

Reference: 20160250

9 September 2016



Thank you for your Official Information Act request, received on 8 July 2016. You requested the following:

“Since 1 January 2016, all reports, briefings, memorandums and correspondence (written and electronic) regarding ‘interchange fees’ and/or card processing fees charged by Visa and Mastercard, given that the European Courts have established that processing charges were excessive and a current court case in the UK that alleges GBP\$19 billion in excessive charges by Mastercard alone.”

On 2 August 2016 the deadline to respond to your request was extended by 25 working days.

I understand that you have made a similar request to the Minister of Commerce and Consumer Affairs.

Information to be provided

Item	Date	Document Description	Proposed Action
1.	11 February 2016	Aide Memoire: Meeting with the Minister of Commerce on retail payments systems	Release in part
2.	10 May 2016	Retail payment systems – agency catch up (email)	Release in part
3.	26 May 2016	Retail payments systems – preliminary Treasury thinking (email)	Release in part
4.	26 May 2016	Retail payments systems – preliminary Treasury thoughts (attachment to document 3)	Release in part

The documents above are released, subject to information being withheld under the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people;
- commercial information, under section 9(2)(b)(ii) – to avoid prejudicing the commercial position of the person who supplied the information;
- information provided in confidence, under section 9(2)(ba)(i) – to avoid prejudicing the supply of similar information, or information from the same source;
- advice still under consideration, under section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials; and
- certain comments and opinions, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions.

In making these decisions, I have taken account of the public interest considerations in section 9(1) of the Official Information Act.

Information to be withheld

There are additional documents covered by your request that I have decided to withhold in full under the following section of the Official Information Act:

- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials.

In making this decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested.

You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Craig Fookes
Team Leader, Financial Markets Team

TOIA 20160250

Information for Release

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Reference: T2016/156

SH-11-4-3-3



Date: 11 February 2016

To: Minister of Finance
(Hon Bill English)

Deadline: 15 February 2016

Aide Memoire: Meeting with the Minister of Commerce on retail payments systems

On Monday 15 February you are meeting with the Minister of Commerce and Consumer Affairs to discuss issues relating to retail payments systems.

The Ministry of Business, Innovation and Employment (MBIE) has provided their Minister a briefing note for this meeting. We understand that this briefing note has been forwarded to your office. The Treasury has provided feedback on this briefing note. We are supportive of the notes assessments and the proposed study of the retail payments market.

Summary of the issue

New Zealanders and New Zealand business rely heavily on electronic payments for retail transactions. In the past, the dominance of the low-cost EFTPOS system has helped ensure that the costs of these electronic transactions were among the lowest in the world. However, the growing dominance of higher-cost scheme debit and credit cards (such as Visa and MasterCard), and contactless payments technologies (such as Visa payWave and mobile wallets) is increasing the costs to business for accepting electronic payments.

To some extent, higher costs are being offset by benefits in terms of convenience, online functionality, and cardholder rewards. However, there is increasing concern that the costs of accepting these payment methods is excessive, and that competition is unlikely to reduce these fees given the unique structure of the market. At present, retailers pay an estimated \$370 million (0.15% of GDP) per year on "interchange fees" associated with electronic payments. There are also concerns that the level and proliferation of such fees could increase substantially over time as EFTPOS use declines (as is widely expected).

The Treasury has in the past expressed concerns over market efficiency in the retail payments sector (T2015/72 refers). Our overarching concern is that "excessive" interchange fees could unduly increase costs for business, particularly smaller businesses, and get passed onto consumers through marginally higher prices. This in turn could result in a deadweight cost to the economy, potentially in the magnitude of hundreds of millions of dollars per annum.

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Policy implications

The Treasury agrees with MBIE's judgement that the case for regulation in New Zealand needs to be investigated, given that market forces appear unlikely to drive more efficient outcomes absent government intervention. Competition between the card schemes appears to be driving higher, not lower, fees. Furthermore, new payments providers (such as Apple Pay, Android Pay, and Semble) continue to rely on bank-issued scheme cards for their underlying payments processing.

Interchange fees are directly regulated in a number of jurisdictions including the United States, the European Union, and Australia. At present, there is no such regulation in New Zealand. Current provisions under the Commerce Act would only be able to address potential issues around interchange fees should there be clear evidence of anticompetitive behaviour or an absence of current or potential competition (which does not appear to be the case).

MBIE is planning to undertake work to assess whether regulatory intervention is justified in New Zealand. This work may lead to recommendations around the form of regulation in New Zealand. The Treasury supports the need for work being undertaken, and plans to engage with MBIE as work progresses.

The Reserve Bank is also reviewing its oversight regime for financial markets infrastructures (FMIs). s9(2)(g)(i)
s9(2)(g)(i)

s9(2)(a) Analyst, Financial Markets s9(2)(a)
Jennie Kerr, Team Leader, Financial Markets, 04 890 7444

From: s9(2)(a) [TSY]
Sent: Tuesday, 10 May 2016 5:17 p.m.
To: s9(2)(g)(i)
Cc: Ben Temple [TSY]; s9(2)(g)(i)
Subject: RE: Retail payment systems - agency catch up [IN-CONFIDENCE]

[IN-CONFIDENCE]

Hi s9(2)(g)(i)

Thanks again for arranging the meeting on Friday, it would good to discuss where the work is getting to.

I just had a few thoughts I wanted to pass on...

Firstly, I think it would be really useful to explain the various “markets” that collectively make up the retail payments sector. Off the top of my had you have payments processing, payments settlement, merchant acquiring, merchant interfaces (e.g. EFTPOS machines, Square, etc), and consumer interfaces (cards, mobile wallets, etc). Each of these is subject to different market structures and competitive dynamics. So it would be good to see some market-by-market analysis. I think this would not only help paint a clearer picture of the picture, but identify where the specific areas of concern are.

Secondly, I emphasise the need to look at the sector not just at this point in time, but in terms of how it is evolving. It is unsurprising to conclude that current levels of interchange fees are not obviously of concern, but will this always be the case? How might the shift to smartphone-based payments methods and tokenisation affect competition and market outcomes going forward?

Thirdly, we shouldn't ignore the fact that the card schemes and the four largest issuing/acquiring banks are foreign owned. Economic rents may therefore entail a welfare cost that would not be the case in a closed economy.

Finally, I'd be interested in your thoughts on the implications of the potential sale of Paymark. Would new owners be incentivised to invest in EFTPOS? (I suspect not) Also, is there anything you know about the sale of EFTPOS NZ that sheds light on likely nature of the transaction and the motivations of the new owners?

Regards,

s9(2)(a)

Analyst | The Treasury

s9(2)(a)

treasury.govt.nz

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Email chain withheld as out of scope of request

From: s9(2)(a) [TSY]
Sent: Thursday, 26 May 2016 3:59 p.m.
To: s9(2)(g)(i)
Cc: James Beard [TSY]; Ben Temple [TSY]; Lucy Greig [TSY]; s9(2)(g)(i)
s9(2)(g)(i)
Subject: Retail payments systems – preliminary Treasury thinking.DOCX
Attachments: 3455137_Retail payments systems – preliminary Treasury thinking.DOCX

[IN-CONFIDENCE]

Hi s9(2)(g)(i)

As promised please find attached the note I have drafted outlining a preliminary position on the retail payments systems issues. Please note that this is a working-level view that is yet to be signed off at a higher level internally. The note is being provided for discussion purposes only.

I am pleased to report that Lucy Grieg will be taking over on the payments systems work for Treasury. As discussed, it would be good for us to meet to discuss where the review is getting to and to get Lucy up to speed.

Happy for you to suggest a time that works for you. Tuesday and Wednesday mornings are looking quite good for us at this stage.

If you have any thoughts or questions on the note in the meantime please don't hesitate to get in touch.

Regards,

s9(2)(a)

Analyst | **The Treasury**

s9(2)(a)

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Retail payments systems – preliminary Treasury thoughts

s9(2)(a) May 2016

Background

The Treasury's recent engagement in retail payments systems matters has largely been in the context of the RBNZ's review of the oversight of financial market infrastructures (FMIs), which was initiated at the end of 2012, and is still ongoing.

We recognised that there existed a "gap" between the existing regulatory influence of the Commerce Commission (the limitations of which were discussed in their review of the 2009 credit card and interchange settlements) and that of the RBNZ (largely relating to the prudential/systemic stability focus).

s9(2)(f)(iv)

s9(2)(g)(i)

In February 2016, the Treasury and MBIE met with Ministers English and Goldsmith to discuss the scope of an MBIE-led review of the retail payments sector. Ministers supported this review, s9(2)(g)(i)

Out of scope of request

² Section 1A of the RBNZ Act sets out that the RBNZ is responsible for "promoting the maintenance of a sound and efficient financial system". The RBNZ has typically interpreted efficiency as a secondary mandate, focused on minimising regulatory barriers to entry and compliance costs.

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s9(2)(g)(i)

The nature of the issue

Retail payments is a two-sided market, where the systems by which payments are processed face significant network externalities. However, this is not a problem in and of itself, especially given the co-existence of multiple major networks (EFTPOS, Visa, MasterCard) which limit the market power that any single network has.

The key issue here is one of “price coherence and adverse intermediation”.³ In a market where buyers face the same price across intermediaries, intermediaries who charge fees to sellers can use these fees to incentivise buyers to use their service. Buyers then switch to using higher-cost intermediaries, with increased costs ultimately been born by sellers and buyers in general. In such markets, competition between intermediaries may actually result in higher fees, as this enables intermediaries to offer greater rewards to buyers to gain market share.

However, this situation does not completely describe how the retail payments market works. The “intermediary” is not a single entity, but three or more entities, including the relevant issuing bank, acquiring bank, payments switch, and (in the case of credit card or contactless payments) card scheme.⁴ The fee that a merchant pays to accept electronic payments is affected by all four of these players.

- **Payments switches** charge switching fees to the acquiring and issuing banks. At present these fees appear low, with competition between Verifone and Paymark and a history of bank ownership helping to moderate prices.⁵
- **Card schemes** (if applicable) charge scheme fees to the acquiring and issuing banks. These fees are higher than switching fees, though competition between Visa and Mastercard, and the availability of EFTPOS (which bypasses the card scheme networks altogether), help to moderate prices.
- **Issuing banks** charge an interchange fee to the acquiring bank. This fees in part reflects the costs to the issuing bank, including the switching fee and scheme fee, and the cost of any rewards payable to the cardholder. Competition between issuing banks for cardholder market share should help to moderate profit margins in interchange fees, though competition appears less likely to drive down the reward component of fees.
- **Acquiring banks** charge a merchant service fee (MSF) to the merchant. This fee in part reflects the cost of the applicable interchange fee, switching fee, and

³ See Edelman and Wright (2014) “Price coherence and adverse intermediation”.

⁴ EFTPOS terminals, mobile wallets, online payments portals and such like also play an important role in facilitating such transactions by routing information to the underlying payments network.

⁵ The fact that the dominant switch Paymark is owned by the four largest banks, may also help deter upward pressure on switching fees. However, we understand that the banks are currently looking to sell Paymark.

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scheme fee payable by the acquiring bank. Competition between banks for merchant acquiring market share is likely to moderate prices, especially for larger merchants, though potentially less so for relatively price-incentive SMEs.

In this complicated intermediation structure, it is the interchange fees that appears most concerning. In general, banks face a disincentive to compete on interchange fees given that lowering their own fees would create an unfavourable asymmetry between the fees they pay as an acquirers, and the fees they receive as issuers, with no resulting gain in market share for issuing. In fact, banks could risk losing market share if they were less able to compete on rewards as a result.

The ability of banks to *unilaterally* increase interchange fees is limited by interchange fee caps set by the card schemes (though determined in discussions with the banks themselves).⁶ s9(2)(ba)(ii)

s9(2)(ba)(ii) lower caps are available for “strategic merchants” within the fee cap structure. s9(2)(ba)(i)

The existence of EFTPOS has provided some competitive tension in the market. At present, if MSFs rose, there is a risk that merchants would take steps to favour EFTPOS, such as by surcharging, not accepting credit card/contactless, which could see overall MSF revenue fall. The fact that dipped/swiped scheme debit transactions do not go via the scheme networks likely reflects this risk. However, as EFTPOS use declines (in part because banks favour issuing more functional and fee-generating scheme debit card), this competitive tension weakens. It is largely expected that the decline of EFTPOS will enable the proliferation and level of MSFs to rise over time (including for scheme debit cards).

I agree with MBIE that the key issue is the unnecessary costs to transactions that are routed through the overseas card schemes at no intrinsic benefit to consumers or merchants (namely, those credit card transactions undertaken solely for the purposes of rewards points). However, the loss of “allocative efficiency” arises, in my view, not just because of the additional cost of sending payments via the scheme networks (i.e. the scheme fees). Firstly, I suspect that the cost of rewards (including associated administration and advertising costs) will in many cases outweigh the benefits received by rewards card customers. Secondly, I am sceptical that banks’ card issuing profits on are not always competed away, especially given that there is a large number of cards out there that do not attract rewards, for which competition between banks appears limited. Both these factors also detract from allocative efficiency.

I agree that broader “fairness” concerns also contribute to the issue, but only on the margins. For the large part the implicit cross-subsidy between credit card users and EFTPOS users is simply a restatement of the allocative efficiency issue, whereby the subsidy incentivises the “over-use” of credit cards. However, there may be additional

⁶ E.g. <http://www.visa.co.nz/aboutvisa/interchange/interchange.shtml>

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welfare losses given the regressive nature of this subsidy, given reward card use is likely to be positively correlated with income/wealth. There is also a “fairness” issue between smaller and larger merchants, though it appears that this is largely attributable to economies of scale rather than some form of market distortion.

Addressing the issues

I consider there to be four broad approaches to addressing potential issues around interchange fees and retail payment systems:

1. *Promoting surcharging*

This approach is appealing from a theoretical microeconomic perspective. However, I do not see this as desirable for several reasons. Firstly, the transition would not be costless, involving systems upgrades, staff training, and potential loss of goodwill. Secondly, there would be an ongoing cognitive burden for both merchants and customers. Thirdly, there might be a rational or irrational return to using cash (as emphasised in the Covec report). Fourthly, allocative efficiency gains would be limited as it is likely that the same surcharge would be applied to different card types, and that some merchants may overcharge customers for the cost of accepting payments.

2. *Reducing barriers to entry and effective competition*

There is nothing fundamental that prevents a system from facilitating both card-present and card-not-present (i.e. online and contactless) payments without using existing card scheme networks. However, upfront investment would be necessary, and barriers to entry do exist. Regulatory measures could be taken to reduce these barriers entry. The key barrier is the need to either negotiate bilateral agreements with each of the banks, or have Payments NZ (owned by the banks) to amend the rules of the Consumer Electronic Clearing System (CECS) to facilitate the new provider. Card Scheme rules applicable to merchants may deter the use of other systems (though the lingering effects of the 2009 settlement, and the threat of further legal action (e.g. under s36), may help deter such barriers). Finally, “latent” demand for a new system is likely to be limited businesses’ (and the general public’s) lack of awareness merchant service fees and their upward trend over time.

3. *Reinvestment in EFTPOS*

The EFTPOS system has the advantage of already being established and included in the CECS rules. However, significant investment would be required to achieve the same card-not-present functionality of the card schemes. Banks (who collectively govern the EFTPOS “scheme”) have no incentive to make such an investment, or promote the competitiveness of EFTPOS given the relative profitability of scheme card transaction (though banks may be inclined to keep EFTPOS “alive” as a contingency and to limit the scope for schemes to raise their scheme fees over time).

s9(2)(f)(iv) & s9(2)(g)(i)

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s9(2)(f)(iv) & s9(2)(g)(i)

4. Regulating interchange fees

Interchange fee caps provide a blunt but effective way to reduce the allocative efficiency concerns discussed above. However, any allocative efficiency gains would need to be weighed up against a potential loss of dynamic efficiency. The risk here is not really about deterring innovation per se, largely because much of the innovation in this space is driven internationally, with the marginal investment required in NZ being relatively small. The larger risk is deterring investment in the type of alternative scheme discussed above. Prevailing high fees are likely to provide the necessary incentive for market entrance. Capping these fees, and the regulatory uncertainty around the nature and level of these cap, may act to deter desirable investment in the market.

Conclusions and recommendations

In my opinion, there is clearly an issue with the efficiency of the retail payments sector. This issues arises largely from the ineffectiveness of competition in moderating interchange fees. The issue is likely to deteriorate over time as the competitive tension provided by EFTPOS declines. This suggests a growing need to consider government intervention in the sector.

None of the regulatory options available are a panacea. The dynamic nature of the sector suggests relatively light-touch intervention would be best suited, at least in the near term. My preferred near-term regulatory response is option two (reducing barriers to entry and effective competition), given the limitations associated with surcharging. This does not rule out introducing direct interchange fee regulation in the longer term, should there be a clear net benefit to doing so. However, it does not appear desirable to do so until we have evidence that the risks described above have crystallised, and that genuine market contestability has proven ineffective at mitigating these risks.

s9(2)(f)(iv)

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s9(2)(g)(i)

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