

Evaluation of the 2009 interchange and credit card settlements

Research report

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Glossary

Merchant – in many cases this is a retailer, who accepts payment from the consumer for various goods and services

Merchant Service Fees – this is a fee that the merchant/retailer must pay for accepting a credit card transaction to the merchant/retailer's own bank.

Interchange Fee – this is a fee, which is included in the merchant service fee, and is paid to the issuing bank of the cardholder.

Card schemes – for example Mastercard or Visa – the platforms over which transactions are made.

Card Issuer/Issuing Bank – the bank that issues the card to the customer

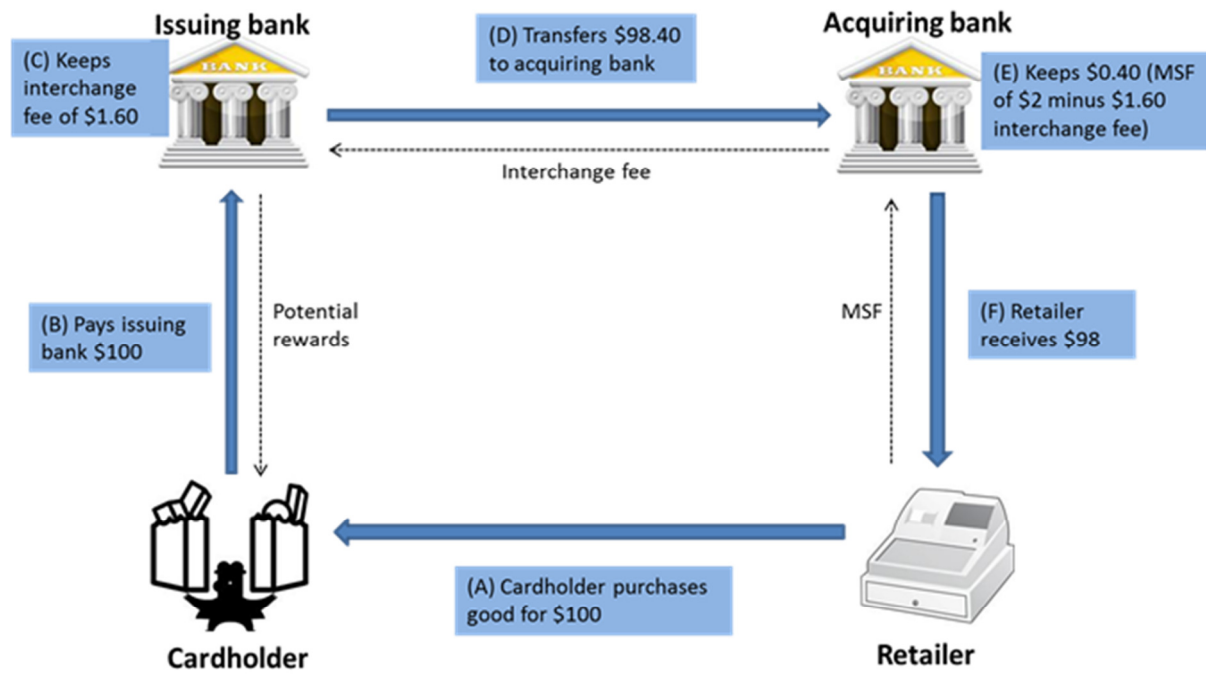
Merchant Acquirer/Acquiring Bank – the merchant/retailer's own bank which provides the credit card accepting service for the merchant/retailer. This includes sending transaction details of each transaction to the bank or financial institution that issued the card.

Specialist Acquirer – A firm that acts as a merchant acquirer (bank) but does not issue credit cards to customers. In New Zealand all merchant acquirers (banks) were also card issuers.

Summary

1. In 2009, the Commission reached settlement agreements with banks and financial institutions in relation to the setting of fees charged to merchants/retailers¹ for accepting credit card payments.

This diagram shows the flow of payments in a credit card transaction, A-F



2. These settlement agreements were designed to significantly reduce the average interchange fee (C), or the fee made from the merchant/retailer's bank to the customer's issuing bank.
3. The settlement agreements also stopped perceived anti-competitive practices by banks that included a "No Surcharge rule"- stopping merchants/retailers recouping bank costs for credit card transactions through a fee; and "No Discrimination Rules" – which stopped merchants/retailers steering customers to forms of payments other than credit cards.
4. The Commission has been evaluating how those settlement agreements impacted the market between 2010/11 and 2012/13. Data show the average fees that merchants/retailers pay to accept credit card transactions have decreased.²
5. As part of that evaluation, the Commerce Commission surveyed merchants/retailers on credit card payments. The Commission's survey results indicate that:

¹ In this context, merchants are considered to be those that accept consumer payments for various goods and services, for example, retailers.

² Merchant service fees, the fees that merchants pay for accepting credit card transactions, are comprised mainly of the interchange fee. The interchange fee is a fee paid to the bank of the cardholder.

- 5.1 while **some** merchants/retailers are now paying lower merchant service fees, (E), (a fee paid for accepting credit card payment), many are paying higher fees for accepting credit cards than they were in 2009;
 - 5.2 larger merchants/retailers are relatively more likely to report a decrease in fees;
 - 5.3 the proportion of merchants/retailers surcharging on credit card transactions or encouraging customers to pay by other means (steering) is relatively small;
 - 5.4 of those that do surcharge, they report this is mostly to cover the merchant service fee; and
 - 5.5 some merchants have used their ability to surcharge or steer when negotiating their merchant service fee with the bank.
6. We estimate that merchants/retailers paid over \$70 million less in interchange fees during this three year period compared to what they would have paid had interchange fees stayed at previous levels.
 7. This represents a significant cost saving for the merchant/retailer sector as a whole; although we cannot determine to what extent these benefits were passed on to consumers. Many merchants/retailers whose merchant service fees decreased reported that they have reduced prices for their customers. However, it is very difficult to test empirically the degree to which merchants/retailers have passed cost savings through to customers, or the degree to which the ability to surcharge on credit card transactions may have led to lower prices for purchases made with other payment methods.
 8. It is not possible to tell from survey responses whether or not the settlement agreements have led to a reduction in the total number of credit card transactions.
 9. The Commission has now concluded its evaluation of the settlements. We are satisfied the settlements contributed to significant savings for merchants/retailers.
 10. However, from the data we have collected, the Commission is aware that the average levels of interchange fees may be starting to increase again. If the trend back towards higher interchange fees continues then something other than non-compliance with the Commerce Act is likely to be the cause of the lack of competition. The Commission is not able to address anything other than breaches of the Commerce Act and so alternative regulatory intervention may be required.³
 11. The Commission will not be undertaking further monitoring of interchange fees at this time. The Commission considers that should regulatory intervention be required

³ It is unclear whether the tests for regulation under Part 4 of the Commerce Act would be met in this instance. The threshold for regulation under Part 4 is high. Part 4 regulation is only imposed on firms with a high degree of market power, usually because of the natural monopoly characteristics of the industry in question.

to address interchange fees, then that would be best achieved under an alternative regulatory framework.⁴

Background

12. In 2009, the Commerce Commission engaged in settlement agreements with MasterCard, Visa and banks and financial institutions in New Zealand. These settlement agreements resulted from the Commerce Commission's investigation into the setting of credit card merchant service fees (MSF)⁵ and associated rules imposed by the credit card schemes⁶ (e.g. Visa and Mastercard). The Commission received numerous complaints from the retail sector regarding these fees and rules.
13. The allegation was that the fixing of the 'interchange fee'⁷ component of the MSF by each of the credit card schemes and card issuers⁸ was anti-competitive. This inflated merchants' costs and led to higher prices for consumers. Interchange fees represented about 80% of the MSF charged by merchant acquirers⁹ to merchants.
14. The Commission also challenged a number of other provisions of the agreements between card schemes and issuing banks.
 - 14.1 The 'No Surcharge Rules' which prohibited surcharging of credit card transactions by merchants.
 - 14.2 The 'No Discrimination Rules' which were closely related to the 'No Surcharge Rules' and prohibited certain forms of discrimination between card payments and other payments, and between cards from different schemes and/or card issuers. Discrimination may include steering customers towards other payment types.
 - 14.3 The 'Access Rules' which restricted who could act as an acquirer of Visa and MasterCard transactions.
15. The 'No Surcharge Rules' and 'No Discrimination Rules' were considered anti-competitive as they worked to eliminate opportunities for merchants to create incentives for the card issuing banks to charge lower interchange fees. For instance, merchants could not charge higher prices to consumers for using credit cards, which potentially could cost the merchant more than other forms of payment. The rules

⁴ Such as the Reserve Bank Act.

⁵ The Merchant Service Fee (MSF) is the fee that the merchant pays its bank (that is, the merchant's acquiring bank) when it accepts a credit card transaction. The fee is usually a percentage of the transactions value, and incorporates the interchange fee.

⁶ Card schemes are the platforms or networks over which transactions are made, for example Mastercard and Visa.

⁷ The interchange fee is a payment made from the merchant's bank to the customer's issuing bank when a transaction is made, usually a percentage of the transactions value.

⁸ The card issuer, or issuing bank, is the bank that issues the card to the customer.

⁹ The merchant acquirer, or acquiring bank, is the merchant's own bank, which provides the credit card accepting service for merchants. This includes sending transaction details of each transaction to the bank or financial institution that issued the card. In New Zealand, the major banks provide acquiring services to merchants, as well as issuing credit cards to consumers.

therefore shielded credit cardholders from the cost of their payment choice and prevented merchants from recovering the cost or steering cardholders to a preferred method of payment.

16. The combined effect of these rules was that the credit card schemes and banks could collectively set high interchange rates without fear that consumers would switch to other payment options. Merchants could not charge consumers for credit card usage and, given the extensive use of credit cards in part driven by loyalty schemes, were compelled to accept credit cards. The high interchange rates would flow through to higher prices for all consumers.
17. The Commission considered that the scheme rules relating to access were also anti-competitive as they hindered entry by specialist acquirers¹⁰ or self-acquirers (generally large merchants), which reduced competition between the four main card-issuing banks that acted as acquirers in New Zealand.
18. As a result of the Commission's investigation, the Commission entered settlement agreements with the banks and schemes. The settlement agreements included commitments to:
 - 18.1 significantly reduce the average interchange fees charged on New Zealand credit card transactions, ensuring that these fees in New Zealand are driven downwards from the rates that were centrally set by the Visa and MasterCard schemes;
 - 18.2 refrain from any standard contracting practices that prohibit retailers from surcharging Visa and MasterCard Credit Cards as a condition of receiving credit card acceptance services;
 - 18.3 refrain from any standard contracting practices that prohibit merchants from encouraging customers to pay by other means;
 - 18.4 offer retailers the option of unblended service fees; that is offering separate fees for Visa and MasterCard transactions, enabling merchants to see the costs of accepting each scheme's credit cards;
 - 18.5 offer the option of fully unbundled service fees as between all types of Visa and MasterCard Credit Card transactions, revealing the exact amount of interchange fees applicable to each card transaction, assisting retailers to negotiate lower service fees and provide incentives to consumers to use their preferred payment methods; and
 - 18.6 change the access rules so that acquirers of credit card transactions did not also have to be card issuers or financial institutions.

¹⁰ A specialist acquirer is a firm that provides acts as a merchant acquirer for merchants, but does not issue credit cards to consumers. In New Zealand, all merchant acquirer (banks) were also card issuers.

Details of settlement evaluation

19. At the time of the settlement, the Commission anticipated that interchange fees would decrease with downward pressure continuing whilst ensuring those fees remained transparent and open to competitive forces in the future. The Commission anticipated savings to merchants of between \$70-80 million in the period 2010-2013.
20. The Commission has been collecting data from the parties involved to ensure compliance with the settlement agreements. We have also been undertaking a broader evaluation of the settlement agreements to help determine their success in promoting competition in the market. From the aggregate data collected by the Commission, we estimate that merchants paid over \$70 million less in interchange fees between 2010 and 2013 compared to what they would have paid had fees stayed at 2009 levels over that time period. We are therefore satisfied the settlements contributed to significant savings for merchants, although we are unable to establish the extent to which these savings have been passed on to consumers.
21. The Commission has now concluded its evaluation of the settlements. We continue, however, to be interested in market developments in this area.

Market developments

22. The Commission is aware that in some instances the average levels of interchange fees may be starting to increase again. As noted above, the parties have been complying with the settlement agreements. As the parties appear to be complying with the settlement agreements then they are likely to be complying with the Commerce Act in respect of those issues (discussed above) that were considered as part of the settlement agreements. Therefore, if the trend back towards higher interchange fees continues then something other than non-compliance with the Commerce Act is likely to be the cause of the lack of competition. The Commission is not able to address anything other than breaches of the Commerce Act and so alternative regulatory intervention may be required.
23. We note that overseas jurisdictions have specifically regulated interchange fees, or taken steps towards such regulation. For instance, in 2003 the Reserve Bank of Australia mandated that interchange fees be set on a cost-based benchmark, which has resulted in significantly lower interchange fees. In 2010, the US Federal Reserve was given the authority to cap interchange fees for debit cards, which the Federal Reserve has now implemented. More recently, in 2013 the European Commission announced a proposal to regulate interchange fees on credit and debit card transactions.

Merchant survey details

24. As part of the evaluation of the settlement agreements, the Commission undertook a survey of merchants. The Commission contracted Nielsen, a market research firm, to undertake the survey.

25. The survey was targeted at merchants in the retail sector.¹¹ The retail sector accounts for around 75% of value and 85% of volume of electronic card transactions in New Zealand.
26. A sample of 3,500 retailers was selected from the following sub-groups of merchants:
 - 26.1 Accommodation;
 - 26.2 Food and Beverage Services;
 - 26.3 Food Retailing;
 - 26.4 Fuel Retailing;
 - 26.5 Motor Vehicles and Parts; and
 - 26.6 Other Retailing (including Non-store Retailing and Other Store-based Retailing).
27. The survey was in the field during October and November 2012. A total of 635 complete responses were received and coded into a database. This was a response rate of about 18%. The responses were weighted on the basis of region, industry and turnover.¹²

Main merchant survey results

28. The main results as outlined below include details of:
 - 28.1 changes in MSF;
 - 28.2 whether merchants are surcharging on credit card transactions, or encouraging customers to use other means of payment (steer);
 - 28.3 the use of the ability to surcharge and/or steer in negotiations;
 - 28.4 any impact on the number of credit card transactions; and
 - 28.5 the impact on merchant's businesses.

How have the costs of accepting credit cards changed?

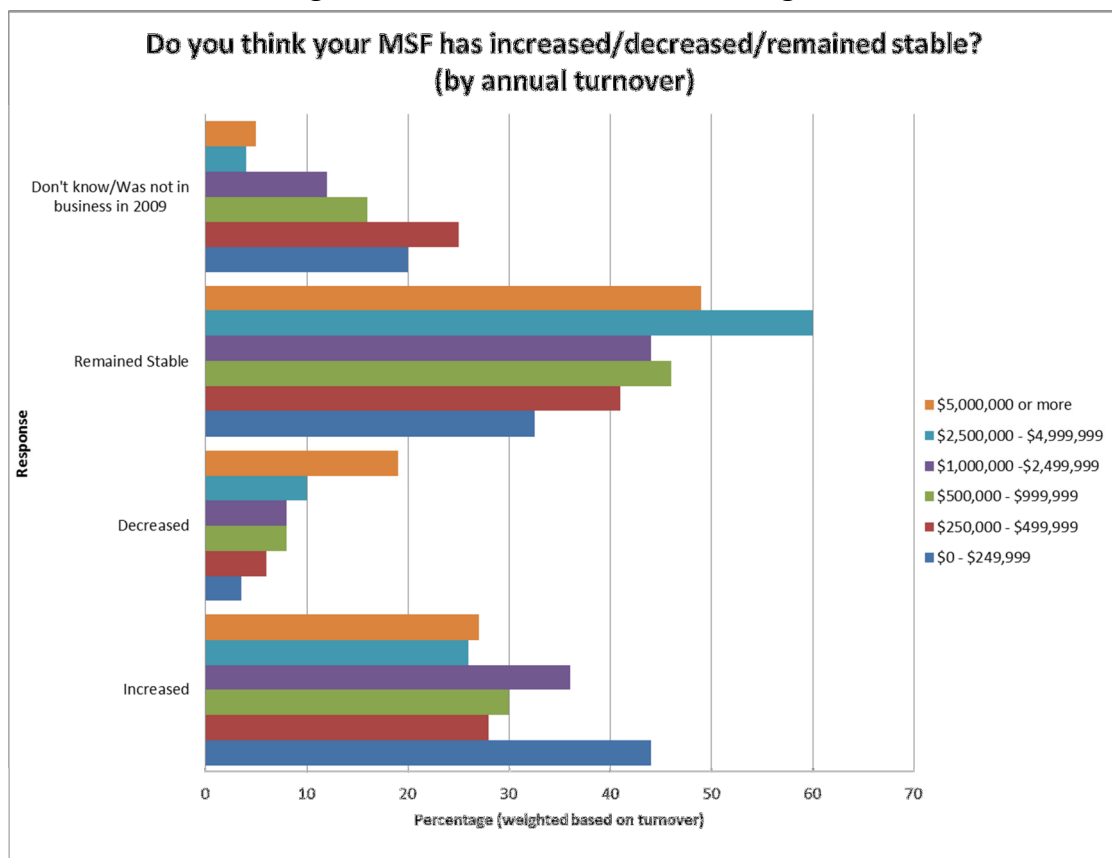
29. As noted above, we estimate that merchants paid over \$70 million less in interchange fees between 2010 and 2013 compared to what they would have paid had fees stayed at 2009 levels over that time period.

¹¹ Other sectors such as airlines, utilities and government services were not included.

¹² As part of the survey method, sample quotas were set to target a number of merchants in proportion to the retail sales for each region and each industry. This was to ensure that a complete range of retailers were covered in the survey. To provide a more accurate representation of retailers, responses were also weighted based on region, industry and annual turnover. Statistics New Zealand data was used for total retail sales by industry and region.

- 30. To get a greater understanding on how these changes have impacted individual merchants the survey asked merchants whether their MSF had increased, decreased or remained stable since 2009.
- 31. On average, merchants were more likely to report an increase in their MSF than a decrease. Almost half of all merchants surveyed reported a stable MSF.
- 32. When responses are disaggregated on the basis of merchants' turnover, the results show that larger merchants are more likely to have reported a decreased MSF and less likely to have reported increased MSF compared to smaller merchants. An overview of merchants' responses disaggregated by company turnover is shown in Figure 1.

Figure 1: Have merchants' MSFs changed?



- 33. There are a number of reasons why more merchants may have responded that their fees have gone up, despite average fees having gone down.

33.1 The survey may not fully capture the population of merchants – for example, some of the largest merchants that account for a large proportion of transactions may not have been included.¹³ Thus, while responses are weighted, the larger merchants (by definition) account for more transactions and so if their fees are more likely to go down, overall fees are more likely to go down.

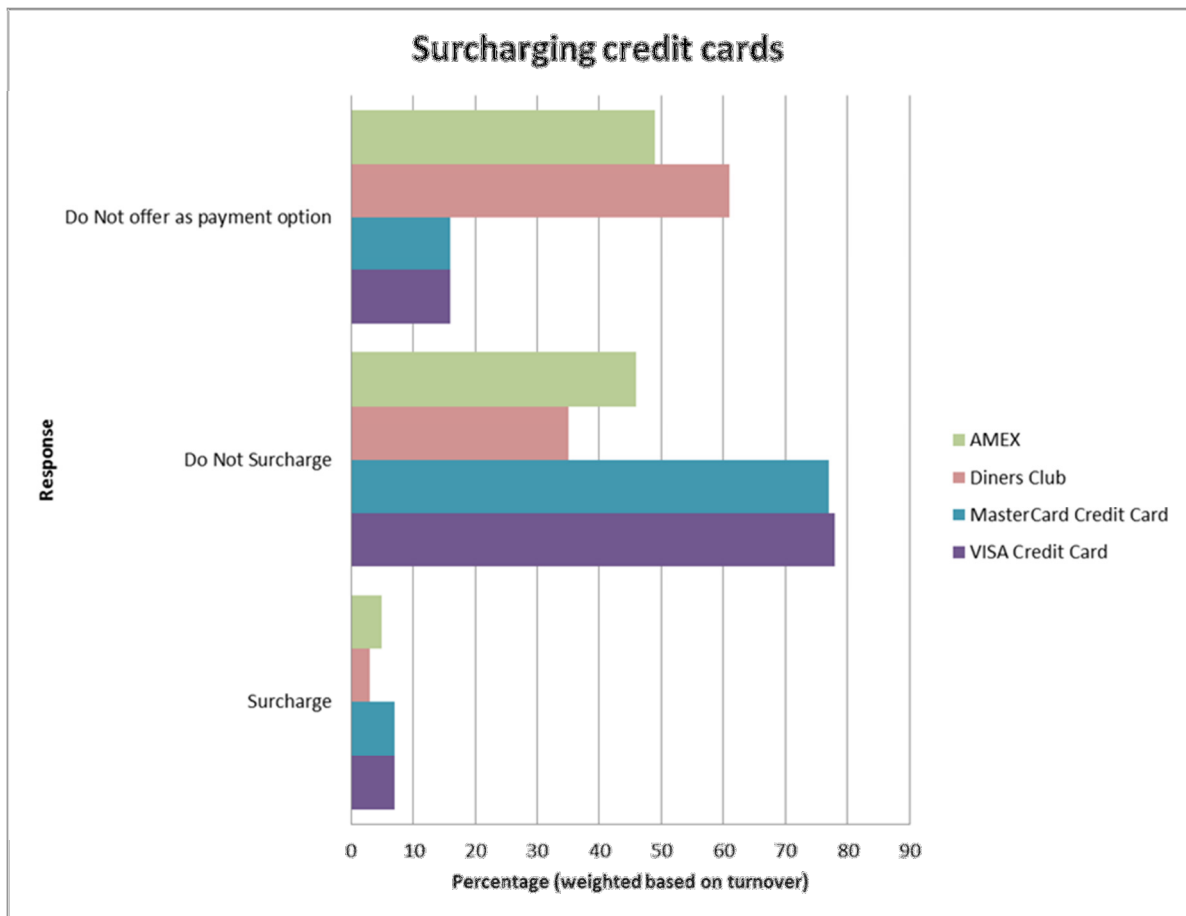
¹³ The survey respondents were anonymous to the Commission.

- 33.2 Banks may have provided end-of-year rebates to merchants which would lead to lower effective fees for merchants, but this may not be included in merchants’ responses on change to MSF.
- 33.3 Any reporting bias that may lead merchants to be more likely to report an increase than a decrease in MSFs.

Are merchants surcharging customers for credit card payments?

- 34. As noted above, the settlements agreements removed restrictions that had previously prevented merchants from surcharging on credit card transactions.
- 35. The ability to surcharge can be an important tool for merchants. Surcharging allows for merchants to directly recoup costs for higher-cost payment options, and can therefore encourage consumers to use lower-cost payments methods.
- 36. Merchants were asked whether they surcharge customers depending on the method of payment used. Most respondents to the survey do not surcharge credit card payments (Figure 2).

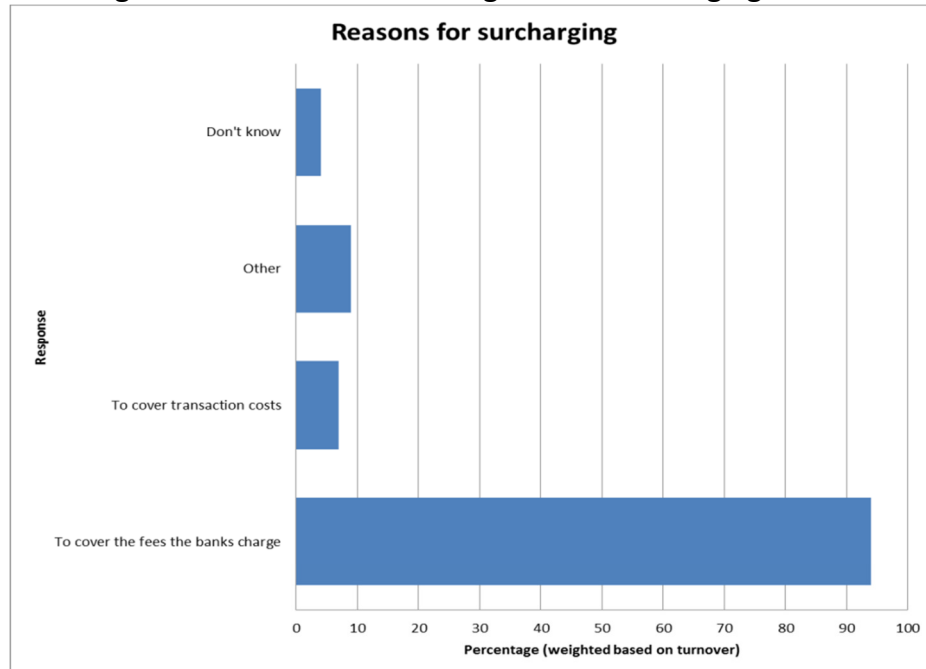
Figure 2: Proportion of merchants that surcharge (by credit card payment option)



- 37. We also asked merchants why they surcharge or, alternatively, why they do not surcharge.

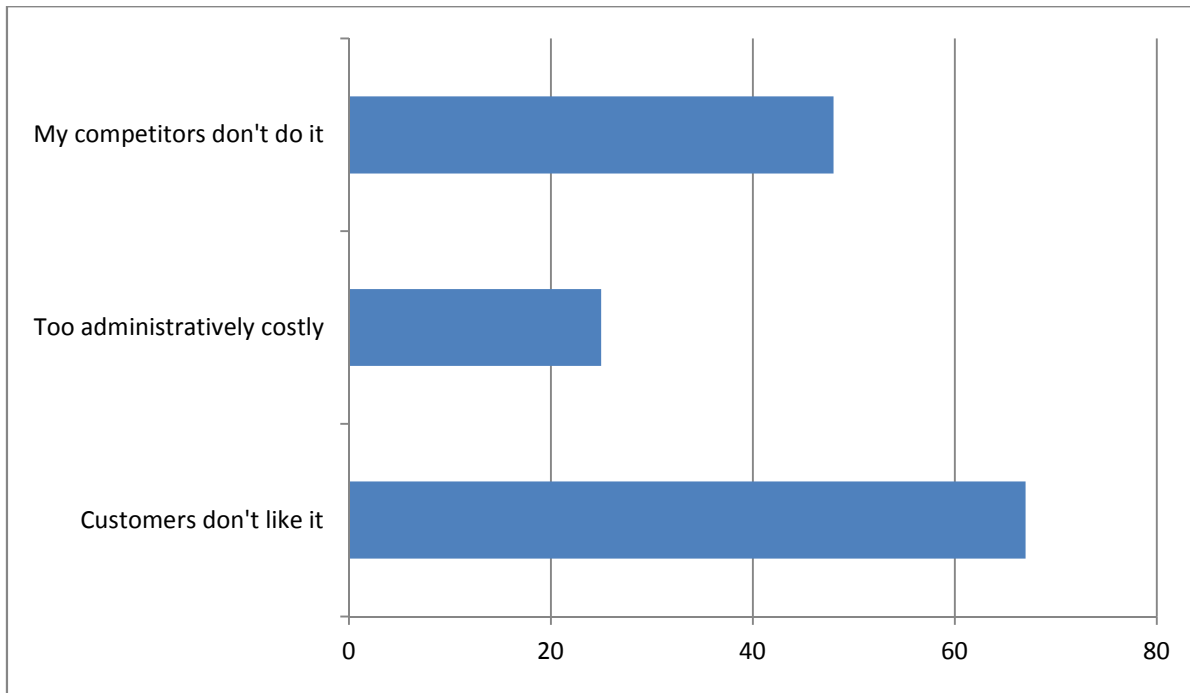
38. For merchants that surcharge on credit card transactions, merchants predominantly responded that the surcharge was to cover MSF (Figure 3). As noted above, however, only a small segment of merchants surcharge on credit card transactions, so this is a relatively small sub-sample.

Figure 3: Merchants' reasons given for surcharging



39. For merchants that do not surcharge on credit cards transactions, the main reasons given by respondents as to why were: customers did not like it, competitors do not do it, or because it was administratively too difficult or costly (Figure 4). Note that merchants could select multiple answers.

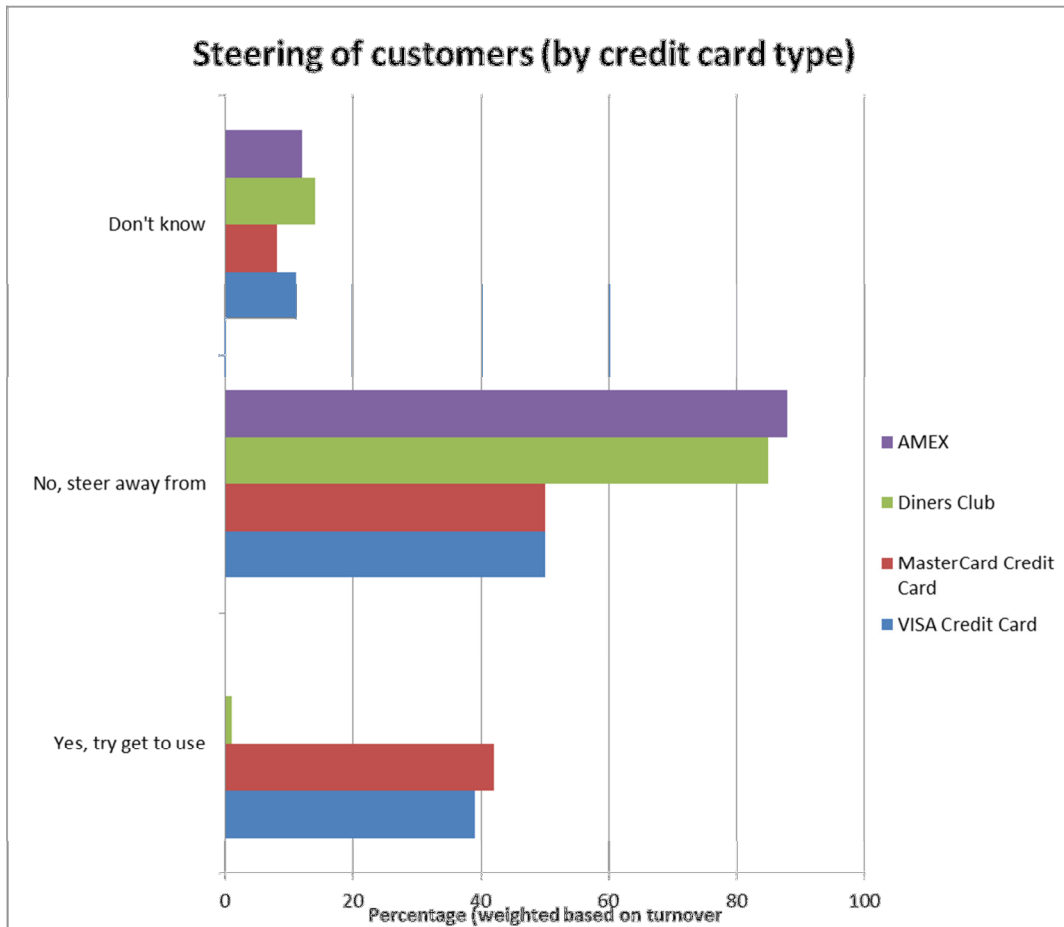
Figure 4: Merchants main reasons for not surcharging



Are merchants steering customers' payment choice?

40. The settlement agreements also allowed greater scope for merchants to steer customers towards preferred methods of payments.
41. The survey asked merchants whether they ever try to steer customers to one type of payment method over another (either through discounts, promotions or sales staff encouraging customers).
42. About 17% of respondents stated that they try steering towards or away from particular payment methods. Of those merchants that do steer, they are more likely to steer away from credit cards than towards. For Visa and Mastercard there were a significant proportion of respondents that stated they try to steer customers towards these payment methods (Figure 5).

Figure 5: Steering customers away or towards using credit cards



Are merchants using their ability to surcharge and steer in negotiations with banks?

43. While the survey indicates only a small proportion of merchants are surcharging, merchants may be able to negotiate lower fees from banks in order for banks to avoid their card transactions being surcharged.
44. Of respondents that directly negotiate their card acceptance fees with the bank, only about 14% responded that they discussed with their banks the possibility of surcharging or steering in order to get a better deal on fees. Of those that did use their ability to surcharge/steer in negotiations, they tended to get a lower or slightly better fee, although this particular result is from a relatively small sub-set of respondents, and as such the results are at best indicative.

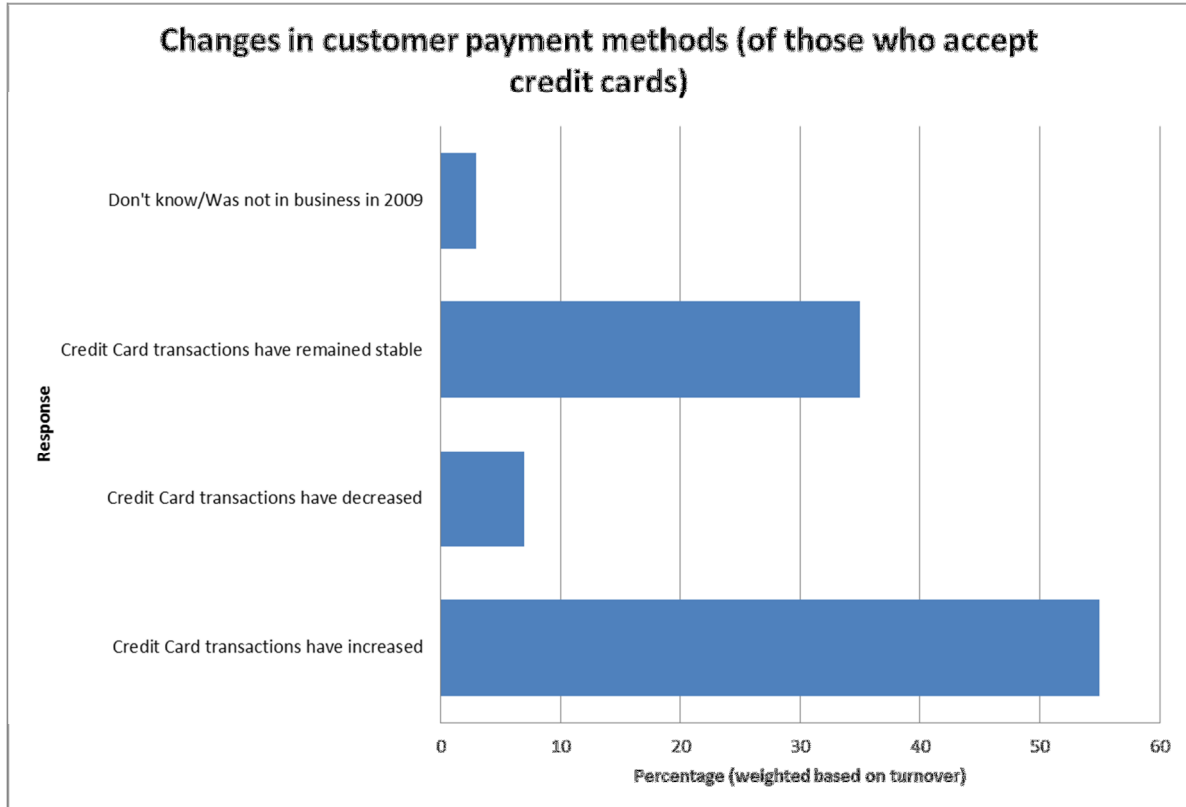
Has there been a change in the relative number of credit card transactions as a result of the settlements?

45. One potential impact of the settlement agreements is that the number of credit card transactions may decrease compared to what they otherwise would have been. This is because the cost of using credit cards may have increased for consumers. Of course, there are a number of factors that are likely to have impacted credit card use over the last three years, including any impacts of the recession and global financial

crisis. This makes isolating the impact of the settlement agreements a difficult task, including when considering more aggregate data on transaction volumes.

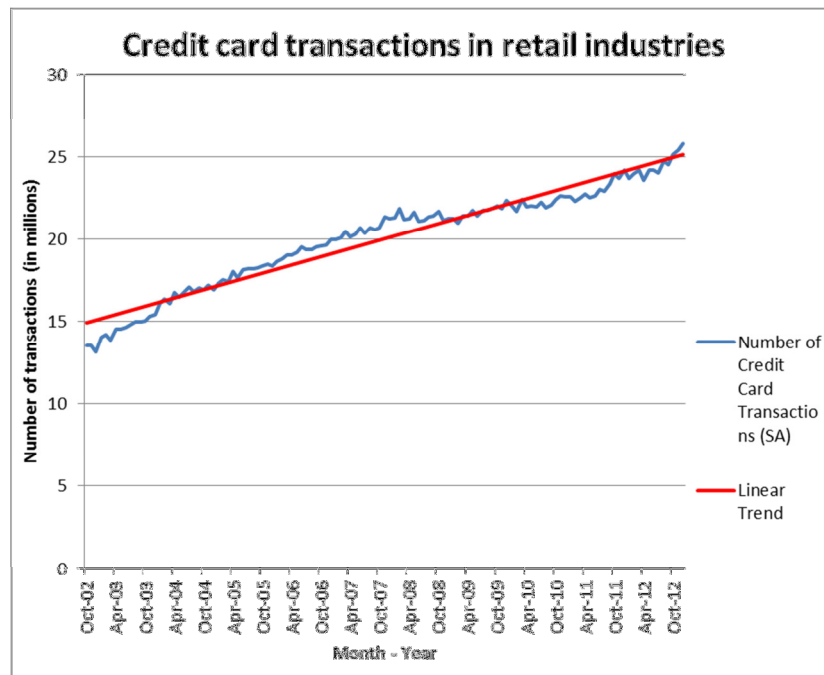
46. We asked merchants whether the number of credit card transactions have changed since 2009. The majority of respondents reported that the number of credit card transactions have increased (Figure 6).

Figure 6: Changes in the number of credit card transactions



47. This increase is confirmed by data from Statistics NZ. That data shows the number of credit card transactions in retail industries from 2002 to 2012 (Figure 7).

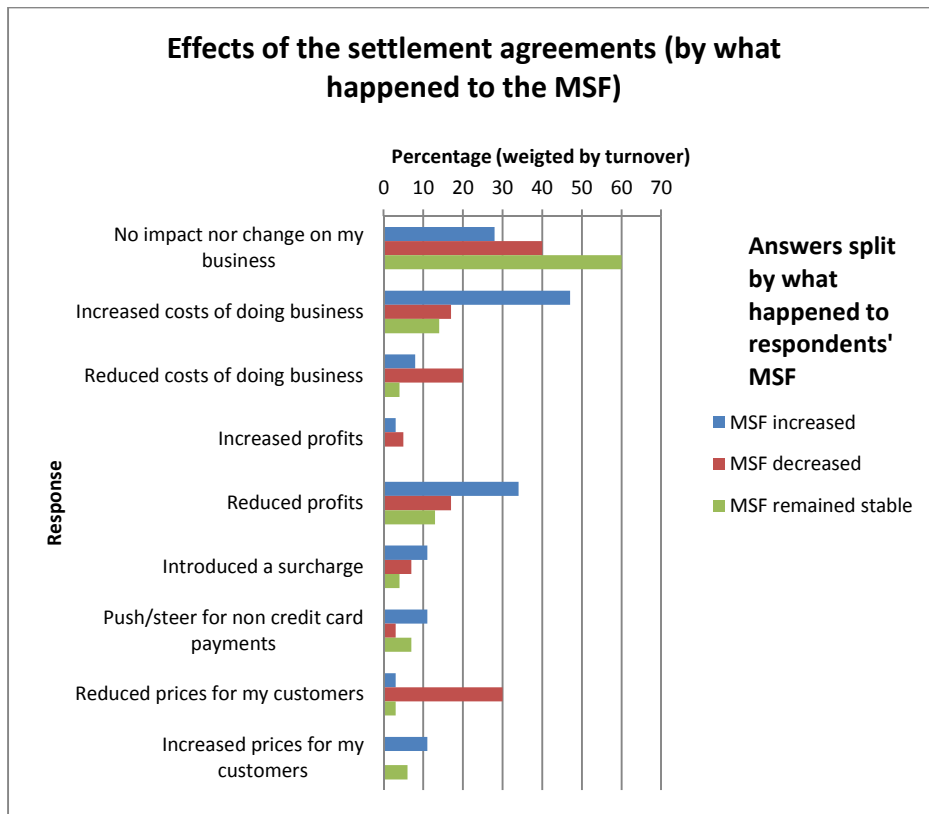
Figure 7: Statistics NZ data on the number of credit card transactions in retail industries



What impacts do merchants see on their business as a result of the Settlement Agreements?

48. Part of the intention for the survey was to assess merchants' perception of the changes resulting from the settlement agreements have had on their businesses.
49. Merchants' views on the effect on their business were correlated with what had happened to their fees for accepting credit cards in the intervening years.
50. Merchants who reported that their fees for accepting credit cards had decreased were more likely to report reduced prices for customers or increased profits (Figure 9). Whereas merchants that reported their fees had increased were more likely to report increased consumer prices or reduced profits. The most common response from merchants, however, was that there was no change or impact on their business.

Figure 9: Effect of the settlement agreements for merchants



Conclusions

51. As noted, the Commission has been evaluating how those settlement agreements impacted the market between 2010/11 and 2012/13. Data show the average fees that merchants/retailers pay to accept credit card transactions have decreased.¹⁴
52. As part of that evaluation, the Commerce Commission surveyed merchants/retailers on credit card payments. The Commission's survey results indicate that:
 - 52.1 while **some** merchants/retailers are now paying lower merchant service fees, (E), (a fee paid for accepting credit card payment), many are paying higher fees for accepting credit cards than they were in 2009;
 - 52.2 larger merchants/retailers are relatively more likely to report a decrease in fees;
 - 52.3 the proportion of merchants/retailers surcharging on credit card transactions or encouraging customers to pay by other means (steering) is relatively small;
 - 52.4 of those that do surcharge, they report this is mostly to cover the merchant service fee; and

¹⁴ Merchant service fees, the fees that merchants pay for accepting credit card transactions, are comprised mainly of the interchange fee. The interchange fee is a fee paid to the bank of the cardholder.

- 52.5 some merchants have used their ability to surcharge or steer when negotiating their merchant service fee with the bank.
53. We estimate that merchants/retailers paid over \$70 million less in interchange fees during this three year period compared to what they would have paid had interchange fees stayed at previous levels. This represents a significant cost saving for the merchant/retailer sector as a whole.
54. The Commission has now concluded its evaluation of the settlements and will not be undertaking further monitoring of interchange fees at this time.