associated with the incumbent schemes make it more difficult for new entrants to gain a foothold. Also many banks have exclusivity arrangements with either Visa or MasterCard, making it difficult for competitors to grow their network.

97. As noted in our overview of the retail payments system, new payment methods are emerging. However, most of these are being developed to operate over scheme rails, meaning that a scheme debit or credit card is still required for payment. The merchant service fee in this circumstance may include an additional margin to cover the costs of the digital wallet provider, perpetuating higher merchant service fees.

98. Ongoing work by Payments NZ in establishing open banking, supported by the Minister of Commerce and Consumer Affairs' (Hon Dr David Clark's) consideration of the case for a

consumer data right, would enable the development of alternative payment solutions. These solutions would be more akin to seamless bank transfers, and may not require cards at all, providing greater convenience and security when consumers are shopping in stores or online. These alternatives would likely provide competitive tension on merchant service fees.

14	What impact is product innovation having on merchant service fees?
15	Is open banking likely to provide sufficient competitive discipline on scheme debt and credit fees?

No clear regulatory governance to oversee the retail payment system

99. New Zealand currently has a relatively light-handed approach to oversight of the retail payments system, with the self-regulatory body, Payments NZ, having a leading role. Payments NZ manages New Zealand's retail payments system for financial institutions. It was established in 2010 by eight banks (the shareholders) with a mandate to open access to, and preserve the integrity of, New Zealand's payment systems. It does this through developing and applying the rules, standards and procedures for payment systems, including operating the Consumer Electronic Clearing System, which includes domestic EFTPOS. However, Payments NZ's ownership by the banks that derive profits from the debit and credit card schemes mean that it is poorly placed to oversee issues related to pricing and business models.

100. There are also two regulatory bodies that have an involvement in the retail payments system:

   a. **Reserve Bank of New Zealand** (RBNZ) has a mandate to promote the maintenance of a sound and efficient financial system. In carrying out its functions, the RBNZ looks to promote the development of payment systems that are efficient, open and flexible; operate with a high level of integrity, and are operationally robust. The Financial Markets Infrastructure Bill, currently before the House, will increase the RBNZ's role in relation financial market infrastructures, which will include systemically important payment systems. This system focus means that retail payment systems, like card schemes, are currently likely to be excluded from oversight and supervision by the RBNZ.

   b. **Commerce Commission** is the expert body in promoting competition and administering economic regulation, but it does not have a specific role in relation to the retail payments system. In 2009, the Commerce Commission entered into a settlement with the Visa and MasterCard credit card schemes and associated banks for alleged contravention of the price fixing provisions in relation to merchant service fees. This settlement expired in 2013, but it continues to have an impact. However, as the Commerce Commission noted in its 2013 evaluation, it has no ability to intervene to address high merchant service fees if they are set in compliance with the Commerce Act 1986. It commented that alternative regulatory intervention may be required in that case.

101. The Commerce Commission does not currently have the statutory mandate to intervene and regulate retail payments. The RBNZ also does not see that it has this role.

16	Do you agree that there is a gap in regulatory governance of the retail payments system relating to promoting competition and outcomes that are in the long term benefits of end-users?
17	Please feel free to provide information on any other issues of concern with the performance of the retail payments system.

5 The objectives for the retail payments system

102. We consider the overall objective is for the retail payments system to deliver long-term benefits for end-users of the retail payments system within New Zealand.

103. We consider this requires that the system:

    a. enables healthy competition between payment providers and payment products

    b. incentivises beneficial innovation for consumers and merchants

    c. is efficient in allocating resources through clear price signals, where prices are cost-reflective for the system as a whole

    d. is fair in its distribution of costs, particularly in its treatment of small business and low-income consumers.

104. In addition to these objectives, it is vital that payment systems are sound, secure and subject to prudential supervision. However, we do not focus on these objectives here, as the RBNZ largely holds responsibility for these outcomes in its prudential role.

18	Do you agree with the objectives for the retail payments system in New Zealand?

6 Options to address the issues

Status quo

105. We consider that the steps taken by Payments NZ, the schemes and banks to-date have led to improvements. However, these self-regulatory measures (unbundling of merchant service fees and reductions to interchange fees) have been slow to be implemented and have not dealt with some of the underlying issues of concern as set out in chapter 4 of this paper. Also, as noted earlier, the Commerce Commission identified in its 2013 evaluation that it is not able to address high merchant service fees if they are set in compliance with competition law and that an alternative regulatory intervention may be required to do so.

106. The Government has therefore directed MBIE to develop regulatory measures to reduce merchant service fees for debit and credit cards, such as through direct regulation of interchange fees. The remainder of this chapter briefly outlines our initial assessment of possible options that could be explored.

107. A full assessment will be carried out in the next stage of this project, taking into account submissions to this paper. We invite you to provide feedback on these options and any others that should be considered.

108. In addition, the Minister of Commerce and Consumer Affairs, Hon Dr David Clark, is exploring the case for introducing a consumer data right in New Zealand which could be used to assist with the development of open banking. This will be a means to promote innovation which could feasibly include innovation in how payments are made. Any introduction of a consumer data right or other steps to speed up open banking would be complementary to this project. Regulatory intervention in the retail payments system does not preclude the introduction of a consumer data right in New Zealand.

Interchange fee regulation

109. Overseas jurisdictions have tried a range of regulatory means to reduce merchant service fees. [Refer **Annex 1**]. Commonly this involves the price regulation of the interchange component of the merchant service fee but the regulatory design has varied. The different approaches tend to hinge on the following choices:

    a. **What is regulated**: The choice of scheme (e.g. MasterCard and Visa) and transaction type (e.g. credit card, contactless debit card, online credit or debit) depends on the factors affecting merchant service fees in each jurisdiction and their relative importance. As noted earlier, the credit card interchange fees in New Zealand are high compared with other jurisdictions.

    b. **The form of the regulation**: Some jurisdictions have applied hard caps on interchange fees, while others have applied soft caps (i.e. weighted averages of interchange fees). Others, like Australia, have applied both a mix of hard and soft caps for individual businesses to ensure small merchants do not face excessive fees. In some jurisdictions certain classes of merchants have different cap levels to others.

c. **How the regulated price or cap is set**: The regulated caps are set on a number of different principles. For example, the European Commission uses a ‘merchant indifference’ test which results in a relatively low interchange fee, while Australia is consulting on whether reducing interchange fees to zero is desirable.

d. **Who is the regulator:** The regulator of the retail payments system or interchange fees is usually a dedicated payments regulator, either associated with the Reserve Bank in that jurisdiction or an independent entity like a payments body.

110. We invite feedback on the following initial proposal for interchange fee regulation:

> Interchange fees for open party credit and debit schemes (MasterCard and Visa) will be regulated with hard caps. The hard caps for each transaction type will be set applying principles linked to the objectives outlined in chapter 5 and may be targeted for different classes of merchants.

111. This proposal is only one aspect of retail payments system regulation and the rest of this chapter discusses potential supplementary options.

19	Please provide feedback on the aspects of the proposal for interchange regulation, including any changes that would improve the impact of it, with supporting evidence of any benefits or costs.
20	Please provide feedback on which body or bodies would be best placed to act as the regulator for interchange fee regulation.

Supplementary options

112. Interchange fee regulation is only one aspect of retail payments system regulation. Evaluations of overseas approaches indicate the importance of taking a ‘systems’ approach to retail payments system regulation. Therefore a regulatory approach will need to also include some of the following classes of options (to supplement interchange fee regulation):

a. **Other price regulation:** Other aspects of the retail payments system could be covered by price regulation, for example the whole merchant service fee, card fees for consumers, or other product types (e.g. online payment gateways, ‘Buy Now, Pay Later’ merchant fees). These charges could be regulated directly or subject to principle-based tests. For example,

i. on the merchant-side, they could be subject to a requirement that fees charged to merchants must be closely connected to the activity for which the fee is charged and not unreasonable, or the regulator could have the ability to regulate other aspects of the merchant service fee if they increase in response to interchange fee regulation.

ii. on the issuer-side, they could be subject to a test of no 'net compensation' from a scheme, similar to the Australian regime.

b. **Information disclosure:** A requirement for acquirers to disclose information to a regulator or the public on the merchant service fees they are charging merchants. This could be used to provide merchants an understanding of the levels of merchant service fees that they should be paying and/or monitor merchant service fees in more depth.

c. **Collective bargaining:** Options to enable collective bargaining by groups of merchants with acquirers and other payments providers may increase the power of merchants when bargaining. For example, Retail NZ has negotiated rates with one of the banks for processing card transactions, which is available for all of its participating members. However, it appears to have had limited uptake.

d. Other options could include:

   i. Codifying rules and practices that would support greater transparency and incentives in the system. This could include rules around cross border acquirers, changes to surcharging and steering allowed by merchants, limiting the extent of rewards and loyalty schemes, prohibiting of bundling of certain services (e.g. acquirers not offering other services to merchants), facilitating access for competing payment methods or providers, or encouraging least-cost routing for transactions.

   ii. Requiring merchants to surcharge for particular higher cost payment methods or requiring discounts for customers that transact using lower cost payment methods. This would avoid consumers paying with lower cost options subsiding customers that pay with higher cost options. However, such requirements would need to guard against excess surcharging to protect consumers.

   iii. Setting requirements relating to product development and technology. This may include such things as requiring payment terminals to be able to automatically surcharge for different payment types or automatically adopt least cost routing.

21	Please provide your views on the impacts of the above classes of options, with supporting evidence of the benefits and costs.
22	Please provide your views on any other feasible options that should be considered, with supporting evidence of the benefits and costs of these options.

7 Recap of questions

Below is a list of the questions raised in this paper. When responding please provide reasons for your response and any supporting evidence if available.

1	Do you have any feedback on our proposed approach to this project?
2	Have we described the retail payments system accurately? Is there any additional information that you would like to provide?
3	Please provide information on your understanding of the levels of merchant service fees in New Zealand, any trends in relation to those fees, and how they compare to merchant service fees in overseas jurisdictions.
4	What is your view on charges incurred by cardholders for the use of payment methods?
5	What impacts do you believe rewards and inducements have on the retail payments system?
6	What is your view on charges incurred by merchants for the use (acceptance) of payment methods?
7	Please provide your views on barriers to merchants steering consumers to lower cost payment methods and the extent that steering occurs?
8	Please provide your views on the barriers to merchants surcharging and the extent that surcharging occurs?
9	What is your view of the wealth transfer by merchants passing on merchant service fees in the price of goods and services to all their consumers?
10	What barriers do small businesses face to obtaining competitive merchant service fees?
11	What information or assistance would assist small business to obtain better deals?
12	What cost differences are there for providing merchant services to small businesses compared with larger businesses?
13	How much competitive discipline does EFTPOS provide on scheme debit card merchant service fees and are there any barriers to domestic EFTPOS providing more competitive discipline on merchant service fees?
14	What impact is product innovation having on merchant service fees?
15	Is open banking likely to provide sufficient competitive discipline on scheme debt and credit fees?

16	Do you agree that there is a gap in regulatory governance of the retail payments system relating to promoting competition and outcomes that are in the long term benefits of end-users?
17	Please feel free to provide information on any other issues of concern with the performance of the retail payments system.
18	Do you agree with the objectives for the retail payments system in New Zealand?
19	Please provide feedback on the aspects of the proposal for interchange regulation, including any changes that would improve the impact of it, with supporting evidence of any benefits or costs.
20	Please provide feedback on which body or bodies would be best placed to act as the regulator for interchange fee regulation.
21	Please provide your views on the impacts of the above classes of options, with supporting evidence of the benefits and costs.
22	Please provide your views on any other feasible options that should be considered, with supporting evidence of the benefits and costs of these options.

Annex 1: International comparison

113. This section of the Issues Paper provides a broad overview of the approach to regulation taken in Australia, Canada, the European Union, and the United States of America.

114. A more complete stocktake of public authority involvement in payment card markets in various countries has been prepared by the Federal Reserve Bank of Kansas City.[5] This shows various approaches to interventions in payment card markets by card type and as a result of either regulation or competition law action.

Australia

115. The Reserve Bank of Australia (**RBA**) has regulated interchange fees and other rules for specific card schemes and types since 2003. The RBA has a mandate to control risk and promote efficiency and competition in the payments system. Given this broad mandate, a Payments System Board ('the Board') is established to have responsibility for the RBA's payments system policy. The Board is made up of two members from the RBA (including the Governor), a member from the Australian Prudential Regulation Authority (**APRA**) and up to five others who have relevant expertise and experience appointed by the Treasurer.

116. The Board has the power to 'designate' payment systems and to set standards and access regimes for these systems (without further legislation). However, it has a presumption in favour of self-regulation by the industry, with it only intervening where the industry is unable to address a public interest concern. This means that, in practice, the Board has imposed regulation in a relatively narrow range of payments system activities, leaving generic competition law to otherwise apply. The RBA and the Australian Competition and Consumer Commission (**ACCC**) have a memorandum of understanding setting out their respective responsibilities in relation to payments systems.[6]

117. Currently the following payment schemes are designated:

    a. Visa and MasterCard credit, debit and prepaid schemes.

    b. The American Express companion card scheme (a companion card is a credit card that is linked to two different schemes e.g. one account with both Visa and American Express functionality).

    c. Australia's EFTPOS scheme.

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[5] Federal Reserve Bank of Kansas City, *Public Authority Involvement in Payment Card Markets: Various Countries. August 2020 Update*. Prepared by Fumiko Hayashi and Jesse Leigh Maniff, 2020. ***https://www.kansascityfed.org/~/media/files/publicat/psr/dataset/pub-auth_payments_var_countries_august2020.pdf***

[6] Memorandum of Understanding between the ACCC and RBA, dated 11 December 2018. ***https://www.rba.gov.au/payments-and-infrastructure/payments-system-regulation/mou/accc-and-the-rba/***

118. In short, in relation to payment card fees:

a. The current credit card regulations have capped interchange fees to a weighted average of 0.50 per cent of transaction value, with a ceiling on individual interchange rates of 0.80 per cent. Compliance with this benchmark is observed quarterly. To address issues of competitive neutrality, interchange-like payments to issuers in the American Express companion card scheme are subject to equivalent regulation to that applying to MasterCard and Visa credit card schemes.

b. The current debit and prepaid card regulations have capped interchange fees to a weighted average of 8 cents per transaction, with a ceiling on individual interchange rates of 15 cents or 0.20 per cent if specified in percentage terms.

c. In the case of credit, debit and prepaid cards, further limits are imposed on scheme payments to issuers that are not captured within the interchange benchmarks so as to prevent circumvention of the interchange caps. That is, issuers are prohibited from receiving 'net compensation' from a scheme.

119. Other rules applying to all designated payment schemes preclude card schemes from applying rules on merchants relating to 'no-surcharging' or from requiring merchants to 'honour-all-products' (which required merchants who accepted a scheme's debit cards to also accept their credit cards and vice versa). The schemes are also required to provide merchants with easy-to-understand information on the cost of acceptance for each designated scheme. The Board has also developed access regimes for the credit card schemes, and facilitated entry and expansion by independent service providers.

120. A review of retail payments regulation by the RBA in 2019 noted that regulation has had a significant effect on the retail payments system[7]. For instance, debit and credit card transactions per capita have increased dramatically since 2004. There has been a substantial increase in the number of new entrants into the payments market. This includes digital wallets and 'Buy Now, Pay Later' products. These innovations have all generally relied on existing payment rails for clearing and settlement of transactions.

121. A further 2020 RBA study (mainly using 2018/19 data) found that[8]:

a. There has been a broad-based decline in average merchant service fees in Australia over the past two decades reflecting various reforms introduced by the RBA.

b. There are still significant differences in merchant service fees for different card networks, with transactions processed through the domestic debit scheme, EFTPOS,

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[7] Reserve Bank of Australia, *Review of Retail Payments Regulation – Issues Paper*, dated November 2019, **https://www.rba.gov.au/payments-and-infrastructure/review-of-retail-payments-regulation/review-of-retail-payments-regulation-issues-paper.html**

[8] Reserve Bank of Australia, *The Cost of Card Payments for Merchants*, Bulletin – March 2020, dated 19 March 2020, **https://www.rba.gov.au/publications/bulletin/2020/mar/the-cost-of-card-payments-for-merchants.html**

being materially cheaper on average for most merchants than the international debit schemes.

c. Merchant-level data also shows that smaller businesses typically face much higher card payment costs than larger merchants, even after the individual interchange cap was imposed in July 2017.

122. The 2019 RBA Issues Paper, however, also identified a number of issues relating to the policy settings for the retail payments system that are continuing to being assessed by the RBA. These include:

a. competition in the cards market, and issues relating to dual-network debit cards and least-cost routing, competition in card acquiring, and transparency of scheme fees

b. interchange fees and net compensation regulation, and issues relating to the principles and methods for setting caps, and changing business models

c. surcharging, and issues relating to differential surcharge, the impacts of changes in technology, and the growth in the use of 'Buy Now, Pay Later' products.

123. In September 2020, the Australian Prime Minister and Australian Treasurer announced a suite of measures designed to accelerate Australia's recovery from the economic impacts of the COVID-19 pandemic. A key element of this package included reviewing the regulatory architecture (or governance) of the Australian payments system (in its broadest sense) to ensure it remains fit-for-purpose and is capable of supporting continued innovation for the benefit of consumers, businesses and the broader economy. Mr Scott Farrell is to lead the review. On 20 November 2020, the Australian Treasury released an issues paper as a first step in that review.[9]

124. These two reviews on regulatory architecture and retail payments policy settings are proceeding in parallel, with the RBA expected to complete its review in 2021 and Mr Scott Farrell to provide a report to the Australian Government by April 2021.

Canada

125. The Canadian credit card market is dominated by Visa and MasterCard. Canada also has a domestic debit card product, Interac, which offers online and contactless functionality (although acceptance is limited). Interac currently operates under an order issued by the Canadian Competition Tribunal which dictates that it must operate on a not-for-profit basis. This means that Interac only charges fees that are sufficient to cover its costs, and it has set its interchange fee at zero.

126. In terms of the schemes, the Competition Bureau attempted to bring a competition law action against the schemes for engaging in price maintenance. This action was dismissed in 2013 by

[9] Australian Treasury, *Payments System Review Issues Paper*, dated 20 November 2020, ***https://treasury.gov.au/consultation/c2020-129951***

the Canadian Competition Tribunal. While the Tribunal found that Visa and MasterCard's conduct was influencing the price of credit card services upwards and having an adverse effect on competition, in its view, regulation of the industry would provide a more appropriate solution than any remedy that the Tribunal could provide.

127. Following the Competition Tribunal's ruling, Finance Canada developed a Code of Conduct for the card payments industry. The key elements of the Code include:

   a. Increased transparency – payment schemes and their participants are required to work with merchants to ensure that merchant-acquirer agreements and monthly statements include enough information and are easy to understand.

   b. Clarifying that a merchant may discount types of payment (but merchants are still prohibited from explicit surcharging by schemes).

   c. Premium credit and debit cards will only be given to consumers who apply for, or consent to, such cards. Premium cards must only be given to 'premium' cardholders (i.e. those who spend, or have more assets than the average).

   d. Rules around how fees are set and varied. For example, merchants must be given 90 days' notice before any variance to interchange. Following notice of a variance, merchants may cancel their contract with the acquirer, without penalty.

   e. Merchants are not required to accept new products. If a scheme introduces a new product or service, the merchant will not be obliged to accept it. The merchant must explicitly express consent. This also applies to contactless cards or terminals. This provision has essentially halted the introduction of Visa debit in Canada.

128. Finance Canada monitors the implementation of the Code and any voluntary commitments made. In particular, in November 2014, Visa and MasterCard separately committed to voluntarily reduce their domestic consumer credit card interchange fees to an average annual effective rate of 1.50 per cent in each year for five years. American Express informally committed to maintain its business model. These voluntary commitments took effect on April 2015 and are estimated to have lowered card fees paid by Canadian businesses by approximately $2 billion over that period.

129. In August 2018, following a review of the effects of 2014 voluntary agreements, Visa, MasterCard and American Express provided new, separate and voluntary commitments. These were designed to address the Canadian Government's objectives for greater fairness and transparency in the payment card market, including by narrowing of the gap between the lowest and highest rates charged to businesses so that small businesses were no longer at a competitive disadvantage.

130. The Visa, MasterCard and American Express commitments took effect in November 2020. They reduce average interchange fees for businesses by up to 15 per cent from their highest levels in 2014, supporting a more level playing field for businesses of all sizes. The reduction in

interchange fees is expected to save small and medium-sized businesses in Canada $250 million per year, based on credit card sales of roughly $250 billion per year.[10,11]

European Union

131. The European Union introduced a number of payment systems regulatory measures in 2015. These were achieved through the revised Directive on Payment Services (PSD2), and through the Regulation on Multilateral Interchange Fees. The effect of this is that member states must:

    a. Regulate interchange fees.

    b. Require acquirers to disclose to merchants the costs of accepting payment associated with each transaction (i.e. unbundle).

    c. Designate a competent authority to supervise interchange regulation and give it the appropriate powers to enforce the regulation.

    d. Support open access by ensuring that consumers have the right to use third-party payments software to execute payments on their behalf. This means that third parties have the right to use a consumer's banks details to make 'direct entry' payments.

132. The interchange rates set by the European Union are based on a 'Merchant Indifference Test'. This is where the interchange fees are set at a rate which renders a merchant indifferent to whether it accepts payment via card or cash from a one-time customer. The current rates are:

    a. 0.2 per cent of the transaction for Visa and MasterCard consumer debit cards

    b. 0.3 per cent of the transaction for Visa and MasterCard consumer credit cards.

133. In addition, surcharging for interchange-regulated cards has been banned. The rationale for this is that where interchange fees are capped at such a low level and the costs of accepting card transactions substantially reduced, surcharging is no longer justified.

134. The European Commission has taken a number of competition law cases against schemes for cross-border interchange since the 1990s. For example, in separate cases the European Court of Justice confirmed that MasterCard and Visa's interchange fees for cross-border payments restricted competition in breach of the EU's competition rules.

135. On June 2020, the European Commission published a report on the impact of the interchange fee regulation for card-based payment transactions.[12] The report concludes the main objectives of the regulation have been achieved. The report found:

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[10] Department of Finance Canada, Backgrounder: New Voluntary Commitments from Payment Card Networks, dated August 2018, ***https://www.canada.ca/en/department-finance/news/2018/08/backgrounder-new-voluntary-commitments-from-payment-card-networks.html***

[11] Bank of Canada, *The Market for Acquiring Card Payments from Small and Medium-Sized Canadian Merchants, staff discussion paper, dated 4 June 2020.* ***https://www.bankofcanada.ca/wp-content/uploads/2020/06/sdp2020-5.pdf***. This paper mainly uses data from 2015.

a. interchange fees for consumer cards have decreased by 35 per cent between 2015 and 2017

b. merchant service fees for card payments have also declined, which may in part also be attributable to increased price transparency rules to inform merchants' decisions. Even so, the majority of merchants (60 per cent) both large and small continue to stick to the default of one blended fee

c. lower fees are likely to result in improved services to consumers and lower consumer prices, with estimated annual consumer cost savings of between EUR 864 and 1,930 million

d. it is too early, however, to assess some elements of the regulation and further monitoring is required.

United States of America

136. There has been a mixed approach to ensuring that payment systems in the United States produce good economic outcomes. Debit rates are regulated by the Federal Reserve, while the rules around credit have mostly evolved out of competition law litigation.

137. There is a history of competition law litigation in the United States against credit card companies. Key features of the credit card market resulting from this litigation include:

a. Visa and MasterCard no longer impose a contractual 'no-surcharge' rule on retailers (as a result of a 2013 settlement between Visa, MasterCard and retailers). However, nine states, which account for 40 per cent of the population, still have a statutory no-surcharge prohibition.

b. Visa and MasterCard agreed to negotiate interchange fees in good faith (2013 settlement).

c. 'Honour-all-cards' rules exist, however due to a settlement in 2003 with Wal-Mart, Sears and other retailers, merchants who accept scheme debit do not have to accept scheme credit.

d. Contractual restrictions on no-minimum purchase rules are restricted, enabling merchants to set a minimum credit card purchase of up to $10.

e. Merchants can discount payment types, but not differentiate within payment types (e.g. they can discount cash, but not Visa over MasterCard).

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[12] European Commission, *Report on application of Regulation (EU) 2015/751 on interchange fees for card-based payment transactions*, staff working document, dated 26 June 2020. ***https://ec.europa.eu/competition/sectors/financial_services/IFR_report_card_payment.pdf***

138. Debit card interchange rates were regulated in 2010 as part of a last-minute amendment to broader financial reform. The purpose of regulation was to lower merchants' cost of accepting payment and to pass the cost savings onto consumers in reduced prices.

139. The reforms require the Federal Reserve to set the debit interchange rate at a level that is reasonable and proportional to the cost incurred by the issuer. The regulation stipulates that the issuer subject to the interchange fee standard may not receive an interchange fee that exceeds 21 cents plus 0.05 per cent multiplied by the value of the transaction, plus a 1 cent fraud-prevention adjustment, if eligible.

140. Since regulation took effect on October 1, 2011, neither the average interchange fee per covered transaction nor the average interchange fee per exempt transaction have changed significantly. [13]

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[13] Board of Governors of the Federal Reserve System, ***https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm***.