



COVERSHEET

Minister	Hon Dr David Clark	Portfolio	Commerce and Consumer Affairs
Title of Cabinet paper	Review of Merchant Service Fees in New Zealand: Release of Issues Paper	Date to be published	No later than 11 February 2021

List of documents that have been proactively released

Date	Title	Author
07 December 2020	<i>Review of Merchant Service Fees in New Zealand: Release of Issues Paper</i>	Office of the Minister of Commerce and Consumer Affairs
07 December 2020	<i>CAB-20-MIN-0510 Minute - Review of Merchant Service Fees in New Zealand: Release of Issues Paper</i>	Cabinet Office

Information redacted

NO [select one]

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet

Review of Merchant Service Fees in New Zealand: Release of Issues Paper

Proposal

- 1 This paper seeks approval from Cabinet to release an issues paper on New Zealand's retail payment systems for public consultation.

Relation to government priorities

- 2 The Government's commitment to regulate merchant service fees to reduce costs on retailers was confirmed in the Speech from the Throne, delivered on 27 November 2020.

Executive Summary

- 3 The Labour Party Election Manifesto made a commitment to regulate merchant service fees to save retailers money. In comparison to Australia, New Zealand businesses were paying on average \$13,000 more per year in merchant service fees¹. The accelerated uptake of contactless debit and credit cards (and the subsequent decline of EFTPOS use) as a consequence of COVID-19, has the potential to increase this gap relative to Australian retailers.
- 4 The Ministry of Business, Innovation and Employment (MBIE) has identified a number of issues related to the efficiency of the retail payments system, barriers to competition and innovation, and a growing cost on smaller business merchants. Based on this assessment of the issues, MBIE has identified a range of regulatory options to reduce merchant service fees, including a proposal for direct regulation of interchange fees – the largest component of merchant service fees.
- 5 It is desirable to test these issues and regulatory options with stakeholders. In particular, to gather stakeholders' views on ongoing developments with retail payments, the likely impacts of interchange fee regulation, and other supplementary options to address the issues identified. Given the complexity of the system, there is likely no single solution to ensuring meaningful and long lasting change, and there is a high risk of unintended consequences.
- 6 I am therefore seeking to release the attached issues paper, by publication on MBIE's website, for public consultation. The issues paper will initiate the first stage of the review and support officials in carrying out further research and analysis as they continue to design and analyse the regulatory options.

¹ Labour Party 2020 Election Manifesto Small Business Policy Factsheet estimate.

- 7 Following its release, MBIE will consult publicly on the attached issues paper for at least eight weeks. I will report back to the relevant Cabinet Committee in April 2021 with the outcome of the consultation and a proposed general policy direction, with a view to subsequently carrying out further targeted consultation on the detail of the new regime.

Background

Election Manifesto commitment

- 8 Regulating merchant service fees to save retailers money was an election manifesto commitment and a top priority identified for supporting small businesses.
- 9 While issues associated with merchant service fees have been around for many years, COVID-19 and its subsequent emphasis on contactless payment methods has made it more important than ever to ensure the retail payments system is delivering good outcomes for businesses and consumers.

Merchant service fees

- 10 The payments system is a set of arrangements 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.
- 11 Merchant service fees are payments made by a merchant (a business) to an acquirer (the merchant's bank) each time certain payment systems are used. The fee may be fixed or as a percentage of the sales transaction's value.
- 12 The interchange fee, typically a percentage of the transaction value, is the charge payable by the acquirer to the issuer (the consumer's bank) to recoup the costs of processing payments, a profit margin, the risk of fraud, and an additional margin to fund inducements or rewards (e.g. Airpoints) for the consumer. It 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.

Previous work has been conducted

- 13 We are not starting from a blank slate. Dating back more than ten years now, there have been various streams of work on merchant service fees and the wider payments system it sits in.
- 14 In 2009, the Commerce Commission entered into a settlement with Visa and MasterCard and the associated banks and financial institutions in relation to alleged anticompetitive conduct in the setting of merchant service fees and associated scheme rules. The settlement included a range of commitments designed to lower merchant service fees. The settlement expired in 2013, but many of its features have continued to shape arrangements.
- 15 In 2013, the Commerce Commission released its evaluation of the impacts of the settlement. It found that, in total, those merchants surveyed had made significant

savings in interchange fees relative to pre-2009 levels, but it also noted that merchant service fees may be increasing again.

- 16** In 2016, MBIE conducted a study into the retail payments system. This study identified concerns about the efficiency of the retail payments systems, how the costs and benefits of the system are distributed across consumers and merchants, and the pace of (or barriers to) innovation in the system. However, it also noted the dynamic nature of the retail payments system, including some positive industry-led developments, and the risk of unintended consequences from intervention. As a result of the study, the Government agreed to continue monitoring and encouraging industry-led solutions, while noting that further regulation was an option if this did not achieve the Government's objectives [EGI-17-MIN-0198 refers].
- 17** Since 2017, MBIE has been monitoring the interchange fees of the card schemes. MBIE estimates that weighted-average credit and debit interchange fees have decreased by around 11 per cent since 2016, which has been particularly advantageous for larger merchants. However, there is limited visibility of merchant service fees. MBIE has been advised that these vary significantly depending on the payment type and merchant. This can result in a lack of transparency and confusion for merchants over what offers are available.
- 18** 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 application programming interface (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 has the potential, among other things, to provide competition for the debit and credit card schemes.
- 19** In August 2020, following consideration by Cabinet, MBIE released a discussion document seeking feedback on options for establishing a consumer data right in New Zealand [DEV-20-MIN-0157 refers]. This was in response to the then Minister of Commerce and Consumer Affairs's dissatisfaction at the speed in which open banking was progressing. A consumer data right, and associated common API standards, could help with some of the frameworks required for the development of open banking in New Zealand.
- 20** My officials are currently analysing the submissions received on the discussion document and I expect to receive their advice later this month. However, considerable work in addition to open banking is required to place downward pressure on merchant service fees.

The issues paper

- 21** I propose to release an issues paper that will test the issues that MBIE has identified with merchant service fees in New Zealand, and the impacts of recent developments. The issues paper will also seek initial feedback on a proposal for interchange fee regulation alongside some other options to reduce merchant service fees. This will enable us to develop appropriate regulatory options that will address the real issues at play.

- 22** The eight issues covered in the proposed issues paper are discussed below, along with the proposed objectives of the review and a brief overview of regulatory options, including the proposal for interchange fee regulation.

Issue 1: Merchant service fees are high based on international comparisons

- 23** First and foremost, merchant service fees for credit card transactions, and until recently contactless debit transactions, are higher in New Zealand than in Australia and the United Kingdom (UK). Interchange fees are regulated in both Australia and the UK.
- 24** Retail NZ's 2019 Payment Survey showed retailers were paying (on a weighted average basis) 1.1 per cent of the value of every transaction on a contactless debit card and 1.5 per cent on credit cards to their banks. This is nearly twice as much as what Australian retailers paid for debit and credit card services. The Labour Party Small Business Policy Factsheet estimated that, based on average sales volumes, New Zealand retailers were paying on average an estimated \$13,000 per year more than their Australian counterparts.
- 25** Since that Retail NZ survey, 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 that were paying merchant service fees close to 3 per cent. This will bring New Zealand closer to the 2019 Payment Survey result for Australia of 0.6 per cent. However, merchant service fees on credit cards remain comparatively high.

Issue 2: Consumers do not face the full costs in choosing their payment methods and may have incentives to use higher cost methods

- 26** Consumers choose which payment method to use based on the costs and benefits that they face. For example, credit cards can be chosen for their convenience or reward schemes, but also come with a cost of annual fees or interest.
- 27** MBIE believes there are incentives in the system that encourages the use of higher cost payment methods, such as credit cards. These are:
- 27.1 Competition between the issuers of credit cards to attract consumers frequently occurs through offers of rewards and inducements. This means that the marginal cost to the consumer of using this higher cost payment method could actually be negative when rewards are factored in.
- 27.2 Contactless payments and digital wallets are significantly more convenient for consumers over 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 and Apple Pay) have higher merchant service fees than payments by cards that are swiped or inserted, but the cardholders, if not surcharged, do not directly incur these costs. Consequently, they may use these higher cost payment methods more than they would otherwise.

Issue 3: Merchants risk losing consumer sales through steering or surcharging and lack countervailing bargaining power

- 28** Merchants also choose which payment method to accept based on the costs and benefits that they face. However, whereas a consumer may make a direct decision at the point of sale, a merchant makes a longer-term decision about which payment methods they are willing to accept across all transactions in the future.
- 29** Merchants may find it difficult to refuse to accept or surcharge for higher cost payment methods if these higher-cost payment methods are valued by consumers. In addition, a merchant is likely to face a greater negative customer response if they remove a particular payment method than if they had never accepted the payment method in the first place. This likely means that the merchant is less responsive than consumers to changes in prices for payment methods.
- 30** MBIE considers there are some features of the retail payments system that also makes it difficult for merchants to steer or surcharge for higher cost payments. These are:
- 30.1 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).
- 30.2 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.
- 30.3 Consumers are increasingly using scheme debit cards, as these are issued by the banks in preference to domestic EFTPOS. Scheme debit cards also have contactless functionality which, as mentioned, is valued by many consumers. However, if merchants accept contactless card payments, currently payment terminals do not have the ability to distinguish between contactless debit and the higher cost contactless credit transactions. This means that merchants have limited ability to just accept (or steer consumers to) the lower cost contactless debit cards.
- 31** Many merchants also have limited countervailing power with their acquirers. Moves by the banks to offer merchants unbundled fees, separated by scheme or type of card, has paved the way for merchants to have greater choice in the way their fees are structured. However, a sizable share of merchants still pay a single rate for all card transactions, which while making it simpler to administer, may well result in merchants paying more on average. As mentioned, the weighted-average merchant service fees in New Zealand remain relatively high.

Issue 4: Costs are passed on to all consumers in higher prices for goods and services, while not all benefit

- 32** As mentioned, merchants face constraints to steering consumers to low cost payment methods or surcharging for high cost payment methods. MBIE understands that there is low prevalence of surcharging and that it is difficult to accurately surcharge, but this will be something to test during consultation. Where merchants do not surcharge, merchant service fees may be treated simply as a cost that is included in the price of goods and services. This means all consumers pay for these costs through higher prices.
- 33** The higher prices for all goods and services faced by consumers is offset for the holders of credit cards, who in some cases may receive benefits (such as Airpoints) that greatly exceed the overall increase in price that they face. On the other hand, those who do not pay with credit cards, or with contactless debit 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.
- 34** 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.

Issue 5: Small businesses are particularly affected

- 35** Small businesses are more likely to bear higher merchant service fees. Many small businesses lack bargaining power with the banks, due to the small volumes and values of transactions that they deal with.
- 36** However, regardless of scale, the retail payment system is complex and relatively opaque, leading to knowledge and capability gaps among businesses. There is some competition between banks for merchants' payment services, but often small businesses will select a supplier of convenience, such as the same bank that provides bank loan services. As a consequence they often do not shop around for the best deals for merchant services. Some businesses engage with merchant service fee advisors to help negotiate better rates, but this is not common.

Issue 6: Domestic EFTPOS provides price competition, but its use is declining

- 37** Currently domestic EFTPOS is providing downward pricing pressure on scheme debit products. Banks do not generally collect merchant service fees on EFTPOS transactions. Inserted and swiped scheme debit cards that are largely close substitutes to EFTPOS also charge no or low fees. This is unusual internationally, and is likely to be a result of the competition with EFTPOS.

- 38 However, the market share of EFTPOS is declining, largely due to it not having contactless and online functionality. This slowness to innovate may be a result of the banks being reluctant to develop a product that would compete with the scheme debit and credit products on which they make higher profits. This can be seen by consumers increasingly being issued scheme debit products rather than EFTPOS cards on renewal.
- 39 MBIE considers that this downward pressure on contactless debit interchange fees will decrease as EFTPOS loses market share. There is likely to be a tipping point, where merchants will have limited choice but to accept scheme debit products, and the schemes will start charging merchants more for accepting these cards.

Issue 7: Barriers to competition remain and innovation is generally over the scheme rails

- 40 New Zealand's debit and credit schemes are heavily dominated by Visa and MasterCard. Concentration in a few card schemes is not unusual internationally, because of the significant network effects of card systems. However, this gives these established schemes a degree of market power.
- 41 The schemes and banks receive revenue from credit card usage through their ability to set interchange 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. Competition between issuers for customers may also increase rewards, and hence interchange fees.
- 42 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 hence cardholder rewards, associated with existing card schemes also makes it more difficult for new card products to gain a foothold. Many banks also have exclusivity arrangements with either Visa or MasterCard, making it difficult for them to grow their network.
- 43 New payment methods are being developed, such as Apple Pay, Google Pay and 'Buy Now, Pay Later' products, such as Afterpay. 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, further increasing merchant service fees.
- 44 As mentioned, I am considering whether a consumer data right should be established in order to facilitate open banking. This would increase competition in the payments system by assisting in the growth of other payment methods, such as direct entry (bank-to-bank transfers) or contactless payment platforms that do not rely on the scheme rails.
- 45 While a consumer data right and open banking would not preclude direct regulation of merchant service fees, there are close connections between the two pieces of work, which we will need to carefully consider.

Issue 8: No clear regulatory governance to oversee the retail payments system

- 46** 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. 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 payments system. It does this through developing and applying the rules, standards and procedures for the payments system, 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.
- 47** There are also two regulatory bodies that have an involvement in the retail payments system:
- 47.1 The 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 integrity, and are operationally robust. The Financial Markets Infrastructure Bill currently before the House will increase the RBNZ's role in relation to 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.
- 47.2 The 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 particular, the Commerce Commission has no ability to intervene to address high merchant service fees if they were set in compliance with the Commerce and Fair Trading Acts. In its 2013 evaluation, the Commerce Commission commented that alternative regulatory intervention may be required in that case.
- 48** The Commerce Commission does not currently have the statutory mandate to intervene and regulate retail payments. Meanwhile, the RBNZ does not see that it has this role. That said, the Reserve Bank of Australia, through their Payments System Board, is responsible for promoting competition and efficiency of the retail payments system through regulatory interventions in Australia.

Objectives for New Zealand's retail payments system

- 49** The issues paper also sets out a proposed set of objectives and criteria for assessing the performance of the retail payments system. This will be tested with interested parties.
- 50** It is proposed that the overall objective is for the retail payments system to deliver long-term benefits for end-users of retail payments within New Zealand. This requires that the system:

- 50.1 Enables healthy competition between payment providers and payment products
 - 50.2 Incentivises beneficial innovation for consumers and merchants
 - 50.3 Is efficient in allocating resources through clear price signals, where prices are cost-reflective for the system as a whole
 - 50.4 Is fair in its distribution of costs, particularly in its treatment of small business and low-income consumers.
- 51** In addition to these objectives, it is vital that payment systems are sound, secure and subject to prudential supervision. However, these matters are the responsibility of the Reserve Bank in its prudential role and largely fall outside this review.

Options for interchange fee regulation

- 52** Having specified the issues of concern that drive high merchant service fees, the issues paper will also seek submissions on possible options to address those concerns. Overseas jurisdictions have tried a range of regulatory means to reduce merchant service fees. Commonly this involves regulating the interchange fee component of the merchant service fee, but there have been a range of approaches. The different approaches tend to hinge on the following choices:
- 52.1 Which types of payment products are regulated? For example, which schemes (e.g. Visa, MasterCard or American Express) and which card products (e.g. debit and/or credit cards).
 - 52.2 What form is the regulation? For example, a hard maximum cap for individual fees, a weighted average maximum cap, or a combination of the two.
 - 52.3 Under what principles is the price set? For example, a cost-based methodology or some other objective.
 - 52.4 Who is the regulator?
- 53** The issues paper lays out a proposal which stakeholders will be invited to provide feedback on:

Proposal for interchange fee regulation:

Interchange fees for MasterCard and Visa credit and debit cards will be regulated under hard caps. The hard caps for each transaction type will be set based on principles that are consistent with achieving the long-term benefits of end-users of the retail payments system and may be targeted for different classes of merchants.

- 54** Including this proposal in the paper is likely to be contentious with some stakeholders, but it will provide a strong signal of the Government's commitment to get action on reducing merchant service fees.

Potential supplementary options

- 55** Other potential supplementary options explored in the issues paper include supporting competitive alternatives to the current payment systems (such as domestic EFTPOS or infrastructure providers) for example through open banking, facilitating collective bargaining by small merchants, and strengthening regulatory governance arrangements.
- 56** The views of interested parties will be important in further developing these options and to ensure the particular features of the New Zealand retail payments system are taken into account. This is a complex system and it is evolving rapidly. There is likely no single solution to ensuring meaningful and long-lasting change, and there is a high risk of unintended consequences.

Release of the issues paper

- 57** I consider that further consultation is required to test MBIE's analysis and to inform the development of a package of regulatory options. While MBIE consulted on retail payment systems in 2016, there have been industry developments since and it will be important to test the issues and initial options identified by MBIE with stakeholders. This will also provide an opportunity to further understand the level of merchant service fees in New Zealand and other countries.
- 58** MBIE will consult publicly on the attached issues paper through its website for at least eight weeks. I will report back to the relevant Cabinet Committee in April 2021 with the outcome of the consultation and a proposed general policy direction, with a view to subsequently carrying out further targeted consultation on the detail of the new regime.

Financial implications

- 59** This paper has no immediate financial implications. A budget bid will be required at the time that final decisions are sought on regulatory proposals and the appointment of a regulator.

Legislative Implications

- 60** There are no immediate legislative implications. Feedback on the proposed issues paper will inform the development of regulatory options to be progressed, which is likely to require legislative changes.

Impact Analysis

- 61** The RIA Team at the Treasury has reviewed and confirmed that the issues paper substitutes for a Regulatory Impact Statement. The issues paper is likely to lead to effective consultation and support the delivery of a quality Regulatory Impact Analysis.

Population Implications

- 62 This paper has no immediate population implications. Feedback on the proposed issues paper will inform an assessment of the implications of regulating to reduce merchant service fees on classes of consumers and communities.

Human Rights

- 63 This paper has no human rights implications.

Consultation

- 64 The Treasury, Reserve Bank of New Zealand, Financial Markets Authority and Commerce Commission staff were consulted on this paper. The Department of Prime Minister and Cabinet (Policy Advisory Group) has been informed.

Communications

- 65 I intend to issue a media statement announcing the release of the issues paper and inviting the public to provide feedback.
- 66 MBIE will post the issues paper on its website and provide copies to interested parties.

Proactive Release

- 67 This paper will be published on MBIE's website, subject to withholdings as appropriate under the Official Information Act 1982.

Recommendations

The Minister of Commerce and Consumer Affairs recommends that Cabinet:

- 1 **note** that the Labour Party Election Manifesto, and the subsequent Speech from the Throne, made a commitment to regulate merchant service fees to support small business growth;
- 2 **agree** that the Minister of Commerce and Consumer Affairs release the attached issues paper for public consultation, to seek feedback on the issues and potential regulatory options to supplement interchange fee regulation, to inform further work on developing the regulatory options;
- 3 **authorise** the Minister of Commerce and Consumer Affairs to make any required minor and/or technical amendments to the issues paper before release;
- 4 **invite** the Minister of Commerce and Consumer Affairs to report back to the relevant Cabinet Committee in April 2021 with the outcome of the consultation and a proposed general policy direction, with a view to subsequently carrying out further targeted consultation on the detail of the new regime.

I N C O N F I D E N C E

Authorised for lodgement

Hon Dr David Clark

Minister of Commerce and Consumer Affairs

I N C O N F I D E N C E