About CMSPI

CMSPI is a global leader in retail payments consulting. Our expert team works to empower the retail community with insights, expertise, benchmarking, and analysis to drive value in their payments supply chain. This consultation response was constructed by CMSPI's market-leading '***Insights Team***', which is made up of economists, data and statistical experts, and experienced payments professionals. We have structured our response to reflect the key areas of the consultation document in which CMSPI can offer unique insights.

CMSPI Response to the Ministry of Business, Innovation and Employment (MBIE)

CMSPI welcomes the MBIE's review into regulating Merchant Service Fees, and the suggestion of introducing hard caps on interchange such as those seen in Australia, the U.S., and the European Union.

Impacts of Interchange Fee Regulation

Our recent review into interchange fees globally found that interchange regulation has generated over $82 billion USD in annual savings for merchants across the world. For Australia, which shares some of the nuances of the New Zealand market such as a local debit network, this figure is around $1.43bn USD.[1]

CMSPI has estimated the impact to New Zealand's merchants of implementing EU-style interchange caps of 0.2% and 0.3% for debit and credit card transactions, respectively. Based on 2019 volumes, we find that these caps could generate annual savings of $284 million NZD.[2] Taking findings from the EY Interchange Fee Regulation Review and the Shapiro Study (covering the European Union and U.S. regulation, respectively), we estimate that 71% of savings from such regulation are passed through to consumers in the form of lower prices.[3]

Merchant Fees in New Zealand

[1] CMSPI (2020). Global Review of Interchange Fee Regulation. https://cmspi.com/eur/resources/download-global-interchange-report/

[2] CMSPI estimates based on 2019 card expenditure using Reserve Bank of New Zealand data: https://www.stats.govt.nz/assets/Uploads/Electronic-card-transactions/Electronic-card-transactions-November-2020/Download-data/ect-nov20-tables.xlsx. Proportion of expenditure by network, card type, and channel taken from Worldpay Global Payments Report (2020). Data on current interchange fees from Federal Reserve Bank of Kansas City (2017).

[3] CMSPI (2020). Global Review of Interchange Fee Regulation. https://cmspi.com/eur/resources/download-global-interchange-report/

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As is noted in the consultation document, merchants in New Zealand are charged higher fees for the acceptance of card products than in many other countries. This is especially so for online, credit, and contactless debit transactions, which are not supported by the local Eftpos debit network. Average interchange on credit cards in the face-to-face environment was around 1% on Mastercard and 0.8% on Visa cards in 2017. Online, the average fee in 2017 rises to above 1.2% for both networks.[4]

Although the Eftpos network's lower fees are beneficial for merchants, the competitive discipline it can exert is increasingly limited by the rise of contactless payments and ecommerce in New Zealand. Figure 1 illustrates the market shares of Visa, Mastercard, and Eftpos in Australia before the RBA's decision to protect merchants' ability to route contactless transactions down the local network. This pattern of falling market share, and the higher fees that come with it, is likely to be even more extreme in New Zealand as the Eftpos network does not support contactless payments altogether. The transition to contactless is also likely to be more rapid given the covid-19 crisis and the decision by some acquiring banks to temporarily waive contactless debit fees.[5]

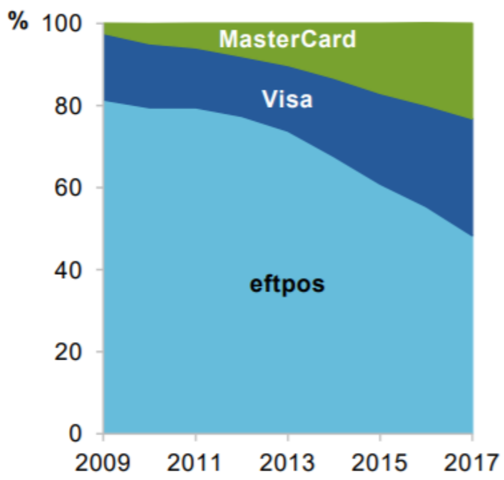

Figure 1 – Eftpos, Mastercard, and Visa Market Shares in Australia Over Time[6]

[4] Federal Reserve Bank of Kansas City (2017). Credit and Debit Card Interchange Fees in Various Countries.
[5] Eftpos (2020). Guide to Contactless Payment Methods. https://blog.Eftpos.co.nz/blog/guide-to-contactless-payment-methods#contactless
[6] https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf

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Given that other countries with zero-interchange domestic networks (e.g. Dankort in Denmark) have opted to regulate interchange, we believe that regulation remains necessary and can be used to protect the benefits of a local debit network through provisions such as co-badging.

Preserving the Long-Run Benefits of Regulation

In our review of interchange regulation globally, we note three main channels through which the savings from regulation can be eroded by actors within the payments supply chain. We believe that additional provisions within the legislation could ensure that its positive effects are safeguarded.

1 – Acquirer absorption. Particularly if merchants are on a 'blended' fee structure, acquirers are able to claim some of the savings from interchange regulation as additional margin and avoid passing them on to merchants. Estimates from the EY study into E.U. regulation suggest that around 45% of the reduction in interchange was absorbed by acquirers.[7] A recent report by the UK's Payment Systems Regulator found that this issue was especially stark for smaller merchants; their study showed that merchants with annual turnover of up to £50 million saw little or no pass-through of interchange savings.[8]

Mandating 'interchange++' pricing structures could ensure that savings are passed on to merchants and their customers, and speaks to question 12 of the consultation regarding provisions to protect smaller merchants. A similar provision was included within the E.U. legislation but was largely treated as an 'opt-in' by acquirers, highlighting the importance of the proper monitoring and enforcement of regulation, particularly in the interests of smaller merchants who may not command sufficient resources to monitor pass-through.[9]

2 – Network fee increases. Network fees are paid by a merchant, via their acquirer, to card networks such as Visa and Mastercard. Experience from Australia, Europe, and the U.S. suggests that they pose a significant threat to interchange regulation. Across these three jurisdictions, our estimates suggest that successive network fee increases have, over time, eroded 40% of annual interchange savings.[10] The presence of a local debit network has not limited this impact; in Australia, the average network fee increased by 16 basis points between 2006 and 2013 (see Figure 2).

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[7] See European Commission Study on the application of the Interchange Fee Regulation.
[8] Payment Systems Regulator (2020). Market review into the supply of card-acquiring services: Interim report. https://www.psr.org.uk/publications/market-reviews/mr18-1-7-market-review-into-the-supply-of-card-acquiring-services-interim-report/
[9] See Article 9 of Regulation (EU) 2015/751
[10] CMSPI (2020). Global Review of Interchange Fee Regulation. https://cmspi.com/eur/resources/download-global-interchange-report/

Figure 2 – Network Fee Increases by Region[11]

These network fee increases, in conjunction with acquirer absorption, are estimated to have completely eroded the benefit of the Interchange Fee Regulation (IFR) in Europe where the average Merchant Service Charge (MSC) is estimated to have increased from 46 basis points in 2015 to 48 basis points in 2020.[12] [13] Including network fees within New Zealand's legislation would therefore preserve the benefits of regulation for merchants and consumers in the long-run.

3 – Issuer loss mitigation. One area that the consultation addresses is the role of rewards in the retail payments system. Cardholder rewards can act to steer consumers towards more expensive payment methods at the point of sale, generating additional cost for New Zealand's merchants who

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[11] Europe and U.S. network fees estimated using retail data. Europe estimates include inter-regional transactions and exclude local networks. Percentage fees for Australia were calculated using average transaction value of card spend in Australia from Euromonitor. Australian network fee data from: https://www.rba.gov.au/publications/rdp/2014/pdf/rdp2014-14.pdf

[12] The estimate for the average MSC in Europe in 2015 has been taken from the European Commission's study on the Interchange Fee Regulation (EY Study). The estimate for the average MSC in Europe in 2020 is made using data from the EY study as well as analysis of retail data. For more information on sources, please refer to the Study published in the following press release: https://www.eurocommerce.eu/resource-centre.aspx#All/13565

[13] The European case is illustrated in Figure 2 through reference to the UK, which transposed the EU's IFR into its domestic law following withdrawal from the European Union.

do not tend to apply a surcharge.[14] However, they may also be an avenue through which issuers can dilute interchange savings. We calculate that, in the Australian case, issuers were able to recover 19% of their losses from interchange regulation through reducing the generosity of card reward programmes. The figure was around 20% in the UK.[15]

However, this is not an indication that banks are dependent on interchange; in the US in 2019, average rewards expenditure was estimated at 65% of interchange revenue, indicating a 35% margin on the fee. In fact, in 2018 the Australian Productivity Commission recommended abolishing interchange altogether.[16] This recommendation was made on the basis that, although interchange costs may fund things like reward programs that are useful in expanding card networks in their infancy, a mature card market should not require such incentives.

Cobadging

In addition to regulating network fees and requiring 'interchange++' pricing by default, we further believe that mandating 'co-badging' for all cards would have a positive effect on competition and acceptance costs. Although most debit cards in New Zealand are co-badged with the domestic Eftpos network, we have recently had reports in other jurisdictions of attempts to bypass local debit networks through 'mono-badging' by international card networks.

Evidence from around the world shows that co-badging cards to allow Least-Cost Routing successfully introduces competition into the otherwise highly concentrated payments industry. A key example of this is in the U.S., where rules to introduce co-badging were introduced as part of the Durbin amendment to the Dodd-Frank Wall Street Reform Act in October 2011.

However, in the U.S., co-badging laws were only extended to the single message debit market and not the dual message debit market.[17] In the dual message market, Visa and Mastercard continue to be the only networks included on the card so Least-Cost Routing is not possible for merchants. The result we have observed is that dual message exempt interchange and network fees have increased since Durbin, while single message exempt interchange and network fees have decreased (Fig. 3 & 4). In fact, dual message transaction fees are now more than double single message fees. Quite

[14] https://retail.kiwi/wp-content/uploads/2020/09/RetailNZ-2018PaymentsSurveyReport.pdf
[15] Estimated by tracking the change in rewards programs offered by the largest banks in the UK and Australia. CMSPI (2020). Global Review of Interchange Fee Regulation. https://cmspi.com/eur/resources/download-global-interchange-report/

[16] https://www.pc.gov.au/inquiries/completed/financial-system/report
[17] Single message refers to transactions where authorisation and settlement take place at the same time. Dual message refers to transactions where authorisation and settlement take place separately, with settlement typically taking place one day after the transaction is authorised.

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simply, we think this huge pricing differential reflects the difference between a competitive and a non-competitive market.

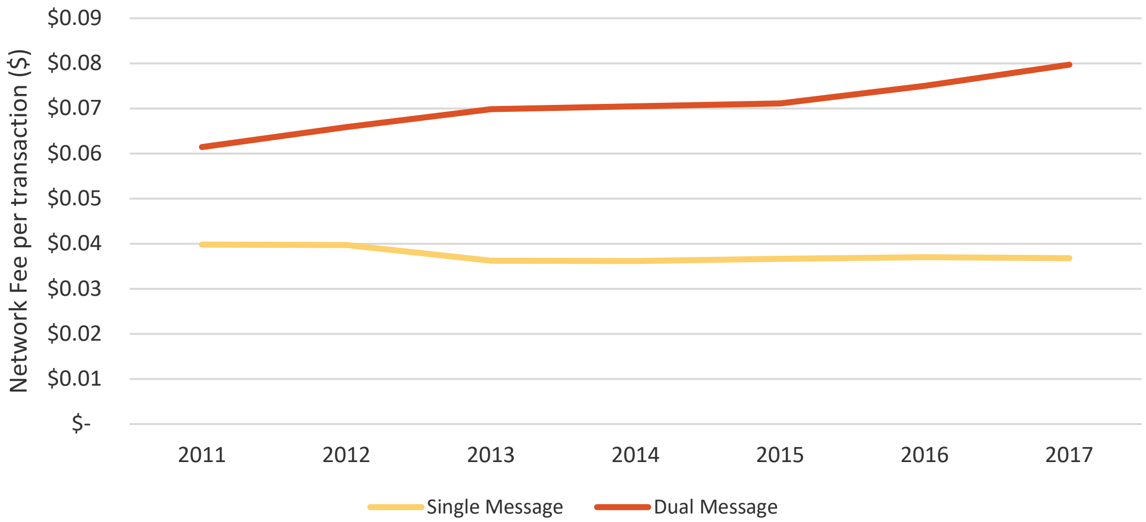

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Figure 3 – Debit Card Network Fee Comparison[18]

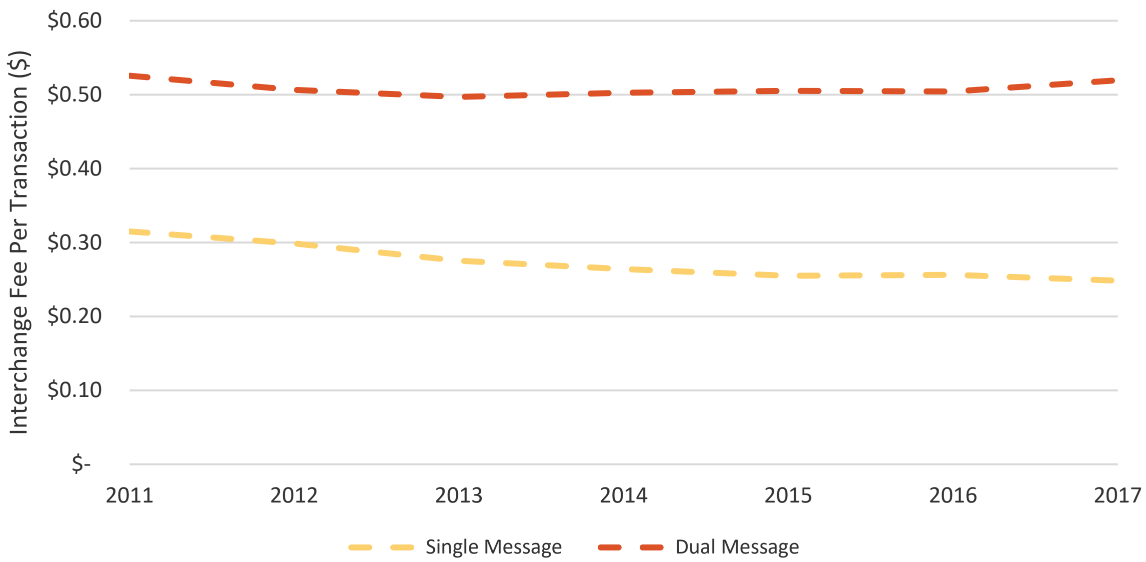

Figure 4 – Exempt Debit Card Interchange Comparison[19]

On this basis, it is clear that the Eftpos network needs to be protected. Eftpos is one of a number of national debit card networks across the world that is vulnerable to the market power of Visa and Mastercard, including the numerous U.S. local networks, Girocard in Germany, Carte Bancaire in France, BankAxept in Norway and Interac in Canada. These networks generally offer merchants more competitive pricing than Visa and Mastercard – especially so in New Zealand's case - and typically have not-for-profit business models and pricing based on cost recovery.

Regulators

Question 20 of the consultation document refers to the importance of selecting the correct body to regulate interchange. Given that central banks are primarily concerned with the financial stability of banking systems, we believe that there is the potential for greater leniency towards issuers and an upward bias in the chosen caps when regulation is implemented by a central bank. In Europe, this responsibility is instead delegated to the European Commission, whereas in other regions such as

[18] https://www.federalreserve.gov/paymentsystems/regii-data-collections.htm

[19] https://www.federalreserve.gov/paymentsystems/regii-data-collections.htm

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the UK an independent payments regulator has been created. We believe a similar approach would be optimal to maximise savings for the end users and intended beneficiaries of interchange regulation.

Summary

CMSPI welcomes the MBIE's proposal to regulate interchange in New Zealand, particularly given the increasing use of contactless and online payments which act to increase merchants' average acceptance costs. Our estimates suggest that implementing EU-style caps could generate $284 million in annual savings for merchants. However, we believe that the benefits of such regulation can only be preserved in the long-run, and small merchants protected, if additional provisions are included to mandate 'interchange ++' pricing and to regulate network fees. Eftpos would be further protected by a provision to mandate the co-badging of debit cards, allowing merchants greater bargaining power with the networks themselves. Finally, the presence of an independent regulator is crucial to ensure that savings from regulation are safeguarded for merchants and consumers alike.

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