



COVERSHEET

Minister	Hon Dr David Clark	Portfolio	Commerce and Consumer Affairs
Title of Cabinet paper	Regulation of the Retail Payments System Additional Policy Approvals	Date to be published	8 September 2021

List of documents that have been proactively released

Date	Title	Author
29 June 2021	<i>Regulation of the Retail Payments System Additional Policy Approvals</i>	<i>Office of the Minister of Commerce and Consumer Affairs</i>
30 June 2021	<i>Regulation of the Retail Payments System: Additional Policy Approvals Cabinet Minutes</i>	<i>Cabinet Office</i>
23 June 2021	<i>Regulatory Impact Statement: Additional tools for regulating the retail payments system</i>	<i>MBIE</i>

Information redacted

YES

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Some information has been withheld for the reason of Confidential advice to Government.



Regulatory Impact Statement: Additional tools for regulating the retail payments system

Purpose	
Decision sought	<i>Analysis produced for the purpose of informing Cabinet decisions</i>
Advising agencies	<i>Ministry of Business, Innovation and Employment</i>
Proposing Ministers	<i>Commerce and Consumer Affairs</i>
Date	<i>23 June 2021</i>
Problem Definition	
<p>There are economic inefficiencies in the retail payments system which are resulting in poor outcomes for many consumers and merchants. Most merchants participating in the system bear disproportionate costs, which are passed on to all consumers in higher prices, while only some of these consumers receive disproportionate benefits. Some payment providers are likely earning excess returns. Weak price signals to consumers about the cost of payments, and the lack of countervailing bargaining power by merchants, means that resources are not put towards the most productive uses for the economy as a whole. Over the past few years, voluntary industry initiatives have been relied on to address the issues. However, slow progress has been made and some of the underlying market dynamics leading to the problem have not been addressed. We have come to the conclusion that government intervention is required.</p>	
Executive summary	
<p>Current levels of competition in the retail payments system (eg payment networks for clearing EFTPOS, debit and credit card transactions), and the application of generic competition law, have been insufficient to constrain unreasonably high merchant service fees (MSF), which imposes inequitable costs on some segments of consumers and businesses. While various agencies are responsible for overseeing prudential, conduct and competition regulation in the system, there is a gap in overall regulatory oversight of the retail payments system specifically, which is constantly evolving with no single regulator with the capacity and responsibility to keep up.</p> <p>In April 2021 Cabinet agreed to establish a regulatory framework to ensure the retail payments system delivers long-term benefits for consumers and merchants in New Zealand. The proposals to inform this decision were considered in a previous iteration of this Impact Statement. Cabinet</p>	

agreed to establish a designation model, which will set the parameters of regulation in primary legislation to give the Commerce Commission (**Commission**) a mandate to regulate designated retail payment networks and participants within those networks. Cabinet agreed that the Commission would have a package of tools to include the ability to regulate interchange fees, information disclosure powers and regulation of other price aspects in the retail payments system.

This additional Impact Statement is to be used to support Ministerial decision-making on additional tools available to the regulator. These are intended to be implemented alongside the tools which Cabinet has already agreed to. The proposals involve supplementing the price regulation and information disclosure with additional tools which are: the ability to direct changes to rules, impose access regimes, monitoring powers and limits on merchant surcharging.

Overall, the package of proposals considered in this and the previous Impact Statement are likely to reduce the profit margins of banks and debit/credit card schemes in New Zealand. The proposals will involve a cost to government to cover new regulatory functions of between \$6 and 10 million per annum.

We estimate that across annual retail sales of \$97.6 billion, a 20 per cent reduction in credit card interchange fees and a 30 per cent reduction in online debit interchange fees would equate to savings for consumers and merchants of \$74 million.

Limitations or constraints on analysis

The November 2020 Speech from the Throne made a commitment from the Government to regulate MSF charged to retailers for debit and credit card transactions to bring them into line with overseas costs. The Government has committed to a regulatory solution to reduce costs for retailers and consumers. This places constraints on our advice as it confines our recommendations to regulatory options (although non-regulatory options have previously been attempted and are discussed in this assessment).

There are also significant time constraints on this project, which impact the advice we can provide as well as the options that we can recommend in the timeframe. The Minister of Commerce and Consumer Affairs indicated to the Ministry of Business, Innovation and Employment (**MBIE**) that this work is a priority in the portfolio. The release of an issues paper on *Regulating to reduce merchant service fees* (**MBIE 2020 Issues Paper**) was a first 100 days priority and was released in the first two months of this Government's term. Cabinet agreement to the design of the regulatory regime and the initial set of tools for the regulator was sought in April 2021. The proposals analysed below are to be considered by Cabinet in June 2021. Our advice is therefore constrained to analysing options that draw from similar overseas regimes, with a particular focus on Australia and the United Kingdom.

Another impact of the time constraint is that it limits the extent and quality of consultation we can undertake with interested parties. We consulted publicly to test the problem in the MBIE 2020 Issues Paper, which received 36 submissions from banks, card schemes and organisations representing businesses and consumers. On the whole, submissions generally agreed with the case for greater regulatory oversight.

We also undertook targeted consultation with 18 affected parties on the detailed options in this Impact Statement prior to final Cabinet decisions being made. This consultation took place over a period of two weeks and was conducted through a series of meetings with key stakeholders who submitted on the MBIE 2020 Issues Paper. Given the timeframe available for consultation, and the form of the consultation (via meetings), we were not able to consult on the detailed aspects of the

options, such as canvassing stakeholders’ thoughts on the types of rule changes that might be directed by the Commission. The timeframe also limited the range of views we could consider, to those key stakeholders who had previously submitted on the MBIE 2020 Issues Paper. For example, we did not engage with some non-bank financial institutions and a full range of merchants, which could have provided a different range of perspectives.

MBIE holds a reasonably good level of data on the evidence of some of the problems. We have up-to-date data from system participants on the level of interchange fees and MSF and can compare these to international levels. System participants, particularly the banks and the card schemes, have been forthcoming with data, which has been very valuable for assessing the scale of the issues identified in the MBIE 2020 Issues Paper. This informs our understanding of issues such as high levels of MSF and the fact that small businesses in particular face higher MSF. However, the data for assessing the likely impact of the various options relative to the status quo is limited. This is because our proposal involves providing a regulatory framework to equip the regulator with various tools that can be imposed on designated participants in the retail payments system. This leaves scope for determining how much of the retail payments system is regulated and how they are regulated. The scale of the impacts will vary depending on the participants that are regulated and how, which we do not make recommendations on given the proposal is to create the regulatory framework but not to designate specific participants in the primary legislation.

If we had more time, we would have liked to include more in-depth analysis of some of the distributional impacts of the problem on certain segments of New Zealand consumers. We discuss the issue of a segment of consumers cross-subsidising another segment of consumers, but would have liked to have better data on the demographics of the consumers who currently bear the greatest costs.


Responsible Manager

Dan O’Grady
 Manager
 Competition and Consumer Policy
 Ministry of Business, Innovation and Employment
 23/06/2021

Quality Assurance

Reviewing Agency:	The Treasury, MBIE
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Panel Assessment & Comment:	<p>A quality assurance panel with members from the Treasury’s Regulatory Impact Analysis Team at the Treasury and the Ministry of Business, Innovation and Employment (MBIE) has reviewed the Regulatory Impact Statement (RIS) “Additional tools for regulating the retail payments system” produced by the MBIE. The panel considers that it meets the Quality Assurance criteria.</p> <p>The RIS has clearly and concisely described the technical and complex proposals in plain language. Additional tools for regulating the retail payments system have been identified and evaluated against a comprehensive assessment framework. The analysis indicates that effective implementation will depend on the Commerce Commission, as</p>
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the regulator of the retail payments system, having sufficient resources to support its new functions. While consultation has been constrained due to timing, the risk is mitigated as a range of stakeholders have been consulted via a targeted approach.

Regulatory Impact Statement: Regulating the retail payments system

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

Background to the retail payments system and nature of the market

The retail payments system transmits, clears and settles financial transactions between consumers and merchants when acquiring goods and services. This assessment focuses primarily on debit and credit card schemes, but other products – including potential emerging disruptors – are also considered given the dynamic nature of retail payments.

The retail payments system is a two-sided market, in which buyers and sellers exchange goods or services using a platform or intermediary. In this case, the system uses intermediaries (financial institutions such as banks that participate in card schemes and the EFTPOS system) to coordinate transactions between customers and merchants. Like other two-sided markets, the system sees strong ‘network effects’ from the use of particular payment methods – consumers prefer to use payment methods that are widely accepted by merchants, and merchants prefer to accept payment methods that are widely used by consumers. Network effects such as these have implications for the state of competition in the market – in this case, it means that transaction routes are typically concentrated in the hands of a few players and a limited number of retail payment networks (methods of paying eg the Visa credit payment network).

The following classes of participants are active in certain retail payment networks such as the scheme debit and credit card networks:

- *Consumers* buy goods and services from merchants in exchange for payment; hold cards issued by banks. Can be individual consumers or business consumers.
- *Merchants* provide goods and services in return for payment; they include retailers, wholesalers, utility companies and central and local government.
- *Issuers* issue cards (including EFTPOS, debit and credit) and provide debit and credit services to consumers; typically are banks ie the bank used by the consumer.
- *Acquirers* provide access to the retail payment network on behalf of merchants to clear and settle funds in a transaction; typically are banks ie the bank used by the merchant.
- *Schemes* provide card branding, develop technology and base card product features, set the commercial model and card system rules; they include Visa, Mastercard, American Express and Diners Club.

- A *switch* is infrastructure that sends the transaction information to the correct card issuer or acquirer so the funds can be taken from the consumer's account in the issuing bank and delivered to the merchant's account in the acquiring bank. Used in EFTPOS, debit and credit card transactions.

Card transactions are the main method of retail payment in New Zealand and are routed through either the switch-to-issuer or the switch-to-acquirer systems:

- a. The switch-to-issuer system is used for EFTPOS and swiped or inserted scheme debit card transactions. The transaction is not routed through the card schemes. Use of this system does not currently incur a direct transaction cost for merchants.
- b. The switch-to-acquirer system (scheme rails) is used for all credit cards (online, swiped, inserted and contactless), contactless debit cards and online debit card transactions. The card schemes are central to this system. When a customer uses a card at the merchant's point of sale, the payment instruction is sent by the switch to the acquirer. The acquirer then sends, via the scheme, the payment instruction to the issuer for clearance. The acquirer recovers the cost of processing a transaction from the merchant through a merchant service fee.

There are variations on these systems, such as digital wallets (eg Apple Pay) and three-party scheme transactions (eg American Express or Diners Club), as well as emerging payment methods, such as BNPL products. Some of these retail payment networks make use of the switch-to-acquirer system, meaning that scheme debit or credit cards are required for prepayment (some digital wallets) or post-payment (by now, pay later products).

Financial markets regulatory system

Participants in the retail payments system are regulated by the financial markets regulatory system. The objective of this system is to have well-functioning financial markets which support sustainable business growth and job creation. It does this through three elements:

- Conduct regulation – financial markets are fair, efficient and transparent, and businesses, investors and consumers are confident and informed participants. The Financial Markets Authority (**FMA**) enforces the Financial Markets Conduct Act 2013, which regulates financial institutions such as banks that participate in the retail payments system.
- Prudential regulation – individual financial institutions and the financial system are resilient so as to minimise any disruption to economic activity. The Reserve Bank of New Zealand (**RBNZ**) has oversight of payment systems for the purpose of promoting the maintenance of a sound and efficient financial system under Part 5B of the Reserve Bank Act 1989.
- Efficiency – effective and reliable services (including those provided by regulators and policy makers) are provided to participants in financial markets in a way that allocates resources to productive activities, minimises compliance costs and encourages positive innovation.

Participants in the system are also subject to competition regulation by the Commission. The Commission can investigate anti-competitive behaviour in markets under the Commerce Act 1986. However, the Commission's ability to oversee the operation of the retail payments system as a whole is limited. The Commerce Act does not empower the Commission to take action to reduce high MSF if they are not the product of collusion between the parties.

The financial markets regulatory system is overseen by a governance body, the Council of Financial Regulators, of which the members are RBNZ, FMA, Treasury, MBIE and the Commission.

MBIE has primary responsibility for maintaining, monitoring, evaluating, and improving the financial markets conduct regulatory system. MBIE is directly accountable to the Minister of Commerce and Consumer Affairs. A regulatory charter for the wider financial sector has been put in place under the auspices of the Council of Financial Regulators. A regulatory system assessment is expected to take place every five years – the next is not likely to take place until recent changes to this regulatory system have bedded in.

Regulatory gap

There is currently no single regulator responsible for the retail payments system. While participants in the retail payments system are subject to competition regulation by the Commission and the twin-peaks model of prudential and conduct supervision by RBNZ and FMA respectively, there is no single body with oversight over the retail payments system. We consider there is currently a regulatory gap in this respect, as the system is constantly evolving with emerging technologies and new entrants, and there is no single regulator with the capacity and responsibility to keep up.

As existing legislation is also more narrowly focused on competition, prudential and conduct aspects specifically, it does not fill the regulatory gap of overall oversight of the system. New legislation is needed which targets the retail payments system in particular and which is able to adapt to its complexities.

The industry body Payments NZ has played a leading role in developing rules, standards and procedures for payment systems. However, the feedback from consultation confirms Payments NZ is influenced by the interests of the banks that own it. As a result, it is poorly placed to oversee issues related to pricing and regulate business models which the banks profit from.

Engagement with stakeholders also indicates a gap in the oversight of schemes which play an integral role in dictating the operation of the scheme rails in New Zealand. Visa and Mastercard are international organisations that dominate the New Zealand scheme debit and credit card market. The schemes have been left to develop their own standards of operation and interchange caps, subject to generic competition and fair trading laws.

Background to the review of the retail payments system

The November 2020 Speech from the Throne made a commitment to regulate MSF to reduce costs to retailers. This commitment is based on concerns raised that MSF are high relative to overseas jurisdictions, with Retail NZ estimating that in 2019, New Zealand retailers paid nearly twice as much as their Australian counterparts. Recent data collected by MBIE has shown that in fact overall, merchant service fees in New Zealand are broadly comparable to those in Australia, but are about twice as high for some individual categories of payment method while some categories (ie EFTPOS) cost nothing in New Zealand.

MBIE first initiated a review of the retail payments system in 2016, seeking feedback on whether New Zealand's retail payments systems were delivering good outcomes for consumers, merchants and the New Zealand economy. MBIE concluded that New Zealand's retail payments systems were not functioning as well as they could, confirming that many of the issues identified were problems.

Successive Governments have engaged with the card schemes and banks to encourage industry-led solutions to get better outcomes for merchants and consumers, while noting that further regulation could be an option. There were also some promising developments including some industry-led initiatives that could go some way to address the issues:

- a. The banks (through the New Zealand Bankers' Association) undertook to provide greater

transparency of fees to merchants. This had the potential to help merchants' decision-making and improve merchants' bargaining power when negotiating fees with banks and schemes.

- b. Payments NZ outlined its intention to work on initiatives that could allow for new entrants and enhanced payment methods. In early 2018, Payments NZ formally began work to facilitate the development of a shared Application Programming Interface (**API**) 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 is expected to, among other things, provide competition through new payment options for consumers and merchants which may be less expensive. Similar projects, at a much larger scale, were also underway in Australia and the United Kingdom at that time.

However, issues in the retail payments system have prevailed. COVID-19 has increased the use of online and contactless payments, at the same time as small businesses are facing financial pressures, making the efficient operation of retail payments an area of high public interest.

The MBIE 2020 Issues Paper consulted on our understanding of the issues in the retail payments system and an initial regulatory option of hard caps on interchange fees for open party credit and debit schemes (Visa and Mastercard). It was out for consultation from December 2020 to February 2021. We received 36 submissions from a range of stakeholders, including banks, card schemes, buy-now-pay-later (**BNPL**) providers, organisations representing businesses and consumers, and others.

Related government workstreams

Ongoing workstreams that relate to this project are:

- a. MBIE is working on developing a consumer data right in New Zealand to give individuals and businesses greater choice and control over their data. Consumer data portability in the banking sector may promote innovation and competition in the retail payments system. This work is linked to the project led by Payments NZ to introduce open banking.
- b. RBNZ supported the recent passage of the Financial Market Infrastructures Act 2021 which will expand and strengthen the RBNZ's and FMA's roles in oversight of payment and settlement systems.
- c. RBNZ is increasing its stewardship role for the future of money. Cash is being used less as a means of payment, and access to cash is declining. This trend is accelerating with COVID-19. RBNZ is working with the banking and service industries to ensure that the cash system continues to be fit for purpose. The retail payments system project therefore excludes cash as a retail payment network that can be designated.

Decisions to date

In April 2021 Cabinet agreed to establish a framework for regulation that takes a systems approach. To future-proof the regime, Cabinet agreed to a designation model to determine the targets of regulation. Under this model, the legislation would define participants in the retail payments system in a broad sense and set out a process and criteria to determine which parts of the system and participants are to be designated for regulation. This would allow for the legislation to be robust as the retail payments system changes overtime and new entrants and new retail payment networks come into the market. This would be similar to the designation approach in Australia and the United Kingdom. A designation model is also adopted in other New Zealand regimes like the Financial

Market Infrastructures Act and the Commerce Act.

In adopting a designation-model, Cabinet noted that the regime would include a principles-based threshold/criteria for designation. MBIE considered that, for example, a particular retail payments network and participants could only be designated where features of the network are resulting, or likely to result in, the objectives of the regime not being met. The Commission, as the regulator, would then have the ability to apply a range of tools to those regulated parties.

Cabinet has agreed to the Commission being the regulator for the regime and having the ability to regulate prices within the retail payments system and in principle agreed to:

- impose requirements for information disclosure
- have the power to make directions requiring designated parties to amend their rules or processes
- enter into enforceable undertakings as an alternative to regulation or to remedy non-compliance.

Price regulation and information disclosure obligations were considered and recommended in the previous Impact Statement. They are therefore not included in the options of this Impact Statement.

The options considered in this Impact Statement are for the additional regulatory tools to be made available to the Commission.

This Impact Statement does not include discussion of options for the design of the designation model (eg process and criteria for designation), as we consider this to be a legislative design issue that does not result in significantly different impacts for businesses and consumers.

What is the policy problem or opportunity?

The policy problem is that there are economic inefficiencies in the retail payments system which mean that end users in the system bear disproportionate costs, while other participants receive disproportionate benefits that are not put towards the most productive uses for the economy as a whole.

As a result, the cost merchants pay to accept some payment methods in New Zealand are high.

The following are interrelated causes of this problem, which are discussed in greater detail below:

- There is a lack of competition in some aspects of the network, and in some parts of the network competition can drive up costs.
- Consumers are incentivised to use higher cost payment methods which generally get passed on to all consumers in the form of higher prices for goods and services.
- Fees merchants pay can be difficult for merchants to understand and negotiate, with smaller businesses disproportionately affected.

This assessment of the problem is based on submissions received on the MBIE 2020 Issues Paper, data received from acquiring banks and card schemes, and conversations with stakeholders.

[The costs merchants are charged to accept some payment methods in New Zealand are high](#)

Background

MSF are charged by the acquirer to a merchant for accepting switch-to-acquirer transactions. MSF are generally passed on to consumers through either higher prices for goods and services, or

surcharges.

MSF are comprised of four main components:

- *Interchange fees* are paid by the acquirer to the issuer. This is generally the largest component of the MSF, particularly for credit card transactions where it can be around 70 to 80 per cent of the MSF. The card schemes independently set caps on interchange fees (although no issuer sets rates below these caps). The card schemes do not directly receive revenue from interchange fees, but can use interchange fees to indirectly expand the use of their networks. Issuers generally prefer higher interchange fees and generally charge in line with the caps set by the card schemes. This is because higher interchange fees allow issuers to collect more revenue from merchants, which can be used to provide rewards to cardholders (and contribute to revenues). These rewards provide consumers with additional incentives to use credit cards in place of other payment options.
- *Scheme fees* are fixed fees paid by the acquirer and issuer to the card scheme for processing the transaction. We understand that some larger retailers earn a rebate on this fee from the card schemes.
- *Switch fees* are fixed fees paid by the acquirer to the switch provider for directing the payment request them.
- *Acquirer fees* cover the cost of processing the transaction and include some margin for the acquirer.

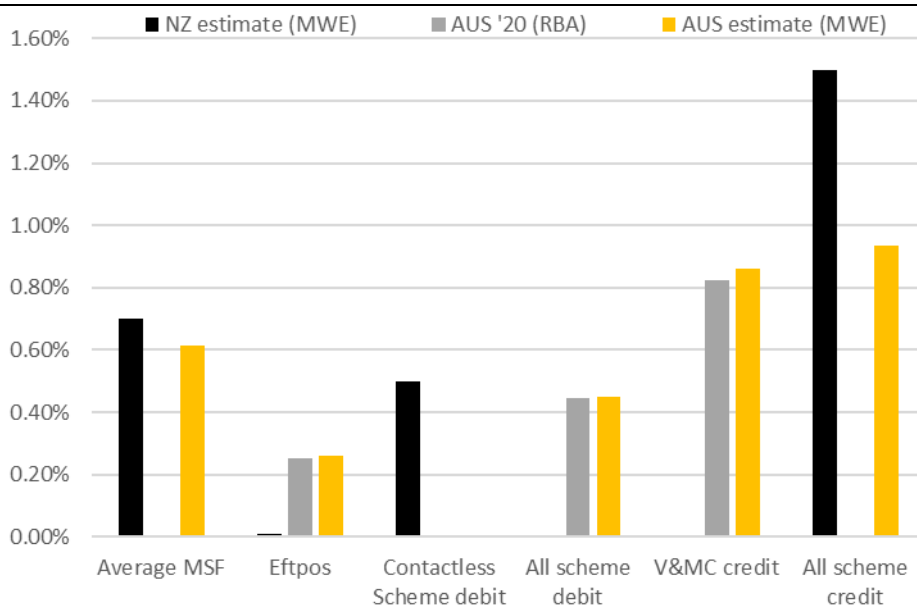
Since 2016, there has been some concern that MSF are high relative to overseas jurisdictions that we compare ourselves to and which generally regulate aspects of these fees. The types of payment methods which attract high MSF are contactless debit and online debit and all credit transactions. (As noted earlier contactless debit transactions are routed via the switch-to-issuer route and do not incur a MSF).

A MWE consulting study commissioned by BNZ and American Express¹ identified that:

- New Zealand businesses are paying significantly more than Australian businesses for some card products – specifically domestic credit cards, international cards and online transactions.
- Due to the large share of switch-to-issuer transactions, the average MSF across all card transactions (including domestic EFTPOS and some scheme debit transactions which do not incur any fees) in New Zealand is marginally more expensive than the average MSF in Australia.

Figure 1: Merchant service fees in New Zealand and Australia for different product types

¹ BNZ submission to 2020 MBIE issues paper; American Express submission to 2020 MBIE issues paper



Source: MWE Consulting report for BNZ as part of their submission, Reserve Bank of Australia²

Many submitters noted that because merchants in New Zealand are not directly charged for switch-to-issuer transactions (about half of all transactions), the overall cost of accepting card transactions in New Zealand is on par with countries such as Australia. Confidential data provided to MBIE by the five main acquiring banks in New Zealand suggests that the average MSF in New Zealand may be close to Australia's. However, as the chart above shows, besides EFTPOS New Zealand has higher MSF, with MSF for scheme credit being more than 50 per cent higher than Australia. MSF for online scheme debit (not shown above) are also higher in New Zealand and are closer to the scheme credit rate estimated by MWE Consulting for New Zealand.

There have been some positive trends in declining MSF for some payment types, largely due to reductions in interchange fees in line with expectations set by Ministers. In the past year in particular, both card schemes and the acquiring banks have made moves to reduce the MSF for contactless debit card transactions, mainly in response to the COVID-19 pandemic.

Why is this a problem?

If MSF in New Zealand are unreasonably high, they will not reflect the actual costs to provide them, which means merchants and some consumers bear additional costs without receiving benefits equivalent to those costs. This is economically inefficient because it concentrates wealth in other parties in the retail payments system instead of allowing those merchants to invest in business growth and consumers to spend more productively elsewhere for the benefit of the wider economy. Several key players in the system benefit from this economic inefficiency, specifically the banks who are both issuers and acquirers and the card schemes.

Lack of competition in some aspects of the market

Background

Competitive pressures in New Zealand (as elsewhere), as mentioned earlier, have generally resulted in higher interchange fees rather than lower interchange fees. This is due to the benefits that can be paid by issuers to attract more consumers to their products. Given the largest acquirers are also

² Data from some sources is not available for each product type. As such, we have included both Reserve Bank of Australia data as well as MWE Consulting data to provide a better picture.

issuers they lack the incentives or ability to negotiate the interchange fees below the caps set by the scheme. As far as we are aware there are no interchange fees set below the schemes' caps.

The users of these services—consumers and merchants—have no direct influence over interchange fees but must rely on their financial institutions to represent their interests. Large financial institutions have the dominant influence on interchange fee setting; however, since they benefit from the revenue generated, they have little incentive to press for lower interchange fees.

The market power of established players is resulting in barriers to competition, which is stifling innovation that could drive down fees. Barriers to competition include:

- There is limited ability for non-issuing acquirers to negotiate scheme fees with the schemes.
- Paymark dominates the switch-to-issuer market as it is the only switch with links to all banks and there are very high technical barriers to competition. While other switches exist, stakeholders have informed us that the banks prefer to maintain technical links with only one switch, due to the very high ongoing running costs. Paymark has substantial market share. Some stakeholders consider Paymark is impeding innovation and is inhibiting access to the system which is why international non-bank acquirers are yet to enter the in-person acquiring market in New Zealand.
- Due to the comparatively small scale of the New Zealand market, it is difficult for new card schemes to establish the infrastructure in New Zealand and achieve the critical mass necessary to be viable.

Additionally, EFTPOS is unlikely to act as a significant competitive constraint due to the transactions not being able to be conducted contactlessly or online. In addition scheme debit transactions offer fraud protection and disputed transaction protection. There are a number of reasons that the functionality of EFTPOS has not developed:

- EFTPOS in New Zealand is a set of multilateral agreements that flow through the switch-to-issuer model which means there is no owner. The infrastructure providers, Paymark and other switches, are the parties that earn transaction based revenue. This has meant there has been no party to take the product forward. This means that EFTPOS cards have not been upgraded to work contactlessly or for online domestic purchases. Issuing banks have therefore relied on the innovation of schemes. In Australia, EFTPOS is a product owned by a company and run as a scheme with fees used to develop the product offering which works both contactlessly and online.
- Issuers also bear the cost of EFTPOS transactions, rather than merchants, which provides issuers incentives to promote the use of scheme cards instead where they can earn revenue. It is argued by the issuing banks that this is a further reason the innovation has not occurred – they have had no way of recouping investment costs in issuing updated EFTPOS cards.

As such, the competitive constraint that EFTPOS may have provided, and any downward pressure on fees for scheme debit payments, has declined.

Why is this a problem?

As a result of these barriers, innovation in the retail payments system has mostly been limited to payment products that rely on the scheme rails, requiring the use of scheme debit or credit cards for payment. This limits the extent of competitive constraints that may be introduced by emerging products, although open banking may offer alternatives once it is practically working in New Zealand.

Visa and Mastercard have established standards with which new entrants must comply if they want

to use their infrastructure. Not only are new entrants forced to impose MSF, but they are incurring additional compliance costs which they will be forced to incorporate into their margins, thereby driving up MSF.

Consumers are incentivised to use higher cost payment methods which generally get passed on to all consumers in the form of higher prices for goods and services

Background

Consumers choose which payment method to use based on costs and benefits, including availability, convenience, security, fees and rewards. Scheme debit and credit cards are increasingly providing consumers with greater functionality (the ability to make online and contactless payments, additional security features and rewards and loyalty programmes) but are also more costly. Product innovation has focused on scheme debit and credit cards as the use of these cards generates greater revenue for system participants. Banks also use incentives to steer consumers to payment systems where they make the highest return. Issuing banks are relying on rewards and inducements to compete for customers as it generates greater revenue.

Submitters almost unanimously agree that rewards play an integral role in influencing a consumer's payment method and the uptake of card payment methods. Submissions confirm credit card reward programmes in particular have been a highly effective way to enhance customer loyalty.

Anecdotal evidence suggests the impacts of the use of high cost payment methods became especially apparent during the COVID-19 pandemic where contactless payments were encouraged for public health reasons. Since March 2020, we have seen consumers move towards higher-cost payment methods like contactless payments, online payments or the use of alternative payment methods like buy-now-pay-later. Contactless debit card payments increased from 17 per cent of transactions in February 2020 to 26 per cent in October 2020 with the share of terminals with contactless functionality increasing from around 35 per cent to near 55 per cent over the same period. This has had implications for merchant costs as higher cost methods make up a greater share of transactions overall.

Merchants often cannot or choose not to discriminate when passing on costs to consumers. Many small businesses are reluctant to surcharge as higher cost payment methods are highly valued by consumers. Apart from surcharging, another option for merchants is to steer consumers away from higher cost payment methods eg through refusing to accept credit cards or contactless payments or restricting the use of these payment methods to transactions above a certain value. The nature of e-commerce is such that customers can shop around to find businesses that accept a more suitable payment method with lower costs. As such, merchants often choose to absorb the costs, which get passed on to all consumers in the form of higher prices for goods and services.

Merchants indicated in submissions that steering consumers towards lower cost methods has become especially difficult since the COVID-19 pandemic. Merchants feel obliged to accept contactless payments due to the public health benefits. Hospitality and smaller retailers, in particular, have felt pressure, and in some cases backlash, for removing contactless payment facilities after initially enabling them following the first lockdown.

We have been told that it is difficult for merchants to surcharge individual consumers when they use higher cost payment methods. Some payment terminals do not have the ability to automatically surcharge or cannot distinguish between some payment types. Unless the merchant is willing to manually check, they have limited ability to steer customers.

Where surcharging does occur, Consumer NZ submitted that surcharges do not always reflect the

real cost faced by merchants with many merchants over-recovering through surcharges. Some bank submitters noted they have come across situations where consumers are charged a five per cent surcharge for credit card or contactless debit transactions, which is well outside the range the bank charges in MSF. On the other hand, Retail NZ noted that it is difficult for merchants to accurately price surcharges, especially if they are on an unbundled rate.

How does this contribute to the problem?

The fact that consumers are incentivised to use higher cost payment methods is not a problem for some individual consumers insofar as they receive corresponding benefits for higher costs ie a consumer may be willing to pay a surcharge for the use of a credit card, in return for rewards value accrued from the use of that credit card. For individual consumers, the costs can be outweighed by the benefits when rewards and the provision of credit are factored in.

Consumer preferences for higher cost payment methods impose higher costs on merchants which they choose to recoup by increasing prices on goods and services or surcharging. This is a problem because it means that all consumers pay the same higher prices even when they use lower cost payment methods.

This results in a wealth transfer from the users of low cost payment options to users of high-cost cards (likely to be on high incomes due to issuer rules or higher annual fees).³ This perpetuates the economic inefficiency of the current retail payments system because it means that users of low cost payment methods essentially fund reward schemes for users of high cost payment methods, rather than matching up the costs and benefits of those different payment types to their users. This cross-subsidisation compounds the inequities within the retail payments system.

Merchant services fees can be complex for businesses to understand and negotiate, and this is particularly the case for small businesses

Background

MSF can be complex for businesses to understand and to negotiate, particularly when they lack bargaining power.

A sizable share of merchants pay a single blended rate for all card transactions (“bundled MSF”), rather than a different rate for each scheme or type of transaction (“semi-bundled”). While bundled MSF may be simpler for merchants, merchants may be paying more on average than if they paid variable semi-bundled rates. This may be especially true for merchants that have a higher share of debit card transactions than average, but pay a bundled rate. This also makes it difficult for merchants to see what the MSF is for different card transactions and what pricing package might suit their business. Many banks also tie lending products into MSF as part of an overall service to merchants. Smaller merchants in particular may select a supplier of convenience, rather than splitting their custom and shopping around.

It is unclear how much merchants shop around to get the best deals on merchant services, particularly beyond the larger strategic merchants. Moves by the banks to offer merchants unbundled and unbundled MSF have paved the way for merchants to have greater choice in the way their fees are structured. However, the range of fees by payment method creates considerable complexity for many merchants. Differences in terminology and the communication of information vary between banks, making it difficult for merchants to shop around, and changing acquirers can be

³ In our 2016 issues paper, MBIE estimated this to amount to an annual regressive cross-subsidy of \$59 million, although this estimate received much criticism.

a costly and lengthy process for some merchants.

Data provided by the five main acquirers shows that MSF can vary substantially, are complex and often are specific to each merchant. This can result in a considerable lack of transparency and confusion for merchants over what MSF they could or should pay.

The lack of transparency and inability to bargain is particularly a problem for smaller businesses. Data from the five main acquiring banks also showed that MSF are significantly higher for small businesses than medium and large businesses.

This is partly due to the fact that the card schemes set a complex range of interchange fee caps that depend on the merchant type and card product. The schemes set a lower interchange cap for strategic merchants, usually being the largest merchants such as supermarkets and fuel chains. Smaller businesses are not seen as strategic because they have smaller transaction volumes, requiring fixed costs of payments to be spread over smaller total sales, and therefore have less bargaining power.

Almost all the submitters that responded to this issue acknowledged the lack of bargaining power for small merchants and the difficulties faced by smaller merchants if shopping around for acquirers.

How does this contribute to the problem?

This is a problem because it means that businesses are not necessarily choosing the most efficient services in terms of value for money, which can impede their ability to grow their business and innovate.

The fact that the complexity of MSF disadvantages small businesses in particular means that there is no level playing field when it comes to MSF – small businesses bear a disproportionately greater cost relative to their size. This means that small businesses have less revenue to invest in business development and growth. This can put these businesses at a competitive disadvantage.

What objectives are you seeking in relation to the policy problem?

The overall objectives for the retail payments system are to deliver long-term benefits for consumers and merchants by promoting efficient operation of retail payment networks and competition in the supply of retail payment services.

In considering these objectives, decision makers should also have regard to the fair distribution of costs to merchants and consumers and transparency within the retail payments system.

We consulted on these objectives in the MBIE 2020 Issues Paper. Submitters generally agreed with the objectives and also noted the importance of soundness of the payments system more broadly.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options against the status quo?

The criteria we use to evaluate the options are:

- Minimises regulatory costs – both compliance costs and costs to the regulator/government.
- Merchants and consumers can transact with confidence using the retail payments system – meaning they have choice and value for money.
- Supports innovation, safety and security in the retail payments system.
- Equity of outcomes for merchants and consumers – across segments of merchants and segments of consumers (i.e. small merchants can expect similar outcomes to larger merchants).

The above criteria are of equal weighting.

There are trade-offs to be made in weighing up the options against the criteria. For example, achieving equity of outcomes for all consumers could come at the cost of value for money for some individual consumers, if it results in the reduction of cardholder benefits.

Due to the time constraints, we have not had an opportunity to test the criteria with stakeholders, however, some stakeholders such as issuers and schemes have noted the importance of innovation for safety and security in the retail payment system.

What scope will options be considered within?

Non-regulatory options

The scope of options considered has been limited to regulatory options, as the Government has committed to a regulatory solution and non-regulatory options have been attempted already. We describe these below.

Using moral suasion to encourage the industry to reduce fees and provide greater transparency

Since 2016, the Minister of Commerce and Consumer Affairs has set expectations on various players in the system that they voluntarily make improvements. In 2017 the then Minister wrote to Payments NZ asking it to engage with financial technology companies to promote innovation and setting expectations that both banks and schemes would improve the transparency of information provided to merchants. However, it was not until 2020 that some of the banks enabled unbundled MSF for all their merchants to enable greater pricing transparency. In 2020 fees for contactless debit also reduced.

The difficulty with this approach is that without regulatory levers, compliance is not mandatory. While fees for some transaction types have reduced over time, this has not been implemented across the system to all transaction types and by all parties.

Encouraging industry initiatives to establish open banking

Open banking would promote competition in retail payments. In 2019 the then Minister of Commerce and Consumer Affairs asked the banks to accelerate the development of APIs to facilitate

open banking. Progress on the infrastructure and processes needed to implement efficient and effective open banking services have been slow. MBIE's work on a consumer data right is underway to provide a viable regulatory pathway for open banking.

A majority of submitters to the MBIE 2020 Issues Paper believed open banking has the potential to provide sufficient competitive discipline on scheme debt and credit fees over the long-term compared with regulatory solutions. However, others thought that the implementation of open banking has been too slow to provide competitive discipline in the near future. Some did not think open banking would have a significant impact on reducing fees because it will depend on how well open banking payment products can compete against scheme cards.

Promoting alternative payment solutions

This could involve encouraging the development of a competing card scheme, as has been tried in Australia, to provide greater competition in payments and put downward pressure on fees. However, we expect that a new domestic-focused card scheme would find it difficult to compete, given that the dominant card schemes currently benefit from their global scale. The costs of developing a domestic card scheme would be significant and there would be significant risks involved, meaning that this option is unlikely to be implemented by any parties.

Alternatively, this option could involve boosting the functionality of domestic EFTPOS. However, it would likely require legislation to change the current rules for EFTPOS to require innovation. Paymark recently adapted its online payment product for contactless use in-store, however it is more expensive than contactless scheme debit card transactions and there has been limited uptake of this by the banks, which reduces the likelihood that this can provide a significant competitive constraint. Most other alternative payment solutions require a scheme debit or credit card to either prefund or post-pay transactions. The operators of these products therefore incur MSF for processing the scheme transaction and thus these payment methods have similar issues.

Other jurisdictions

We have considered the experience of similar jurisdictions that regulate retail payments systems, such as Australia, the United Kingdom, the European Union, Canada and the United States.

Australia regulates interchange fees and other rules for specific card schemes and types. The Australian regulator has the power to designate payment networks and to set standards and access regimes for those networks (currently Visa, Mastercard, American Express companion card scheme and Australia's EFTPOS). Apart from regulating interchange fees, Australia also has rules relating to merchant surcharging and 'honour all cards' rules. The schemes also have to provide merchants with information on the cost of acceptance for each designated scheme. The United Kingdom has a similar designation model.

In Canada, Finance Canada has developed a Code of Conduct for the card payments industry, which includes providing information to merchants, allowing merchants to offer discounts for types of payment and rules around how fees are set and varied.

The European Union Directive on Payment Services directs member states to regulate interchange fees, require acquirers to disclose the cost of accepting different transaction methods and designate a competition authority to supervise interchange regulation. It also bans surcharging for interchange-regulated cards, on the basis that surcharging is no longer justified if interchange is regulated.

In the United States, debit card interchange rates are regulated by the Federal Reserve, while the rules around credit have evolved out of competition law litigation: Visa and Mastercard can no longer

impose contractual 'no-surcharge' rules on merchants or contractual restrictions on no-minimum purchase rules and must allow merchants to discount payment types.

The range of options considered in this assessment are drawn from these various jurisdictions and evidence of the effectiveness of these measures.

What options are being considered?

The options considered below are not mutually exclusive, but can be implemented in combination. The options have been implemented successfully in other jurisdictions, which is why we are considering them for the regulatory regime in New Zealand.

The options below can also be implemented in combination with the options Cabinet has already agreed to within the designation regulatory model (price regulation and information disclosure).

The status quo

The status quo describes what we expect is likely to happen in the future if there is no regulatory intervention and there continues not to be a regulator responsible for oversight of the retail payments system. We have not analysed the counterfactual as including the previous decisions made by Cabinet to establish a regulatory regime for the retail payments system, but instead have compared the options to a state of no regulatory intervention. This is because we do not yet know for certain what the state of the system is likely to be with these previous decisions, which makes it difficult to compare the marginal impact of additional tools with the impact of the previous decisions.

Our view is that if the status quo continues, some consumers and merchants in New Zealand will continue to experience adverse outcomes and pay costs disproportionate to the benefits they receive from the payments system. This will become especially detrimental as it creates an economic disparity that holds small New Zealand businesses back.

There has been very slow progress in non-regulatory industry-led initiatives to reduce fees and develop competitive payment methods, as described in the background section.

While in the past year interchange fees have reduced for contactless debit transactions, this has largely been as a response by the banks and card schemes to COVID-19 to encourage uptake of contactless functionality. We do not have confidence it is part of a longer term trend towards reducing fees. In addition, fees for online debit and credit transactions remain elevated. Furthermore, rolling out these changes took longer than expected and the approach was not consistent across all acquirers.

While there are new emerging payment methods, we do not consider they provide significant competitive constraints to the card schemes. By and large, emerging payment methods typically use the scheme rails which are operated by card schemes. If products are developed which do not use the scheme rails, it would be difficult to get them off the ground and into widespread usage, because of the network effects that currently benefit the card schemes.

Work is underway to introduce open banking, which has the potential to revolutionise retail payments and provide competition to the main payment systems. While we think this is likely to be implemented sometime in the future, to date progress has been slow. Additionally, we think the same issues are likely to remain with the retail payments systems which are currently in widespread use.

As such, we consider that government intervention is required to achieve better outcomes for New

Zealand merchants, consumers and the economy overall.

Option 1: Directions to make changes to or establish network rules

Participants in retail payments system have a set of commercial arrangements, or 'rules', which other participants must adhere to in order to use their services. For example, Mastercard and Visa both have a set of rules which establish the terms of use for parties that make use of their scheme rails. Such rules can include 'honour all cards' rules, which require merchants to, where they accept Visa debit cards for example, accept all forms of Visa payment (including contactless and credit cards), regardless of the price of acceptance or the institution that issued the card. Rules can also relate to surcharging or product categories which have flow on effects for merchants and consumers.

Under this option, the regulator would have the ability to direct operators of a designated retail payments network to make changes to rules which currently inhibit greater levels of competition or which allow inefficiencies. There would be certain criteria or principles for the Commission to adhere to before requiring regulated parties to change their rules, to ensure the direction to do so aligned with the objectives of the regulatory regime.

The regulator would also have the ability to set rules in networks where there are no rules, and to authorise substantive rule changes.

Stakeholder views

Stakeholders could not envision what the rule changes might be and how the power may be exercised without further detail. Given the time constraints discussed previously, MBIE could only provide limited illustrative examples of what the specific rule changes might be, such as changes relating to surcharge or honour all cards rules. However overall, stakeholders were supportive of the power and considered it would be beneficial to promoting the overall objectives of the regime.

Some stakeholders emphasised that the reasons for those rule changes should be carefully considered, which is why we are proposing that certain criteria be met before the Commission directs changes. One stakeholder considered that the Minister should have the right of veto where the Commission directs amendments. However, we consider that technical decisions such as this should be left to the regulator and should not be made into a political decision.

Benefits

Providing the Commission with the ability to direct changes to network rules that promote the overall objectives of the regulatory regime to promote the long term benefits for merchants and consumers. Allowing the Commission to direct rule changes as problems are identified ensures that the system is responsive and keeps pace with emerging issues.

Some benefits of specific rule changes which the Commission might make:

- The regulator could require schemes to make changes to 'honour all cards' rules to enable merchants to accept contactless debit but not credit transactions. Providing merchants with the ability to refuse to accept some but not other scheme cards would allow them to better manage the costs of particular payment methods.
- The regulator could direct changes to scheme rules on exclusive card issuance to allow dual branded cards to provide for scheme competition. Allowing dual branded cards could put competitive pressure on the scheme fee as merchants and/or acquirers will be able to choose which scheme the transaction is routed through based on cost.
- The regulator could require changes to the no-surcharging rule in BNPL contracts for

merchants, to allow merchants to directly recoup the cost of certain payment methods. Requiring changes to no-surcharging rules by BNPL providers is likely to reduce the cost of processing transactions for merchants.

Costs/risks

A key risk with this option is that the regulator has a broad remit to develop, impose and enforce changes to network rules. This increases regulatory uncertainty for regulated participants – especially those that may not have contractual arrangements directly with the network operator (eg terminal providers or gateway providers). This risk can be mitigated by placing limits on the regulator’s exercise of this power, in particular, through requiring the Commission to consult with affected parties prior to directing amendments to network rules, and binding the Commission to have regard to certain criteria and the objectives of the regime before exercising the power.

Some of the potential rule changes identified above are likely to limit the profits of some network participants, but we do not necessarily see this as a negative given a key issue identified with the status quo is that end users (consumers and merchants) are currently bearing costs which are not necessarily cost-reflective.

A potential cost of ruling against honour all cards rules is that consumers may not be able to use particular cards if not accepted by some merchants. However, we consider this risk to be low, given that removing honour all cards rules means that merchants would not have to accept all cards on the terms at which they are currently offered, and could still accept a range of cards but might be able to better negotiate the terms of acceptance or choose to impose different surcharges to reflect different costs.

Option 2: Access requirements

The regulator would have the ability to set requirements on regulated parties to provide access to their networks. The Commission could set and apply an access regime for how entities may become participants of a designated payment network, or to access infrastructure needed to become participants of a designated payment network. For example, the regulator could apply an access regime for new acquirers to access switch infrastructure to create more competition in the switch and acquiring markets, leading to lower MSF for merchants.

An access regime would set out who is eligible to apply to seek access to a particular network and any conditions on the eligibility criteria the operators of a network may require.

This would provide the regulator with the ability to require open access for new participants in networks, such as for new acquirers, or access to switch infrastructure for new entrants to the switch market. Currently, restricted access to certain infrastructure could be inhibiting competition in some markets which might have flow on impacts for competition in the broader retail payments system.

This would be similar to Australia, where the Australian payments system regulator is able to impose access regimes on participants of a designated payment network. Because the Australian regime has a narrow definition of participants, access regimes would only be imposed on corporations that administer the operation of a network. Given the definition of participants will be broader in New Zealand, we envision that access regimes could be imposed at any point in the network, rather than to just the operator of the network.

Stakeholder views

The ability for the regulator to impose access regimes was supported by a range of submitters, who

considered impediments to access to affect competition. A bank commented that the criteria around imposing access regimes needs to be carefully considered so that it does not discourage investment for participants who build networks and then have to provide access. We are taking these comments into account by designing the framework for imposing access standards so that the Commission must take into account whether imposing an access standard is likely to inhibit innovation.

Benefits

Access regimes will reduce barriers of entry to new entrants that could provide competition and innovation. This could indirectly bring down MSF if there is more competition in acquirer markets, meaning lower prices as they compete for merchants' business. It would not directly address the issue of the complexity of merchant service fees, although with greater competition it could mean acquirers make greater efforts to compete for the business of merchants and attempt to make products simpler.

Greater competition could mean lower prices for payment methods overall, which would go some way towards addressing the problem of all consumers facing higher prices for goods and services.

Costs/risks

This could impact the profit margins of banks and card schemes in the system if more competition is introduced, but we do not necessarily see this as a negative impact.

Allowing the regulator to intervene to impose requirements for the operators of a network to provide access does impact on the property rights of the network operators, in that they have invested in infrastructure which they are now being directed to provide access to. As mentioned above, the Commission would have to consider whether imposing an access regime would serve as a disincentive to innovation.

This option would have low costs for the regulator to implement and enforce.

Option 3: Power to require information provision

The Commission would have a power to require parties in the system to provide information to support the Commission's studies. Monitoring powers would enable the Commission to monitor and conduct studies into the state of competition in retail payments systems. The Commission would be able to produce public reports on the state of retail payments systems, which could include matters such as levels of merchant service fees in the market.

Stakeholder views

Retail NZ and some bank stakeholders agreed that this would be an important function of the Commission, to provide public accountability and transparency. No stakeholders we spoke to opposed this function as they viewed it to be integral to the regulator's monitoring function.

Benefits

Monitoring powers would allow the regulator to keep up to date with the state of competition in the retail payments system and any emerging issues as they arise, for example any issues created by new emerging payment methods. This will support the overall health of the retail payments system.

Costs/risks

There will be additional costs for the Commission to monitor the retail payments system. There will also be low ongoing costs for participants in the system if they have to contribute information to the Commission from time to time.

Option 4: Pricing limits on merchant surcharging

Option 4A: Empower the Commission to issue standards or guidance that limits merchant surcharging

This would provide the Commission with the ability to regulate the surcharges applied by merchants generally across the retail payments system (not just those payments that are regulated as part of designated networks). This would limit surcharging to cost-recovery prices for merchants.

If reductions in interchange fees result in lower MSF, we would expect levels of merchant surcharges to reduce correspondingly. However, if they do not, the Commission could have the power to issue standards that would set limits on excessive surcharging that does not reflect the costs to the merchant providing those particular transaction types. This could take the form of the Commission issuing standards as to what costs are reasonable to factor into a surcharge.

Option 4B: Prohibit surcharging for payment methods regulated as part of designated networks

The other option would be an explicit prohibition on surcharging for regulated payment products, which follows the approach taken in the European Union. We do not consider that prohibiting surcharging on all regulated products altogether would be appropriate, as regulating the input costs of MSF does not necessarily remove those costs altogether for the merchant. Surcharging, if reasonable, may still be useful for merchants to steer consumers towards lower cost methods.

Stakeholder views

Generally stakeholders we spoke to during targeted consultation agreed that excessive surcharging that goes beyond cost recovery is an issue which the regulator should have the ability to deal with. Most stakeholders considered that some form of regulation to limit surcharging was necessary to ensure merchants pass on the reductions from regulation to consumers. There was particular concern with larger utility style businesses and government entities, where surcharging is already present and may not reflect the underlying fees that the entities are being charged.

A couple of stakeholders commented that regulation should go further to prevent surcharging altogether (Option 4B), as surcharging should no longer be necessary where regulation of interchange fees has resulted in reduced MSF. One submitter argued that continuing to allow surcharging creates complexity for merchants and regulators and allowing the use of surcharging to recover reasonable costs will be hard to measure and define.

On the other hand, Retail NZ considered regulation of surcharging would not be necessary if the market was competitive.

Benefits

Both Option 4A and Option 4B will help to ensure that the benefits of reductions in interchange fees (and therefore MSF) are passed onto consumers, ensuring that they receive value for money on different payment types. This is critical to help ensure that the long-term benefits of regulation flow through to consumers.

Costs/risks

For Option 4A, there are 'costs' for merchants in that they will not be able to charge more than the costs of providing particular transaction methods, but we do not necessarily see this as a negative impact. For Option 4B, there may be real costs to merchants unless they pass on costs in the price of goods and services.

There is a risk that surcharging limits under either option will result in merchants raising prices for

goods and services, although this would not be justified given that reduced MSF should lower costs for merchants.

There is also a risk that limits on surcharging steers consumers to using 'higher cost' methods, but because the MSF for these 'higher cost' methods has been reduced, we do not see this as resulting in significantly greater costs for merchants.

There is a risk of both Option 4A and Option 4B not being adequately enforced, because the amount of surcharging at an individual level is likely to be small and either not seen as worth pursuing by consumers, or not sufficiently widespread that the Commission has the capacity to enforce complaints about surcharging restrictions. As some submitters have identified, regulating what is in and out of surcharging under Option 4A can be complex and is likely to require some resource for the Commission to enforce. Given this, the effectiveness of this option would have to rely on the deterrent effect of penalties and education of consumers to raise issues, however this is also true for Option 4B.

How do the options compare to the status quo?

	Status quo	Option 1: Amendments to rules	Option 2: Access regimes	Option 3: Information provision and monitoring	Option 4A: Limits on surcharging	Option 4B: Prohibit surcharging
Minimises regulatory costs	0	- Low compliance costs for regulated participants to make and comply with changes.	- Low costs for regulator to enforce access.	- Moderate costs for regulator to study market and publish reports. Low compliance costs for regulated parties to produce information.	-- High ongoing regulator resource required to properly enforce and educate merchants. One-off compliance costs for merchants to make changes to surcharging schedules.	- Moderate regulator enforcement and education costs. One-off compliance costs for merchants to make changes to surcharging schedules.
Merchants and consumers can transact with confidence	0	+ Likely to promote competition and increase value for money for merchants and consumers (although removing honour all cards rules could restrict consumer choice slightly).	+ Increases competition, which improves quality of service.	+ Enables regulator to identify system improvements to support objectives of regime.	+ Would provide consumers with greater transparency. However, merchants may find it more complex to surcharge.	0 Would provide consumers with greater transparency. However, merchants may not be able to recover costs of particular payment methods.
Supports innovation and security	0	+ Rule changes can be designed in ways to support innovation and continued security of payment methods.	0 May reduce investment and innovation in network infrastructure if operators are required to provide access. However, may also result in innovation if it incentivises new market entrants, which will be	+ Enables regulator to identify system improvements to support objectives of regime.	0 Would be unlikely to impact innovation significantly, if surcharging is restricted to cost-recovery.	- Could limit innovation in provision of customer transactions if merchants cannot recover costs of particular payment methods.

			considered by the Commission when using this tool.			
Equity of outcomes	0	+ Overall, likely to result in better quality services for a range of merchants and consumers.	+ Increased competition could lower prices for merchants and consumers overall.	+ Does not directly improve equity of outcomes, but could inform system improvements in order to do so.	++ Ensures that cost savings are passed onto consumers and that those who pay with higher cost payment methods bear those costs.	0 Ensures that cost savings are passed onto consumers, but may raise prices of goods and services for consumers overall.
Overall assessment	0	++	+	++	+	--

Key:

- ++** much better than doing nothing/the status quo
- +** better than doing nothing/the status quo
- 0** about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo
- preferred option

Conclusions

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

In April 2021 Cabinet agreed to establish a regulatory framework to ensure the retail payments system delivers long-term benefits for consumers and merchants in New Zealand. Cabinet agreed to establish a designation model, which will set the parameters of regulation in primary legislation to give the Commerce Commission a mandate to regulate designated retail payment networks and participants within those networks. Cabinet agreed that the Commission would have a package of tools to include the ability to regulate interchange fees, information disclosure powers and regulation of other price aspects in the retail payments system.

We are proposing an additional package of options in this Impact Statement. Our preferred package of additional options is for the Commission to have the ability to:

- Option 1: direct rule changes within designated retail payments networks
- Option 2: impose access regimes
- Option 3: information provision and monitoring powers
- Option 4A: impose limits on merchant surcharging.

Our preferred package includes all of the options considered above, except for Option 4B: prohibit merchant surcharging for regulated payment products. We do not consider that prohibiting surcharging on all regulated products altogether would be appropriate, as regulating the input costs of MSF does not necessarily remove those costs altogether for the merchant. Surcharging, if reasonable, may still be useful for merchants to steer consumers towards lower cost methods. As such we prefer Option 4A, which will rein in excessive surcharging but continue to allow merchants to recover the costs of higher-cost payment methods.

These will be additional tools for the regulator, on top of the tools Cabinet has already agreed to. We consider that the additional tools will support the objective of the regulatory regime to ensure the retail payments system delivers long-term benefits to merchants and consumers.

Overall, we expect that price regulation, of interchange fees in particular, is likely to have the biggest impact. However, these additional tools will enable the Commission to take steps to promote the objectives of the regime and ensure any unintended consequences or flow-on effects of price regulation (eg surcharging no longer being cost-reflective) can also be dealt with. While some of the standards or rule changes may have relatively minor impacts, collectively we consider that the exercise of these tools will promote greater competition and address the economic inefficiencies that are currently present in the retail payments system.

As additional impacts on top of those already agreed to, we think that these proposals in particular will enable new entrants to benefit and increase competition and innovation in the market. They are also important to ensure that the benefits of fee reductions flow through to consumers.

Stakeholder views

We understand from Retail NZ and MAGNET that merchants are strongly supportive of regulatory intervention in the retail payments system.

The schemes and acquiring and issuing banks are well-resourced and sophisticated stakeholders and have been expecting changes. Some welcomed the changes, but raised specific concerns with the

design of the regulation which they have asked MBIE to take into account. For example, the need for the regulatory regime not to be inconsistent with regulatory regimes in other jurisdictions which regulated parties in New Zealand are also subject to. Several stakeholders also raised the need for regulation to ensure a level playing field and maintain competitive neutrality (for example, in relation to other schemes such as American Express, as well as BNPL providers).

Stakeholder views on the specific options are provided above.

We discussed all of the preferred options with the Commerce Commission to ensure that they are workable, a good fit with the Commission's existing functions, and would be likely to be made use of if desirable. We also consulted the Treasury, RBNZ, FMA and Inland Revenue on the proposals. We also discussed Australia's experience with similar regulation with the Reserve Bank of Australia.

What are the marginal costs and benefits of the option?

Affected parties (identify)	Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	Impact \$m present value, for monetised impacts; high, medium or low for non-monetised impacts
Additional costs of the preferred option compared to taking no action		
Regulated parties	<ul style="list-style-type: none"> • Ongoing reduction in profit margins equivalent to benefits to other parties • One-off and ongoing compliance costs 	<ul style="list-style-type: none"> • \$74 million per annum • Low
Regulators	Initial and ongoing implementation and enforcement costs	\$6-10 million per annum
Wider government	N/A (the role of government as merchants is covered below)	N/A
Merchants and consumers	<ul style="list-style-type: none"> • Ongoing increased card fees, reduced rewards for consumers • Ongoing compliance costs of complying with surcharging standards 	Low
Total Monetised Cost		\$80-84 million per annum
Non-monetised costs	Compliance costs for merchants and regulated parties and transaction costs for consumers. Non-monetised costs have been estimated by MBIE. We did not receive any data from stakeholders either in response to the 2020 MBIE issues paper or through our targeted consultation to help quantify compliance costs. Stakeholders did not have sufficient time during the targeted consultation period to produce any data on the potential impacts. As such, we do not have a high level of confidence in the non-monetary costs.	Low

Additional benefits of the preferred option compared to taking no action		
Regulated parties	<ul style="list-style-type: none"> • May enable new entrants to benefit • Increased competition and innovation in the market which will indirectly benefit regulated parties as participants in the market. 	Medium
Regulators	Sets out an established institution with a mandate to manage issues in the retail payments system	N/A
Wider government	N/A (the role of government as merchants is covered below)	N/A

Merchants and consumers	<ul style="list-style-type: none"> • Ongoing cost savings for consumers and merchants as a result of reduced MSF equivalent to costs to regulated parties • Ongoing increase in ability for merchants to invest in business growth 	<ul style="list-style-type: none"> • \$74 million per annum • Medium
Total Monetised Benefit		\$74 million per annum
Non-monetised benefits	Enabling new entrants and increasing ability for merchants to invest in business growth. As above, due to a lack of data we have been unable to estimate the non-monetary benefits.	<i>Medium</i>

Further information on the preferred option

Assumptions

In summarising the costs and benefits in the table above, we have combined the impacts of the additional tools considered in this analysis with the impacts of the tools that have already been considered in the previous Impact Statement, so that we are summarising the overall impacts of the retail payments system regulatory regime. We have not added to the monetary estimate of costs and benefits summarised in the previous Impact Statement, as we have not been able to estimate the costs and benefits of these additional proposals due to a lack of data. The additional costs and benefits are covered by the non-monetised impacts.

A significant assumption underlying our analysis is that the regulator will make use of the package of tools to result in the above impacts. Otherwise, the assumption would be that the regulatory framework is set up but the regulator does not choose to regulate, resulting in implementation costs to government but no additional benefits to New Zealand (and no additional costs to regulated parties). We consider this to be a low risk however, as the designation of regulated participants will be made by the Minister (on the recommendation of the Commission) and the Minister will be able to transmit statements of Government policy to the Commission to which it must have regard. The two layers of decision-making and accountability will ensure that the exercise of powers is carried out in an appropriate manner.

The preferred options mostly provide additional benefits for merchants and consumers. We have assumed that to produce the most equitable outcomes for New Zealand as a whole, any cost savings/benefits for merchants from reduced MSF will be passed onto consumers in whole or in part, given that costs are currently passed onto consumers in whole or in part. The costs in lost profit margins to regulated parties and the benefits in cost savings to merchants and consumers are the same – these are redistributed, rather than additional, benefits.

Some uncertainty over overall impacts of proposal

As described in our earlier Impact Statement, given the proposed design of the regulatory regime involves setting out the methods of regulation in legislation and then designating certain participants in the system for regulation, there will be some uncertainty over which participants may be designated in future and what combination of regulatory levers will be applied to designated participants.

Additionally, the proposals to allow the Commission to direct rule changes within designated systems make it difficult to assess the impacts of future regulation overall, if the particulars of each standard or rule change are up to the regulator. This uncertainty will be mitigated by constraints on the exercise of these powers by the regulator, namely requirements to consult and have regard to certain principles or criteria that further the purpose of the regulatory regime.

Section 3: Delivering an option

How will the new arrangements be implemented?

How will the proposals be implemented?

Primary legislation will be introduced in the form of new standalone legislation as we have not identified an existing appropriate Act for this regulatory framework to sit in. Secondary legislation will also be required.

The legislation will set out the process for the Commission to follow when issuing a standard or directing a rule change, including consultation requirements and the criteria it must consider.

The Commission will need additional resources to support its new functions.

When will the proposals come into effect?

The proposals will require primary legislation to be passed by Parliament. The Commission's general monitoring and enforcement powers are intended to come into force upon enactment, with the rest of the proposals, including the Commission's powers to direct rule changes, impose standards for information disclosure, regulate merchant surcharging and impose access standards coming into force by Order in Council, or six months after enactment.

Communications

The parties who will be subject to regulation are generally well informed about and engaged with the possibility of future regulation. As such, there is little risk of regulated parties being surprised about the need to comply. The Commission will issue communications to provide further information to regulated parties once the regime is in place and the Commission is set to issue standards.

Implementation risks

The biggest risk is the fact that the regulatory model relies on providing the Commission with powers and tools via primary legislation, but the practical application of these powers and tools will be at the discretion of the Commission. The legislation will set clear objectives and principles for their use, which will reduce this risk. Additionally, it is the responsibility of the Minister to initially designate parties for regulation where it is desirable to do so. The two layers of decision-making and accountability will ensure that the exercise of powers is carried out in an appropriate manner.

Another implementation risk is the Commission not being adequately resourced to carry out its new functions. MBIE will work with the Commission and the Treasury to ensure the necessary funding arrangements are in place. Specifically, we will support the Minister with a budget bid to ensure the Commission is appropriately resourced to carry out its functions. We have consulted with both the Treasury and the Commission and estimated that the Commission may require additional funding of between \$6 million and \$10 million per annum to implement the regime.

Offences and penalties

The proposed approach is to provide for a range of penalties and remedies, to include pecuniary penalties, injunctions and court orders, including compensation and damages. We have consulted Ministry of Justice on the proposals to ensure that they are consistent with existing frameworks.

The approach to penalties is largely focused on deterrence, given the potential for large

commercial gains from a breach of the obligations by regulated parties.

The Commission would also have the ability to accept enforceable undertakings from parties in the retail payment system. Enforceable undertakings would be used to either remedy a situation where the Commission might otherwise take enforcement action, or to serve as an alternative to designation or other regulation.

The Commission may enter into enforceable undertakings where designating a particular retail payment system is not necessary to achieve similar outcomes that can be achieved by a party committing to certain actions. For example, a card scheme that holds a very small proportion of the market might enter into enforceable undertakings with the Commission to take certain actions that would enhance competition and improve efficiencies, without needing to be designated.

Disputes and appeals

There are a range of types of disputes that might occur in relation to the new obligations envisaged for this regulatory regime.

Regulated parties disputing the decision to designate

We are proposing that parties will have a right to appeal decisions to the courts through judicial review for designation decisions. Since the decision to designate will be made by the Minister, there will be an additional layer of accountability and oversight. As such, we think it is sufficient to leave appeals against designations to judicial review.

Regulated parties disputing the Commission's exercise of powers to issue standards

Regulated parties will be able to appeal a determination made by the Commission through judicial review. This proposed approach strikes an appropriate balance between the need for finality and minimising cost whilst ensuring there are processes for decision makers to be held accountable and principles of natural justice can be upheld. Providing for a full appeals process could potentially draw out the decision making process with protracted litigation by well-resourced regulated parties.

Between merchants and acquirers (for example, over information disclosure, breach of price standards)

Small businesses will be able to refer disputes with payment service providers (such as banks) to a financial dispute resolution scheme, which can currently consider complaints valued at under \$350,000 referred by businesses with 19 FTEs or under.

Businesses will also be able to make complaints to the regulator to investigate, since breaches of the types of obligations which are likely to cause disputes (eg price regulation, information disclosure and other standards) are compliance matters.

Between merchants and consumers (for example, over surcharging)

Misleading surcharging is already subject to the Fair Trading Act 1986, and actionable by consumers (including through the Disputes Tribunal). We acknowledge that the disputed amounts are likely to be negligible on an individual level however, such that consumers are unlikely to take action. Any regulation of surcharging is likely to have to rely on the deterrent effect of penalties for adequate enforcement.

Consumers can also lay complaints with the Commission and the Commission may take action if it found that there were systemic issues.

How will the new arrangements be monitored, evaluated, and reviewed?

As the lead policy advice agency for the retail payments system, MBIE intends to monitor, evaluate and review the regulatory framework in line with the Government's expectations for regulatory stewardship. In particular, the new monitoring powers and functions of the Commission will support the overall health of the retail payments system. As part of our regulatory stewardship role, we will take a proactive approach to identifying any issues by periodically consulting with key stakeholders on the impacts of the proposals and looking to overseas jurisdictions. Regulatory system assessments would also identify any issues with the operation of the new regime.

The Commission has a constructive relationship with MBIE, as the policy advising agency, meaning that there are regular opportunities for any implementation issues and unintended consequences of the regulation to be raised as they arise and reviewed. We expect the Commission to also provide enforcement data and information about the costs of implementing and enforcing the changes to MBIE. Both agencies will also be responsible for alerting relevant Ministers to any issues requiring a review of the legislation.

We expect the Commission to raise any issues with the Council of Financial Regulators on an ongoing basis as part of the monitoring and governance arrangements for the financial markets regulatory system as a whole.

MBIE will continue to monitor MSF and interchange fees over time to ensure the regulation is having the intended effects. While there are no current plans for a formal review of these changes, MBIE regularly reviews amendments to the laws we administer. We intend to periodically review the regulatory changes, with a view to assessing their effectiveness three years after they come into effect to provide sufficient time for the changes to bed in and produce expected outcomes. An earlier review may take place if we are alerted to serious unintended consequences. We would evaluate whether the regulation has been effective using the criteria which we have used to evaluate the options above. Some specific measurables we might collect could include, for example:

- reductions in interchange and merchant service fees, particularly for small businesses (to determine whether merchants can transact with confidence and have equity of outcomes)
- cost savings passed onto consumers (to determine whether consumers can transact with confidence and have equity of outcomes)
- data on levels of fraud (to determine whether the regime is supporting safety and security).