Regulating to reduce Merchant Service Fees

Your name and organisation

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

We welcome the Government's ambition to ensure New Zealand (NZ) has a competitive, innovative, efficient and fair payments ecosystem. We believe opportunities exist to drive innovation and to remove costs, duplication and redundant technology. By extension, the goal must be to future proof the system and deliver increased value for all users of NZ's payments system.

We welcome the efforts of the Government to take a systems-wide approach and learn from other markets. There are numerous examples where countries have implemented forms of regulation, but there are few examples where the end result is reduced costs for small merchants without broader negative effects on the ecosystem. Moving through the consultative process we look forward to further discussion around how government intends to mitigate these unintended consequences, particularly given the unique context of the NZ retail payments network.

The proposed approach in the consultation presents a number of statements as fact, without providing much in the way of evidence. For proposed regulation to have the best chance of achieving the intended result, the consultation would benefit from MBIE releasing their analysis (as is usually the case with government consultations) to support statements like:

- NZ merchants pay… *"nearly twice as much as their Australian counterparts for some transaction types."*[1]

- *"Many merchants pass on the costs of the payment system by charging higher prices for goods and services."* [2]

Whilst we appreciate MBIE is collecting more data as the consultation progresses, it is clear the consultation would benefit from the release of the analysis to ensure respondents better understand the areas of focus and engage in a more robust data-driven discussion.

Our concern around the proposed approach outlined is:

- The consultation **focuses purely on the cost to small merchants**, rather than the value delivered. Regulating on this basis both misrepresents merchant needs and the dynamics of a well-functioning retail payments ecosystem.
- The consultation explicitly **excludes the topic of safety and security**, saying these are RBNZ's responsibility. This is a dangerous omission considering the current state and future of a retail payments system where security is paramount.
- The consultation **focuses on interchange and Merchant Service Fees (MSF) rather than on all the drivers of payment costs and value to small merchants, plus others in the NZ ecosystem** (detailed in question 2).
- The barriers to – and the role of – competition and innovation in NZ to deliver more value to the retail system is underplayed, as is the opportunity to also consider innovation and advancement in account-to-account infrastructure and services (detailed in question 17)
- We believe the consultation would benefit from **separating card-present transactions and card-not-present transactions** given a very different value and complexity (detailed in question 19).

[1] MBIE Issues Paper-Regulating to Reduce Merchant Service Fees December 2020 p. 9
[2] Ibid p.7

Focus on cost not value
The proposed approach, driven by an almost exclusive focus on merchant costs, understates the value of electronic payments to New Zealand merchants and the broader economy. There are an increasing number of participants in the ecosystem, all of whom have a role to play in delivering safe, secure and seamless payments to merchants and cardholders.

Merchant Service Fees (MSF), which of course include interchange, play a vital role in the payments ecosystem. MSF is what merchants are charged to accept payment, while the interchange element helps subsidise the value that issuers that provide in products to end consumers or small business owners.

To understand the costs of any form of payment, it is important to account for the value derived from different options. In the case of electronic payments, both paying by card and accepting cards provides tremendous benefits to participants and to the wider economy.

For the economy:
The benefits of increasing the proportion of electronic payments in the economy include:
- **Greater access to global markets** – New Zealand businesses and consumers can easily trade with anyone around the world
- **Facilitating government services** – Electronic payments are used around the world to deliver services like public transport ticketing, digital Identification and disaster recovery
- **Supporting the tourism sector** – Being able to pay by card improves tourist experience and enhances New Zealand’s reputation as a tourist-friendly destination, supporting the ongoing growth of this critical sector
- **Reducing the shadow economy** – Electronic payments increase transparency and traceability in the economy, reducing tax avoidance and criminality. As a result this increases government revenues.

For consumers:
- **Safety and security** – Interchange covers some cost of fraud protection, so cardholders are protected in the event of a fraudulent transaction. For example, in the event of a stolen card, Mastercard cardholders are protected from fraud or unauthorized transactions under Mastercard’s Zero Liability Policy as long as they have not contributed to the fraud. Continued investment in EMV chip technology has also enhanced the anti-fraud capability of cards, adding an extra layer of protection not possible with magnetic stripe cards.
- **Flexibility** – Not only does interchange allow businesses to accept cards, in the case of credit cards it pays for quantifiable items like fraud mitigation and interest-free days.
- **Convenience** – Payments also allow consumers to access money whenever and wherever they want, whether in-person, online or in-app. Innovations like contactless and mobile payments would not have been possible without investment by payment schemes and the banks.

For businesses:
- **Peace of mind** – Merchants who accept contactless transactions in a face-to-face environment, or transactions verified by 3DS2.0 in an online environment are protected by the cost of any subsequent fraud. By accepting tokenised transactions, merchants benefit from lifecycle management – expiring card details especially for

recurring transaction or subscription services has historically been a pain point for merchants.

- **Guaranteed payment** – Electronic payments are made directly to a business' bank account, reducing the risk of theft or loss that comes with cash. Without cards, retailers would have to provide customer accounts, at a cost which would far exceed that of interchange; or simply refuse certain transactions.
- **Reduced administrative costs** – Accepting cards reduces the significant costs associated with counting, safeguarding and transporting cash, limiting the losses that occur when cash received is lost or stolen. The cost of cash is estimated to be 2.3 per cent, comparable to interchange or a merchant service fee.[3]
- **Faster acceptance** - In-store, face-to-face innovations like contactless payments enhance customer and merchant experiences, particularly in high-traffic segments where fast transaction times are important. Contactless payments are up to ten times faster than cash and 'Chip and PIN' (dipped) card transactions[4], which reduces queuing and transaction times.
- **Boosted sales** – Studies show that consumers spend more when they use cards and businesses make more money when they accept cards:
    - Debit and credit transactions are between two and six times larger than cash purchases[5]
    - Premium credit products result in larger transactions
    - New Zealand merchants are the main beneficiaries from overseas visitors using their cards, with incremental sales generated through a combination of larger transactions and the ability to accept larger, cross-border and card-not-present transactions.

While the Issues Paper references the impact of COVID-19 on business costs, it fails to acknowledge the importance electronic payments - particularly online payments - have played maintaining business activity during lockdown. Analysis by the New Zealand Post states:

> *"After a small decline at the start of lockdown, overall online sales saw a huge increase during Alert Levels 4 and 3."*
>
> *"Online spend peaked in late April as the country moved to Level 3. On that week shoppers could finally have their 'non-essentials' purchases delivered, driving spend to 105% of the same week a year earlier. $1 in every $4 spent that week through New Zealand was online!"*[6]

Once New Zealand moved out of Level 4 lockdown, innovations in payment acceptance allowed New Zealand businesses to continue to trade in a manner safer to both customers and staff. Examples of this include Burger Burger introducing QR codes to allow customers to order and pay at their table, and the increased use of ordering apps such as Regulr to allow customers to order and pay contactlessly via an app.

The New Zealand payments market has evolved significantly over the past few years. New entrants, technologies, payment options and the introduction of new products and innovations by companies like Mastercard are proof of a competitive, dynamic sector that needs a regulatory framework to promote this evolution rather than inhibit it.

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[3] Peter T Dunn & Company, **Illustrating the Value Provided by Electronic Payment Products**, New Zealand April 2016 p.4
[4] See Deloitte, Contactless Payments Technology: Catching the New Wave, pp. 6-9
[5] ibid
[6] NZ Post eCommerce Spotlight. The Covid-19 Special Edition July 2020 https://thefulldownload.co.nz/covid-spotlight

Exclusion of safety and security:

There is no area where cost versus value is more acute than safety and security. Numerous recent public and private sector breaches provide a timely reminder of the devastating impact of purely cost-based security decisions.

The rollout of the 5G network, advances in artificial intelligence (AI) and the development of the Internet of Things (IoT) will result in a different payments landscape than exists today. While card-not-present transactions will continue to grow, “person not present” transactions – for example, those that allow a fridge to order more milk will increase pressure on domestic-only systems that are systemically underfunded. Electronic payments are playing a critical role in the digital transformation of the economy.

Our more connected, digitised world also poses cybersecurity challenges. The shift to online payments has significantly increased the risk of fraud and data theft for consumers. Threats to consumer information, and the potential for payments fraud against retailers, can occur at more points in the transaction flow as transactions become more complex. CERT NZ reports that cyber security incidents were up 33 per cent in Q3 2020 compared to Q2, with $6.3 million in direct financial loss reported.

A comprehensive approach to managing these risks is vital and it must focus on approval, security and, importantly, the consumer experience. The nature of the threat is different through the consumer and retailer journey. Mastercard is at the forefront of preventing fraud in all its forms and maintaining system security and resilience. By using biometrics, data and tools like AI and machine learning, Mastercard protects the ecosystem from the beginning (e.g. at account log in) through to making the payment and finally, to any disputes that may arise. At the same time, we ensure a high-quality consumer experience, resulting in more sales for retailers. Mastercard looks at the process from end-to-end in its focus on contributing to safety, efficiency and resilience for consumers and merchants in this new ecosystem.

It is critical that any proposed regulatory framework does not inhibit the capacity of payment system participants to continually invest in a safe, secure, innovative, competitive and efficient payments system.

Interchange compensates issuers for investments that they continue to make in improving the safety and security of the payments ecosystem. Cyber risks are a fast-evolving space, and so this necessary, proactive investment is ongoing – particularly in the card-not-present space, where interchange rates are typically higher. In the last 12 months Mastercard – along side our issuing and acquiring partners - has invested a huge amount of resource and time into implementing the following to continue upgrading the ecosystem for all participants:

- **Network tokenisation**- replaces the original card number with a surrogate value called a token, and attaches a cryptogram for each transaction. In the instance of a data compromise, no fraudulent transactions can be made using the token. Lifecycle management gives real time access to updated account details meaning merchants and cardholders will experience fewer false declines[7].

7 The removal of card data removes the value of NZ card details - https://www.stuff.co.nz/business/124013101/kiwi-identity-theft-how-much-is-your-identity-worth-on-the-dark-web

- **EMV 3DS** - provides next generation customer authentication reducing fraud, false declines and customer friction. When EMV 3DS authentication has been used, the merchant is not liable for fraudulent transactions. Mastercard data from Australia shows a 27 basis point (bps)fraud reduction for fully authenticated transactions vs non authenticated transactions[8].

Issuers also provide zero liability to their customers for any unauthorised transactions, and provide chargeback protection to a consumer or small business should a merchant not be able to fulfil its obligation to provide goods and/or services as described.

These investments deliver huge value to the merchant as part of their MSF. We have seen how the ability to move to safe and secure in-app and online payments, for example, has driven unprecedented growth for NZ businesses over the last 12 months. Accepting these increasingly authenticated and tokenised payments decreases risk and cost for merchants and provides peace of mind in the face of increasing cyber threat considerations. Nowhere is this more important than for small merchants who will often not have the bandwidth or resources to invest in incremental cyber defences of their own, and for whom a breach would be catastrophic. Their reliance on a system which has security at the heart of it, is critical.

It is also important to note that 29 per cent of card-present transactions and 30 per cent of card-present value in NZ still runs through magstripe transactions on EFTPOS proprietary cards[9]. This technology, created in the 1960s and popularised in the 1980s, is inferior to the EMV standard which has now been universally adopted in markets around the world.

While we understand that magstripe proprietary EFTPOS cards are considered important for certain segments, and provide a 'low cost' option in the NZ market, we believe this risk should be flagged as part of the design of a future retail payments system for NZ.

Investments into safety and security are difficult to quantify as they most often about ensuring potential events do not happen. But it is critical for an effective retail payments system to be able to continually invest in this space as bad actors are doing, and so our strong recommendation is that the government considers both the cost and value of the safety and security of the retail payments system as an integral part of this consultation.

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

The Issues paper refers to EFTPOS as *"essentially fee-free"*.
EFTPOS is often misunderstood as a "free" payment option because there is no interchange and so for a merchant it appears *'essentially fee-free'*. However, there are costs relating to EFTPOS borne by other participants in the ecosystem (including merchants). These costs vary by size and the type of participant. To increase the chances of regulation achieving the objectives set out in this consultation, we would recommend the value and cost of EFTPOS for each party in the ecosystem be better articulated and considered.

Conversely, because the EFTPOS business model does not distribute cost and value across all parties in the ecosystem, and is therefore just a cost for issuers with no clearly attributable

[8] Mastercard Australia data Q4 2020 for issuers using their own ACS for 12 months
[9] Dec PaymentsNZ data. We understand that a portion of the dipped debit volume, originating on scheme cards but switched via EFTPOS, is also magstripe rather than EMV, but we do not have visibility of the proportion.

revenue, there has not been investment in the technology that runs in the background, specifically the switch. In fact, as approved by the previous government, the main banks in NZ sold the operator of the switch (Paymark) to a French multinational (recently sold to another French multinational).

When comparing other markets, it is important to note EFTPOS in Australia and Interac in Canada are schemes (the EFTPOS set of rules, and the main operator of the switch in NZ, are not) that operate an interchange model, enabling cost and value to be spread across the system. They are also both owned by domestic entities.

The focus of international schemes like Mastercard has been to make their networks more secure while also investing in innovation to deliver greater value to customers and end users. As a result, Mastercard products have significant extra functionality and safety features.

Mastercard partners with domestic switches and schemes around the world to increase security and functionality – for example JCB in Japan leverages our Chip. We are very open to engaging in these discussions for NZ.

'Switch to issuer' transactions are not always EFTPOS transactions.
There are a number of 'switch to issuer' models:

- EFTPOS transactions
- Bilateral relationships between merchants and issuers
- 'on-us' transactions where the issuer and acquirer are the same entity
- Online transactions where a gateway switches a transaction to an issuer and advises the acquirer

Therefore it would be more accurate to refer to EFTPOS rails and scheme rails.

It is then important to consider who processes that transaction, and what value is delivered as a result. If Mastercard switches the transaction we provide:

- Safety Net – an AI based security monitoring solution that monitors transactions in real-time to detect and block fraud on all channels;
- Any proactive BIN blocking as a result of fraud detected above;
- Stand-in authorization – this service enables merchants to process the sale even when the bank's system is unavailable, without disrupting the consumer experience, and enabling them to continue trading;
- Decision Intelligence – a network-based risk decision tool that leverages proprietary data and machine learning to deliver a score for transactions, passing those risk scores to the banks to reduce fraud and minimize false declines;
- Ethoca – intelligence sharing between banks and merchants on the network and helps resolve queries for online transactions before they become disputes or fraud claims. Ethoca lowers operational costs for issuers, merchants and acquirers and reduces fraud at the source;

In addition, where we switch the transaction, we are able to offer issuers a range of additional services to their customers including for example:

- Mobile payments – as these are tokenised transactions and require the scheme switch to detokenise;
- Card controls (spend limits, turning on/off certain types of transactions e.g. cross border, card block etc.);

- Loyalty points redemptions at the point of sale.

Acquirers are increasingly not banks:
The acquirer definition refers to acquirers as being "typically a bank". This is rapidly changing in New Zealand, particularly regarding card-not-present acquiring. There are now more non-bank acquirers than bank acquirers in New Zealand, including Windcave, Adyen, Stripe, Worldpay and Checkout.com; the market share of this segment is growing. More participants means increased competition and choice for merchants, and many of these acquirers have a strong focus on innovation and improved customer experience.

The role of interchange:
The Issues Paper suggests issuers use interchange, in large part, to offer cardholder rewards. This assertion is incorrect.

Interchange fees reflect the value merchants receive from accepting scheme products and play a key role in balancing the costs and benefits that consumers and merchants derive. Mastercard does not earn revenues from interchange fees.

Generally, interchange fees are collected from acquirers and paid to issuers to reimburse the issuers for a portion of the costs incurred. These costs are incurred by issuers in providing services that benefit all participants in the system, including acquirers and merchants, whose participation in the network enables increased sales to their existing and new customers. Interchange pays for tangible and measurable elements of the transaction, including:

- guaranteed payment to merchants, whether the cardholder repays their purchase or not;
- efficiencies in the delivery of new and existing products;
- improved experiences for their customers;
- the cost of fraud mitigation and losses;
- continued investment in systems and products to help reduce cyber risk;
- constant innovation, product development and go-to-market activities;
- cardholder benefits, and
- dispute and fraud resolution;

It is important to note that particularly for new entrants in the transactional space, interchange is an important revenue line to support new propositions to market.

In NZ, Mastercard establishes "default interchange fees" that apply when there are no other established settlement terms in place between an issuer and an acquirer. We administer the collection and remittance of interchange fees through the settlement process.

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.

	As the Issues Paper notes, there has been a reduction in the weighted average interchange for international scheme transactions as well as reductions in MSF for contactless debit transactions. Mastercard also reports weighted average interchange to the Minister of Commerce on a regular basis. Additionally, the Issues Paper points out *"…many of the banks have announced that merchants will not be charged more than 0.7 per cent to process contactless debit card transactions."* In relation to Mastercard, weighted average interchange for card-present debit transactions has fallen from 0.32 per cent in December 2016 to 0.18 per cent in December 2020. 2019 research undertaken on behalf of Mastercard found the *"quantitative value provided to merchants from electronic debit products is more than twice the total cost of acceptance (3.64% vs. 1.40%)"* and *nearly twice the total cost of acceptance to the merchant (6.20% vs. 3.40%)"* for credit payment products.[10] For any international comparison in the context of a like-for-like analysis of merchant cost, it is important to consider all types of retail payments.
4	What is your view on charges incurred by cardholders for the use of payment methods?
	Consumers make active and considered choices about how they pay, including whether to use cash, cheques, cards, Buy Now Pay Later, or any other form. As highlighted in the issues paper, electronic payments including contactless and online, have grown significantly in recent years. This suggests cardholders correctly perceive they get greater value when they pay by card (including convenience, safety, security, and other benefits) compared to the costs. Put simply, if the costs of card payments exceeded the value provided, consumers would not use cards. In markets where interchange has been regulated we have seen an increase in cardholder costs as issuers look to recover lost revenue through items like increased annual fees and other charges (covered further in question 21).
5	What impacts do you believe rewards and inducements have on the retail payments system?
	Cardholders (including many small business cardholders) and merchants make rational decisions about how they pay and, in the case of merchants, what form of payments they will accept and how they will accept them (for example, with a surcharge). The economics of electronic payments relies on a balance. In the case of interchange for example, the rate must be set low enough to encourage merchant acceptance and high enough to compensate issuing.
6	What is your view on charges incurred by merchants for the use (acceptance) of payment methods?
	We have outlined our response to this in question one.

[10] Peter T Dunn & Company- Illustrating the Value Provided by Electronic Payment Products New Zealand 2019. pp10-11

7	**Please provide your views on barriers to merchants steering consumers to lower cost payment methods and the extent that steering occurs?**
	We do not believe that there are barriers to merchant steering beyond the desire for a businesses to match the preferences of their customers
8	**Please provide your views on the barriers to merchants surcharging and the extent that surcharging occurs?**
	It is incorrect to assume that a low rate of surcharging by merchants is a result of anything other than a rational decision being made by a merchant about the benefits of accepting cards compared to the costs. While the cost of accepting cash and card payments is broadly comparable, card payments provide tremendous extra value: increased spend, fraud protection, traceability, and the greater security of guaranteed payment for merchants, all delivering ease and convenience for both consumers and merchants. Merchants make decisions that grow their customer base. As Gans and King pointed out in a 2002 paper: *"…when surcharging occurs the interchange fee is neutral, and hence, both association attempts to increase profits and regulatory intervention to improve welfare will be fruitless."*[11] In most jurisdictions which regulate interchange, surcharging is not allowed. This is because regulators appreciate the point made by Gans and King. Mastercard strongly believes that should interchange be regulated, surcharging should be prohibited. Australian regulators were required to place restrictions on allowable costs for surcharges because there, some merchants saw it as an opportunity to generate additional revenue.
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?**
	As noted above, the value merchants gain from accepting electronic payments is greater than the cost of acceptance. As the Issues Paper rightly points out, the costs associated with cards that come with a high level of cardholder benefits are largely borne directly by the end consumer through charges such as annual fees. In any event, within an appropriate regulatory framework, technology exists that allows for card types to be identified at point of sale, so that the minority of merchants who choose to surcharge could apply differential surcharges based on the costs of acceptance for specific categories of cards. However, differential surcharging between card categories (foreign/domestic, standard/premium) would lead to a poor consumer experience, particularly for overseas tourists who may not understand why they are being surcharged while locals are not.

[11] Gans and King, A Theoretical Analysis of Credit Card Regulation, 2002, page 23.

Disclosure of all the differing surcharge rates, which must be part of any regulatory regime that allows surcharges, is also likely to be highly complex for both merchants and consumers.

In addition, as noted above, research commissioned by Mastercard assessing the impact of European Interchange Fee Regulation (IFR) regulation *"...could not find any available evidence of whether merchant to consumer pass through took place. However, consumers faced increased cost of ownership for regulated credit and debit cards post-IFR as issuers were forced to revise their cost structures and pricing policies as a result of the decrease in interchange fees received."*[12]

10 What barriers do small businesses face to obtaining competitive merchant service fees?

As with many markets, it is true that small participants in any vertical segment have reduced scale and therefore less negotiating power when compared to larger players.

An Australian study commissioned by Mastercard in 2019 underlined that small merchants prefer simplicity in billing arrangements and topics such as interchange were often overly complicated for small businesses and as a result, these merchants typically prefer blended or bundled pricing. Interestingly, the study also showed that in some cases, even larger merchants did not regularly market test the cost of acquirer services due to "more pressing priorities." [13]

New Zealand research conducted by RFi in 2019 had a similar response, with 72% of merchants surveyed stating that they would prefer either a single rate for all transactions, or transactions categorized into one or two different rates. For small merchants, this was higher at 79%[14]. The same study also found that customer service, product range, ease of doing business, simplicity of product structure and the suitability of the acquirer's product range were all considered higher priority to New Zealand merchants than MSF.

There is the assumption built into the view that cost is the biggest consideration for small business. Many of the most innovative acquirers around the world who are gaining significant market share are not the cheapest. For example, Square, a service provider becoming increasingly popular with small business, offers Australian merchants a flat fee of 1.6 per cent for transactions processed through one of their terminals which is more expensive than some other published merchant fees in Australia[15]. The terminal can be purchased from electronics retailers or the company directly. A key selling point made by the company is fee simplicity for merchants[16].

11 What information or assistance would assist small business to obtain better deals?

To increase understanding around fees, Mastercard is happy to continue to work with the small business community to consider measures that will improve transparency for all market participants.

Firstly, it is important to define 'better'. In the context of this paper our understanding is this is defined in terms of costs. However, like every other business decision, cost is just one component (see question 10).

12 Edgar Dunn and Company, Interchange Fee Regulation Impact Assessment Study. January 2020 p.2
13 The Initiatives Group (2020), Report on Merchant Acquiring in Australia, p. 9
14 RFI Research (2019) New Zealand Merchant Programme

15 https://www.westpac.com.au/business-banking/merchants-and-payments/Eftpos/Eftpos-fees/
16 https://squareup.com/help/au/en/article/6109-fees-and-payments-faqs accessed on 22 January 2020

It needs to be understood that while payment services comprise an important part of a merchant's relationship with their acquiring bank, there are several other factors that influence their reasoning for engaging with a particular acquirer. Merchants rely on banks for a wide range of financial services, including acquiring, lending, cash handling and personal banking. It is likely merchants consider their acquiring needs as part of their overall assessment about their banking needs and make their assessment accordingly.

RFi research conducted in 2020 showed that the top drivers when choosing a merchant acquirer vary greatly. For example, merchants with ASB and Westpac identified customer service as the top driver; merchants with BNZ were more likely to state that they had the best product range for their business; and Kiwibank merchants mentioned fee structure as the most important factor[17].

Additionally, 2020 research conducted in Australia found acquirers agreed that *"...small merchants prefer simplicity in their billing arrangements, hence bundled and blended pricing suits them better; indeed topics such as interchange, scheme fees, debit routing, etc. were complicated and confusing to most operators in this segment..."* A small business group told one major acquirer, "reduce complexity and make it easy cost is not the key issue and businesses are time poor[18].

The same research highlighted the case of a large (AUD500m+) that merchant did not regularly shop around for acquiring services, despite being able to potentially achieve significant savings (~$1m), as they felt they had *"other more pressing priorities"*[19].

Further, any transparency measures introduced must serve a genuine need in the market and provide valuable information which can be used by the intended audience.

12 **What cost differences are there for providing merchant services to small businesses compared with larger businesses?**

The acquirer has a certain level of fixed costs per merchant. Among other things, these include set up costs, AML and ongoing compliance checks and requirements. For example, an acquirer is obligated to:

- ensure the merchant business is legitimate
- monitor merchants' websites for appropriate fraud protection
- examine their card processing practices to ensure appropriate treatment of card numbers
- undertake analysis of the business to determine risk (including prepayment exposure) and
- ensure the business conducted is legal.

[17] RFI Research (2020) New Zealand Merchant Programme
18 Report on Merchant Acquiring in Australia. The Initiatives Group 20 January 2020. P.9

19 ibid

	Much of this work needs to be conducted and checked manually by the acquirer. This is equally important for small merchants as large ones, however the volume of transactions processed for larger merchants allows for faster recouping of these costs.
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?
	As outlined in the Issues Paper, MBIE has noted downward pressure on interchange rates. Debit card-present interchange is already at/below global norms, as shared in 6-monthly reporting with the Minister and MBIE. However as noted throughout our response, merchants consider value as well as cost when making decisions about electronic payment acceptance.
14	What impact is product innovation having on merchant service fees?
	We believe innovation is increasing value for money and in some case reducing overall dollar spend. There are clear examples in the market where merchants are adopting innovation at a higher cost because they perceive the value they are receiving is higher (BNPL, Online EFTPOS for in store use cases, AliPay, WeChat). An example of payment innovation in New Zealand is Wendy's recent partnership with Windcave to roll out new payment devices at drive-through with a goal of streamlining operations, removing contact between customers and drive-through staff, and avoiding the need for payment terminals to be hung out of the window. Wendy's CEO Danielle Lendich has reported "amazing" customer feedback and an increase in the speed of service, however their primary objective is operating more safely[20]. Specifically on interchange, the adoption of innovation around tokenisation will see the card-not-present rate reduce to 0.8 per cent for debit (currently 0.92 per cent) and 1.17 per cent for credit (currently 1.4 per cent), as well as vastly reducing online fraud and improving lifecycle management. Mastercard sees competition as a critical driver of innovation and improved merchant value, and so removing barriers to entry for new acquirers will likely increase value offered to smaller merchants. As noted above, there are now more non-bank acquirers than bank acquirers in New Zealand, including Windcave, Adyen, Stripe, Worldpay and Checkout.com; and the market share of this segment of acquirers is increasing. More acquiring participants offer increased competition and choice for merchants, and many of these acquirers have a strong focus on innovation with improved merchant and consumer experience.
15	Is open banking likely to provide sufficient competitive discipline on scheme debt and credit fees?
	Open banking will likely lead to more competition across the financial services sector - Mastercard continues to serve on the API Council and as part of the working groups. We believe there is always opportunity for innovation. Products and services enabled through open banking increases these opportunities – we have supported the rollout of open banking across many markets including the United Kingdom and Europe.

[20] https://www.nzherald.co.nz/business/burger-chain-wendys-unveils-new-nz-first-payment-technology/DU5OT2ZRCVYGAFNXXD63VKJPT4/

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?
	Based on our responses above, no. We believe there continues to be opportunities to increase value through efficiency, innovation and cost reduction for the retail payments system, and particularly small merchants. However, these would be better achieved through broader industry consultation and direction from the minister, rather than narrow regulation with known unintended consequences.
17	Please feel free to provide information on any other issues of concern with the performance of the retail payments system.
	Competition & the impact of regulation on new market entrants and small players Interchange and MSF provides fuel for new competitors to come to market. Mastercard is proud to be working with many organizations (home-grown and international) looking to enter the market with new propositions for NZ consumers (including business owners) and merchants (including small businesses) in 2021. *New issuers:* On the issuing side, many new financial service providers, including neo banks, start in the transaction space when they enter a market. Interchange fees provide an important source of revenue for smaller issuers to provide customers with innovative, differentiated propositions leveraging the latest technologies[21]. These drive the bar higher on market expectation, encouraging competition and better products and services for consumers and small business owners. These new entrants have less scope to offset the costs with other business activities, such as lending.[22] Unique to NZ, if the new entrants are in the debit space, they will also have transactional and build/test/maintenance costs to enable EFTPOS transactions. Given this, regulating interchange has had the unintended – and undesirable – consequence of discouraging new entrants and further extending the market position of existing participants. Reductions in interchange hurt these businesses disproportionately and are harmful to competition in financial and payments services. Research by ACIL Allen states: *"Absent interchange fees, small financial institutions will not be able to offer as good a product as the dominant banks, and they will not have the scale to justify the investment in new technologies. Lowering interchange fees will entrench the dominant position in financial services of the big banks."*[23] As a small country where both home-grown and international fintechs are increasingly considering market entry options around the world, it is even more important for this equation to add up.

[21] ACIL Allen Consulting (2020), Payments systems and interchange fees, pp. 9-11
[22] Oxera (2020), The competitive landscape for payments: an Australian perspective, p. 71
[23] ACIL Allen Consulting (2020), Payments systems and interchange fees, p.10

New Acquirers
On the acquiring side of the business, complexities in the domestic processing space are also limiting new entrants and their speed to market. Many of these acquirers have a strong focus on innovation and improved merchant and consumer experience. It is more difficult for these acquirers to compete for card-present transactions, compared to other markets, as access to and the complexity of an additional switch and ongoing compliance to processing EFTPOS transactions is a barrier to entry.

The issues outlined highlight the real potential that the proposed regulatory framework, focusing almost exclusively on the cost of acceptance for merchants, will simply lead to a 'race to the bottom', inhibiting competition, innovation, security and resilience. This appears to be inconsistent with the Government's commitment to increase competition in financial services.

We know that smaller players and new entrants have limited bandwidth and resources to respond to consultations, if they are aware of them at all. We hope that as part of the consultative process, government is able to engage with these new market entrants and consider their perspectives.

Innovation

The consultation document refers to the fact that much of the payments innovation is happening on the back of scheme cards – we are hugely proud of the work we have done with our partners to deliver customer experiences: from contactless through to mobile payments, tap on phone, frictionless online checkout, anywhere reward redemption and open-loop BNPL. This innovation has been enabled by our significant investments into our own technology products and services, but also by interchange which has supported the investment by issuers to bring them to market, and elements of merchant service fee which have supported acquirer developments. We are thrilled that NZ consumers are adopting these innovations[24], and that merchants are increasingly choosing to implement them[25].

We continue to work with all our market partners to develop propositions that leverage different rails. We believe there is an opportunity for new propositions and would always expect fair compensation to parties who are delivering value into the system. This is crucial for innovation to thrive and new entrants to see NZ as a desirable market.

Real-time account-to-account infrastructure

Card payments represent a small proportion of all electronic transactions in NZ. According to PaymentsNZ 2019 stats, for every $1 of card payments, $13.47 of electronic debit and credits were made.[26] New Zealand is now an outlier amongst the OECD for not having a real-time domestic payments infrastructure. A real-time infrastructure which importantly offers more than just speed (e.g. real-time fraud protection, enhanced data, directory services, etc.) is able to provide much more base functionality which could then be leveraged for innovative new retail payment propositions, with different business models. As the

[24] Contactless, mobile and ecommerce transactions have all increased over the last 12 months
25 December data from Payments NZ shows that number of contactless terminals has increased 37.3% YOY, and continues to increase every month
[26] *https://www.paymentsnz.co.nz/resources/articles/new-zealand-payments-stats-2019-in-review/*

	Government considers what a future-proof retail payments system should look like, we believe this should be considered.
18	Do you agree with the objectives for the retail payments system in New Zealand?
	Overall we agree with the objectives of the retail system stated; but we do not agree that: • Safety and security should be excluded from consideration in this consultation; and • That 'fairness in the distribution of costs' can be done without a better analysis of the value being delivered.
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.
	We believe there is a clear opportunity for the government to consider card-present transactions and card-not-present transactions (online) separately. This is due to the very different cost and value profile of the different transaction types driven by: • Substitutability • Risk, necessary investment into cyber security, and value provided to merchants for that cyber security • Audience reach – can appeal to consumers across the country.
20	Please provide feedback on which body or bodies would be best placed to act as the regulator for interchange fee regulation.
	N/A
21	Please provide your views on the impacts of the above classes of options, with supporting evidence of the benefits and costs.
	Unintended consequences Mastercard's experience is that the impact of regulation is often not in line with the objectives. There has been an unfortunate tendency for regulation to result in unfair and uneven playing fields as a result of a regime that covers some, but not all participants in a sector. An example of that was in Australia, where the RBA regulated Mastercard and Visa, but initially left American Express (AmEx) outside payment system regulation. Regulation with the aim of reducing costs for merchants, actually resulted in their acceptance costs increasing. Australian issuers began issuing American Express Companion Cards – essentially a second card issued alongside a Mastercard or Visa credit card. Issuers incentivised use of that AmEx card by offering more reward points per dollar spent (in some instances three times the points offered on the regulated Mastercard od Visa cards), which resulted in that card

becoming the preferred one for cardholders to use. The higher cost of accepting American Express cards saw merchants paying more despite regulation intended to reduce their costs.

The Reserve Bank of Australia ultimately amended its regulations to cover companion cards[27]. This highlights the vital need for regulation in a highly competitive business to be carefully considered and applied with great attention to consistency.

Additionally, unregulated new market entrants such as BNPL services already charge significantly higher fees to merchants compared to scheme cards. Therefore, if the objective of the regulation is to reduce merchant service fees, the consultation should consider all retail payment options as being in scope for regulation.

In the **United States of America** debit interchange rates were capped in 2011 under the *Durbin Amendment* (as part of the *Dodd-Frank Act*) with the aim of reducing costs for merchants and consumers. Instead, this led to increased banking costs through higher deposit fees[28] and the introduction of annual debit card fees.[29] Few merchants were found to have reduced prices or debit restrictions as their debit cost acceptance decreased.[30]

In the **United Kingdom**, MSF for merchants with £50M turnover or under hasn't changed since 2016[31] despite regulation designed to reduce the cost.

In **Europe** we have seen the cost of transactional banking increase for consumers, and the choice of cards diminish[32].

Following implementation of the interchange caps, European issuers responded promptly by reducing their rewards value, rationalising their product set and relying more on fees to drive product revenues. Research conducted by First Annapolis Consulting[33] observed the following:

- **Higher annual fees** – in major markets such as France, Spain, Italy and Portugal, almost half of the top five to six issuers have raised their annual card fees. In Spain, the average increase in annual fees was as high as 26%. In Germany, several large, well known issuers are now charging on average 20% more than they did at the beginning of 2016.
- **Increased APRs** – issuers in Portugal, Poland and Italy have increased their APRs by 30, 100 and 131 basis points respectively.
- **Less generous rewards programs** – Czech bank Ceska Sporitelna eliminated its 1% cash back on credit card purchases except for e-commerce and foreign purchases, and Raffeisen has reduced its monthly cash back rewards on premium cards from CZK 1,000 to CZK 250.

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27 https://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/q-and-a/card-payments-regulation-qa-conclusions-paper.html#interchange-fees-q9

28 Kay, B., Manuszak, M., Vojtech, C. (2013) 'Bank Profitability and Debit Card Interchange Regulation: Bank Responses to the Durbin Amendment', Federal Reserve Bank of Boston, p. 5

29 McGinnis, P. (2013) Misguided Regulation of Interchange Fees: The Consumer Impact of the Durbin Amendment , *Loyola Consumer Law Review*, vol. 25, no. 2, p.306

30 Study conducted by the Federal Reserve Bank of Richmond and Javelin Strategy & Research, found in Mitchell, N., Schwartz, S., Wang, Z. (2014) The Impact of the Durbin Amendment on Merchants: A Survey Study , *Economic Quarterly*, vol. 100, no. 3, p.184

31 https://www.psr.org.uk/publications/market/mr18-1-7-annex-2-pass-through-analysis-card-acquiring-market-review/

32 https://edgardunn.com/wp-content/uploads/2020/01/Interchange-Fee-Regulation-Impact-Study-Executive-Summary-EDC.pdf

33 Data sourced from First Annapolis Consulting European Card Research 2016. See: http://www.paymentscardsandmobile.com/six-months-interchange-regulation-card-products-changed/

- **Higher fees on associated services** – some European card issuers raised fees on other services such as when consumers choose their PIN numbers. Others increased ATM cash withdrawal fees on some cards.

Research commissioned by Mastercard assessing the impact of European Interchange Fee Regulation (IFR) *"...could not find any available evidence of whether merchant to consumer pass through took place. However, consumers faced increased cost of ownership for regulated credit and debit cards post-IFR as issuers were forced to revise their cost structures and pricing policies as a result of the decrease in interchange fees received."*[34]

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.

Competition should not simply be a race to the bottom. Competition should deliver increased innovation, safety and security reflecting the changing preferences and habits of retailers and cardholders and the challenges some of these changes pose.

Mastercard contends that a regulatory response is not warranted for New Zealand. Mastercard has listened to the concerns of Government and industry, and has acted accordingly, without the need for regulation. As a result, and as acknowledged in the Issues Paper, there has been downward pressure on interchange rates. There evidence provided as to why this collaborative, industry-led approach couldn't continue.

Such an approach would allow all participants to better focus on meeting MBIE's and the Government's broad objectives for the retail payments system – competition, efficiency, innovation and overall cost & value, while addressing unintended consequences along the way.

Canada provides a good example here: following concerns about the cost of payment fees, downward pressure on fees in Canada has been achieved without regulation.

In 2014, Mastercard and Visa separately committed to voluntarily reduce some interchange fees for five years taking effect from April 2015. They also committed to increased transparency. Following a review in 2016 the Minister of Finance established three guiding objectives for greater fairness and transparency in the payment card market:

1. a reduction in the overall level of interchange rates charged to Canadian businesses;
2. a significant narrowing of the range of interchange rates (the gap between the lowest and highest rates charged to businesses); and
3. greater transparency on the range of interchange rates.

The objectives are intended to benefit small and medium businesses.

New separate and voluntary commitments took effect in 2020 to meet the Minister's objectives. These commitments will see reduced interchange.

34 *Edgar Dunn and Company, Interchange Fee Regulation Impact Assessment Study. January 2020 p.2*

In 2018 the Canadian Department of Finance expected these voluntary reductions would save Canadian small and medium businesses CAD250 million per year.[35]

There is no reason why an approach like Canada's would not work in New Zealand.

Other Comments

In conclusion, following a review of responses and additional data you have gathered, we believe that the government should:

- Revisit the overall cost and value delivered by electronic payment to the NZ retail payments ecosystem, taking into account all payment flows, competition, innovation and most importantly the safety and security of the system
- Engage with industry around specific areas of concern and timeframes to resolve, to enable the market to make adjustments without suffering the same unintended consequences of other regulated markets

[35] Canada Department of Finance *Backgrounder: New Voluntary Commitments From Payment Card Networks* Date modified 2018-08-09