



TOWARDS FAIRER PAYMENTS FEES

TAKING RETAIL
FURTHER //

Retail

NZ

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Towards fairer payments fees

New Zealand is increasingly a nation where payments for everything, from groceries to airline tickets, to restaurant and doctor's bills, are paid electronically.

Unlike most developed economies, there is no explicit regulatory regime covering the costs of payments systems in New Zealand, and there is little transparency regarding fee levels. This means that New Zealand consumers pay substantially more in hidden charges for debit and credit card payments than consumers in other markets such as Australia.

In a recent report, economic consultancy Covec, estimates that, in 2015, the hidden cost of payment systems to shoppers is currently approximately \$380 million per annum. This is forecast to rise to as high as \$711 million¹ by 2025 - an estimated total cost of \$3.1 billion over the next 10 years as consumers increasingly adopt scheme debit.

The costs are expected to rise substantially over coming years. Banks and card companies are incentivising customers to move away from traditional EFTPOS and adopting new forms of contactless payments, such as Visa PayWave and Mastercard PayPass. These come at a substantially higher acceptance cost for the merchant, which translates into higher prices for consumers, and a wealth transfer from New Zealanders to foreign-owned banks and credit card companies.

¹ The actual costs could be substantially higher than this because the Covec research only considered the costs faced by retail merchants (representing approximately 65 per cent of all transactions) - and excludes hospitality, tourism, ticketing and other kinds of merchants, who typically pay higher merchant charges.

How we pay in New Zealand

There are four main ways of making an electronic payment for goods at the point of sale. These are:

- **Domestic EFTPOS** - our traditional way of paying for goods since the 1980s, EFTPOS cards have a magnetic strip which is swiped to effect a transaction, with money transferred directly from a customer's account to that of the merchant.
- **Visa and Mastercard scheme debit cards** which carry both a chip and magnetic strip and are inserted into an EFTPOS machine (or sometimes swiped), with the money transferred from a customer's account to that of the merchant.
- **Visa and Mastercard scheme debit cards** can also be used contactlessly for payments worth \$80 or less - that is, the card can be passed over a terminal and the money is transferred from a customer's account to that of the merchant, via the card company.
- **Visa, Mastercard, American Express and Diners Club credit cards**, which can be used either contactlessly, or inserted. The merchant receives funds from the credit card company which retrospectively recovers the funds from the customer through a monthly billing process.

Consumers are also able to use their scheme debit and scheme credit (although not EFTPOS) cards over the Internet or telephone. These transactions are typically undertaken at the merchant's risk (the card companies will not guarantee payment) and attract substantially higher fees compared to transactions where the card is present.

ChinaUnion Pay also offers debit cards (although these are not currently being issued by any New Zealand bank, they are important for tourists and migrant communities), and there is a small number of niche credit card providers, such as Farmlands. New payment technologies such as Semble or ApplePay typically rely on the existence of a credit or debit card number.

What do payments cost?

The fees paid by New Zealand merchants for accepting scheme debit and credit cards are substantially higher than in other jurisdictions, as shown in the table below:

	NZ	UK	Australia
EFTPOS	0.00%	0.32%	\$A0.10
DEBIT Swiped/dipped	0.00%	0.32%	\$A0.12
DEBIT Contactless	1.00%	0.32%	\$A0.12
CREDIT Visa /Mastercard	1.40%*	1.00%	0.84%

These charges reflect weighted average charges to retail merchants as reported in a British Retail Consortium study and replicated in New Zealand by Retail NZ. Australia figures are as reported by the Reserve Bank of Australia.

The market for payments is changing. Customers are moving away from old fashioned EFTPOS towards contactless Visa and Mastercard debit cards. They are being incentivised to do this by the banks, which are increasingly replacing EFTPOS cards with scheme debit cards as a matter of course (rather than at a customer's request), and by glamorous advertising by the card companies.

There is no denying that, from a consumer's point of view, scheme debit cards are attractive: they can be faster to make payments at point of sale and, unlike EFTPOS, can be used to pay online, like a credit card.

Estimated total cost of \$3.1 billion in electronic payments fees over the next 10 years

* Retail NZ has negotiated a commercial agreement with a bank on behalf of its members for credit card transactions.

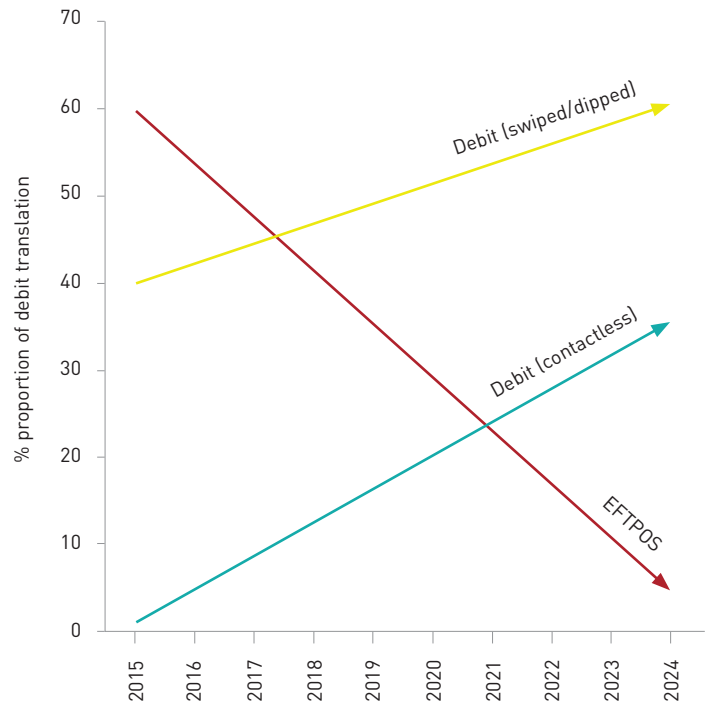
The shift from EFTPOS to Scheme Debit

Economic consultancy Covec estimates that the proportion of contactless debit payments could increase from 1 per cent in 2015 to 35 per cent in 2024, and non-contactless debit from 40 per cent to 60 per cent. The increase in debit card use will displace traditional EFTPOS, which declines from 59 per cent to 5 per cent in 2024, as seen in Figure 1.

The proportion of contactless debit payments is forecast to increase from 1% in 2015 to 35% in 2024

10 year forecast growth of debit

Figure 1. Estimated proportional electronic debit over the next 10 years.



What does this mean for merchants?

For the merchant, this will be accompanied by a significant increase in cost and an impact on cashflow. EFTPOS is effectively free, paid for by customer transaction and account fees - while contactless scheme debit currently has an average transaction fee of 1.0 per cent.

Many small business retailers, including dairies and convenience stores only accept EFTPOS. They typically do not accept contactless debit or credit cards because of the higher fees associated with these kinds of cards. The margins and viability of these small businesses will be disproportionately impacted by any movement towards contactless transactions, or the introduction of fees on debit transactions.

Figure 2 shows the likely fees that will be paid by merchants to Banks and card companies over the next 10 years if the payments system remains unregulated.

Total cost of electronic payments fees without regulation at least 3.1 billion over next 10 years

Figure 2. Estimated total annual payments costs faced by NZ retailers.*



* Assumes merchant service fees for: Credit 1.4%, Contactless debit 1%. If banks and card companies were to introduce fees on non-contactless debit in 2019, a possible scenario based on overseas trends identified in the Covec research, the fees would be \$992 m per annum by 2024.

NZ's relatively high fees point to a systemic problem

Payment systems are critical to the functioning of a modern economy, but there is little transparency in fee-setting and payment systems are largely unregulated in New Zealand. We are out of line with comparable international jurisdictions.

General purpose payment systems, such as EFTPOS and scheme debit have many characteristics in common with essential service utilities such as those in the energy, communications and transport sectors. These similarities include:

- a small number of players with significant market share;
- significant economies of scale; and
- relatively inelastic demand.

One unique feature is that consumers adopt payment systems based on convenience and the incentives offered by banks and card companies - but the cost of handling payments is generally met by the merchant who receives the funds. This contributes to relatively inelastic demand for general purpose payment systems: the person who chooses a form of payment does not typically meet the costs of the transaction.

Payments systems generate value (and revenue) by encouraging two different types of users to interact - consumers and merchants. The interaction between

these groups creates a network effect, meaning that the more users of the "other" type participate, the higher is the network's value to any user. For example, merchants are more likely to accept a card that many of their customers carry, and consumers are more likely to carry a card that is widely accepted by merchants.

Merchants have little control over the type of cards issued to consumers by banks. Banks offer incentives and additional features to encourage customer to adopt new card technologies.

Banks and card schemes are therefore able to distort consumer choice in favour of payment methods that are costly for merchants, and that generate revenue for them.

In New Zealand, prices to merchants are set by the Banks - but they are heavily influenced by the interchange and other fees that are imposed by international card companies. The Reserve Bank of New Zealand has an interest in payments from a prudential point of view - it wants to make sure that there is no shortage of funds in the system to make payments. However it has no statutory mandate to pursue transparency, competition or innovation goals, and to date has not shown any wish to pursue a goal of economic efficiency.

The Commerce Commission has an interest in payments insofar as there is any potential competition issue emerging - but unlike telecommunications or electricity, it has no statutory mandate proactively to consider pricing, transparency or economic efficiency.

How does New Zealand compare internationally?

In a 2014 study, Bruce Summers and Kirsten Wells undertook a review of governance in relation to general purpose payments systems.² They identified that the existence of a central governance body leads to greatly reduced payments fees, and established six principles for the effective governance of such systems:

1. Explicit objectives that reflect public policy considerations;
2. A means for measuring whether each of the major payments schemes meets the needs of end-users;
3. Broad stakeholder participation in key decisions including strategy, design and rules;
4. Arrangements that provide clear responsibility and accountability for outcomes;
5. Incentives that promote the policy objectives, including fair and effective enforcement; and
6. Openness and transparency.

A comparison of New Zealand's governance arrangements for payments systems, with those of major OECD jurisdictions is set out below. In New Zealand, Payments NZ provides overall industry-led system governance but has no mandate to provide oversight of fees. It is clear that this falls well short of international best practice. The existence of a central governance body which maintains oversight and transparency over fees, is an important divider between countries that generally have, or are on course for, effective governance of general payments systems.

New Zealand's current institutional arrangements fall well short of international best practice



Table 1: Summary of Governance Attributes by Country [Source: Summers and Wells, 2014]²

Effective Governance Attribute	Australia	European Union	United Kingdom	Japan	Canada	United States	New Zealand ³
	Central governance body			No central governance body			No central governance body
Explicit objectives that reflect public policy considerations	✓	✓	✓	✗	✓	✓	✗
A way to measure whether the major payment schemes meets the needs of end-users	✓	✓	✓	✗	✓	✗	✗
Broad stakeholder participation in key decisions including strategy, design, & rules	✓	✓	✓	✗	✗	✗	✗
Arrangements that provide clear responsibility & accountability for outcomes	✓	✓	✓	✗	✗	✗	✗
Incentives that promote the policy objectives, including fair and effective enforcement	✓	✓	✓	✗	✗	✗	✗
Openness and transparency	✓	✓	✓	✗	✓	✗	✗

² Bruce J Summers and Kirsten E Wells, 2014, *Governance of payment systems: a theoretical framework and cross-country comparison*. <http://ssrn.com/abstract=2476552>

³ New Zealand column considers the governance of payments fees only and was added by Covec for comparative purposes

Options for increased transparency and oversight

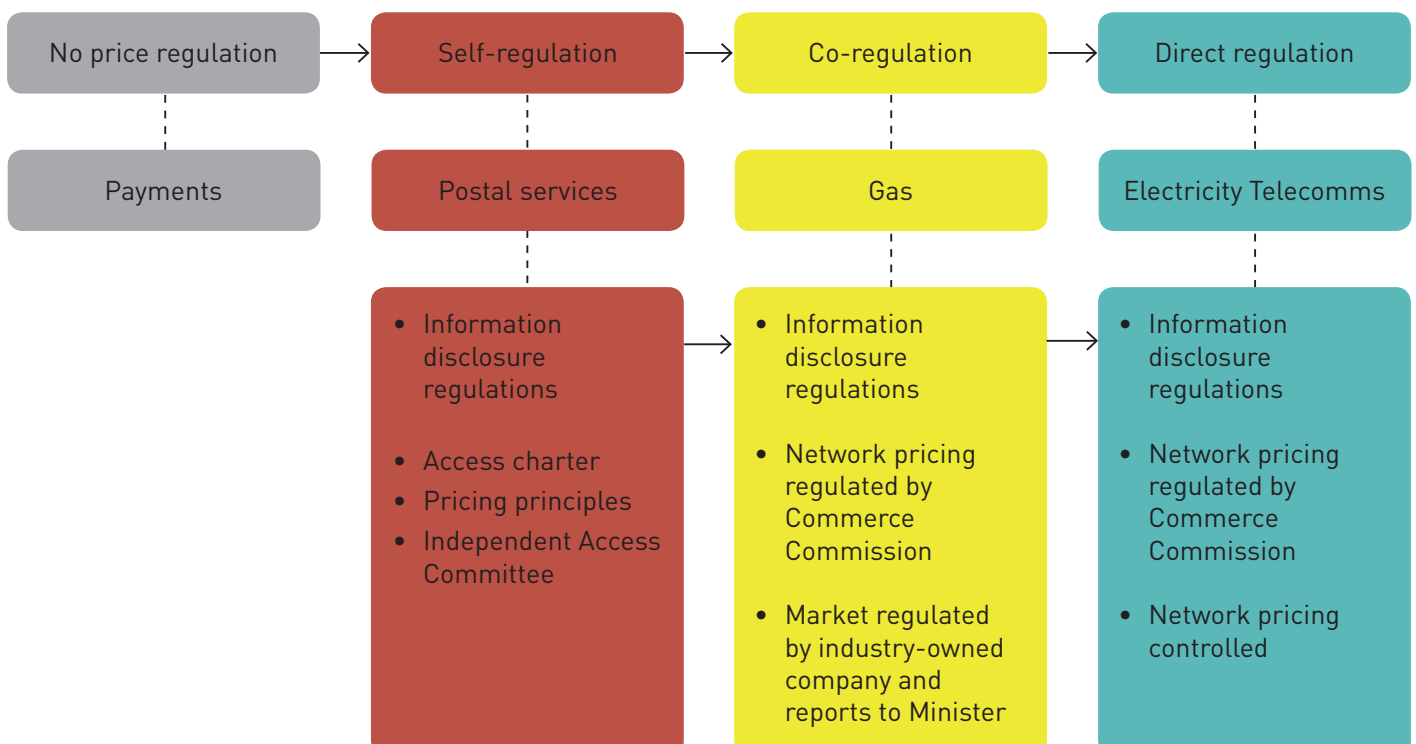
Across New Zealand's essential services, a range of regulatory solutions has been implemented. These range from payments (where there is no sector-specific pricing or market regulation at all) to postal services (where a voluntary access regime was set up, supported by information disclosure regulations), to gas (with co-regulation between the industry-owned Gas Industry Company and the Commerce Commission), to telecommunications or electricity (where there is direct regulation of almost all aspects of the industry).

Typically regulation starts with a simple information disclosure regime, becoming more prescriptive over time if market players do not respond, or continue to behave inappropriately over time. From 1988 to 2001, for example, telecommunications was lightly regulated - with information disclosure requirements underpinned by the Commerce Act. Over time, the regulatory regime was strengthened until ultimately, Telecom was split into two separate retail and lines businesses, with price control and extensive sector-specific regulation established.

It is worth noting that, in most overseas markets, governments have either moved, or are moving towards, direct regulation as the most appropriate way of maintaining oversight and transparency over payments fees. In Australia, for example, the Reserve Bank is specifically charged with regulating interchange fees that apply to credit and debit transactions.



The regulatory continuum



A way forward

The 2015 Covec study commissioned by Retail NZ is the first assessment of the hidden costs of payment systems to New Zealand merchants and consumers, (time-series information is available for other countries). Given the similarities between the Australian and New Zealand markets, it is likely that direct regulation will ultimately prove to be the most appropriate way of regulating payments systems. However, this would require legislation, and potentially significant administrative expense.

Three immediate actions

There is an opportunity to increase the fairness of our electronic payment system by the payments industry agreeing:

1. not to introduce fees on inserted or swiped scheme debit cards
2. to grant voting rights for merchant representatives on the Consumer Electronic Clearing System Committee
3. to an oversight regime to provide greater transparency of fees and charges, as is common in other industries.



An oversight regime

An oversight regime could entail:

- (a) Tasking an independent body (options could include the Reserve Bank of NZ, the Commerce Commission, Payments NZ or another industry body) with responsibility for analysing disclosures, and comparing pricing in the New Zealand market with that in other OECD countries; and
- (b) the public disclosure by card acquirers of:
 - standard merchant service fees;
 - standard terms and conditions offered to merchants;
 - any discount or rebate of greater than .1% of the transaction value on standard merchant service fees, and the reasons for those discounts or rebates;
 - any substantial variation in the terms and conditions offered to merchants, and the reasons for those variations;
 - the costs of handling each transaction, by type of transaction; and
- (c) the public disclosure by card issuers of:
 - standard interchange fees (for each interchange category);
 - any discount or rebate (whether to acquirers or direct to merchants) of greater than .1% of the transaction value on standard interchange fees (for each interchange category), and the reasons for those discounts or rebates;
 - any substantial variation in the terms and conditions offered to acquirers or offered in respect of particular merchants, and the reasons for those variations;
 - the costs of handling each transaction, by type of transaction; and
- (d) the public disclosure by the card companies of:
 - scheme fees and any other fees levied by the card companies to card issuers or acquirers;
 - standard terms and conditions offered to the card issuers including any conditions associated with interchange fee setting;
 - any discount of greater than .05 per cent of the transaction value on the fees offered to issuers, and the reasons for those discounts;
 - standard terms and conditions offered to acquirers;
 - any discount of greater than .05 per cent of the transaction value on the fees offered to acquirers, and the reasons for those discounts
 - any substantial variation in the standard terms and conditions offered to issuers or acquirers and the reasons for those variations;
 - incentive schemes offered to the card issuers;
 - the cost of handling each transaction, by type of transaction.

We propose that such a system be implemented by 1 October 2016 and be reviewed on a 12 monthly basis. Depending on the outcomes of this process, additional governance could be considered, if necessary.