MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Dr David Clark	**Portfolio**	Commerce and Consumer Affairs
Title of Cabinet paper	Retail payments system: initial policy decisions to reduce merchant service fees	**Date to be published**	12 May 2021

List of documents that have been proactively released		
Date	**Title**	**Author**
14 April 2021	Retail payments system: initial policy decisions to reduce merchant service fees	Office of the Minister of Commerce and Consumer Affairs
14 April 2021	Appendix 1: Background on card payments and the retail payments system	Office of the Minister of Commerce and Consumer Affairs
14 April 2021	DEV-21-MIN-0075 Cabinet Economic Development Committee: Minute of Decision: Retail Payments System: Initial Policy Decisions to Reduce Merchant Service Fees	Cabinet Office
30 March 2021	Regulatory impact statement: Regulating the retail payments system	MBIE

Information redacted **YES / NO**

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In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

Retail payments system: initial policy decisions to reduce merchant service fees

Proposal

1 This paper is a report-back on regulatory solutions to reduce merchant service fees (**MSF**) for retail payments and seeks:

1.1 agreement to establish a new regulatory regime to address inefficiencies in the retail payments system, which would be regulated by the Commerce Commission; and

1.2 agreement to some of the core elements of the new regulatory regime, including a transitional price path to reduce interchange fees.

Relation to government priorities

2 The Government committed to reducing MSF in the Labour Party election manifesto and the Speech from the Throne. The Government's intention is to bring these fees in line with overseas jurisdictions to reduce the burden on small businesses and the effect of these costs on consumers.

Executive Summary

3 This paper proposes establishing a regulatory regime to reduce MSF. MSF is the charge payable by merchants to their bank (the acquirer) for processing of certain credit and debit card transactions. The MSF payable for each transaction varies depending on the card product, method of use (eg online or contactless), and merchant type. A major component of the MSF is the interchange fee paid to the cardholder's bank (the issuer).

4 Following public consultation on the issues concerning card payment products, there is evidence that there are economic inefficiencies in the retail payments system, which are resulting in poor outcomes for many consumers and merchants.

5 Following voluntary reductions of MSF in 2020, the average MSF across all card products in New Zealand is appears at face value to be comparable with Australia. However, as acceptance of domestic EFTPOS and contacted debit card transactions do not incur a MSF in New Zealand, the average MSF data looks a lot more positive than the reality faced by merchants for other product types. The reality is, the MSF in New Zealand remains higher than Australia for a majority of card products – including credit card and online debit card transactions.

6 Current levels of competition in retail payments markets, and the application of generic competition law, have been insufficient to reduce MSF to levels payable in other jurisdictions. In order to address these inefficiencies, I recommend a new *Retail Payments System* Bill is developed that will:

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6.1 introduce a regime to regulate (on a case by case basis) classes of retail payments system participants, their providers and any associated infrastructure operators (including secondary infrastructures) to reduce economic inefficiencies in the retail payments system

6.2 establish a transitional price path to reduce interchange fees for the main credit and debit card schemes

6.3 appoint the Commerce Commission as the regulator

6.4 empower the regulator to:

6.4.1 impose pricing principles or limits on fees

6.4.2 impose information disclosure requirements

6.4.3 make directions to amend rules and systems, and

6.4.4 accept enforceable undertakings.

7 The new transitional price path will lead to savings for New Zealand merchants of approximately $74 million per annum. These savings will be particularly felt by smaller merchants or those merchants that rely on credit card or online sales.

8 There are, however, a number of risks associated with regulation which could result in system participants recouping costs of regulation through other means (eg new fees). In addition, there is a risk that regulation may not keep up with new and evolving retail payment methods, creating an uneven playing field. To avoid these unintended consequences, the regime will be broadly scoped to potentially apply to any retail payment method (excluding cash) that is important to merchants and consumers, and equip the regulator with a broad toolkit to address problems that may arise in the future.

9 The proposals in this paper establish the overarching framework for the new regime. However, there are a number of secondary policy issues that are yet to be determined as they require further engagement with stakeholders and the regulator. To enable these engagements to take place, I am seeking authorisation to release a discussion document for targeted consultation and report back Confidential advice to Government on the outcome of the consultation.

Background

10 Retail payments provide for the transfer of funds from consumers to merchants for goods and services acquired. The retail payments system is constantly evolving and comprises of various retail payment methods like card products, cheques, cash, bank transfers and more recently, Buy-Now, Pay-Later products.

11 MSFs are fees payable by merchants to their acquirer (the party who acquires a payment on the merchant's behalf – usually the merchant's bank but sometimes a non-bank acquirer) each time certain card payments, such as credit or debit cards used contactless or online, are processed. Unlike many overseas jurisdictions, EFTPOS card transactions and contacted debit card transactions, roughly half of all card transactions, do not incur a MSF.

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12 A detailed summary of how card payments operate in the retail payments system, and the participants involved, is provided in **Appendix 1**.

13 In December 2020, Cabinet agreed to release an Issues Paper, *Regulating to reduce merchant service fees,* seeking submissions on the issues and potential regulatory options to reduce MSF [CAB-20-MIN-0510 refers]. I was invited to report back to the relevant Cabinet Committee in April 2021 with the outcome of the consultation and a proposed general policy direction, with a view to subsequently carrying out further targeted consultation on the detail of the new regime.

14 The Ministry of Business, Innovation and Employment (**MBIE**) received 36 submissions, representing views from card schemes (Visa and Mastercard), banks, merchants, consumer representatives, and other industry representatives. I have since met with some of these stakeholders and received the following advice from MBIE:

14.1 Card scheme participants have taken some steps towards offering more transparent MSF pricing structures and reducing fees for some transactions since a review carried out by MBIE in 2016. MBIE estimates that weighted-average credit interchange fees have decreased by between 7 and 11 per cent since 2016 and the debit interchange fees have reduced by 25 per cent.

14.2 While the average MSF payable by New Zealand merchants for card products overall is comparable with Australia, New Zealand merchants continue to pay more for accepting credit cards and online debit cards (services where New Zealand's proprietary EFTPOS has no product offerings).

14.3 MSF pricing is particularly having adverse impacts on small merchants. Small merchants are impacted more than larger merchants – not only are they charged more due to their smaller scale and limited bargaining ability, there is a greater risk and consequence of losing customers through steering or surcharging. For many small merchants, refusing to accept certain card types is not an option, forcing merchants to absorb the cost or rely on surcharging for a fee that is often difficult to quantify.

15 MSF for some card products remains high due to an apparent lack of efficient competition in some aspects of the retail payments system. At the centre of the card scheme business model are interchange fees. Interchange fees are charged by the party who issues the scheme card to the consumer (ie the consumer's bank or finance provider) to the merchant's acquirer. The interchange fee is then on-charged to the merchant as part of the MSF. The schemes use the level of interchange fees to encourage banks and finance companies to issue their branded cards. This fee in turn allows issuing banks and finance companies to incentivise consumers to use their cards (eg through reward programmes).

16 In New Zealand, a few large banks dominate both sides of the retail payments system (ie provide services to both merchants and consumer/cardholders) such that the interchange fee may simply be a transfer inside the bank or between banks. Submissions identified a number of barriers to competition which include:

16.1 Limited ability, and willingness, of the merchant's bank to negotiate lower fees with card scheme and cardholders' banks. The market power of banks and Visa and Mastercard means banks have little incentive to negotiate lower scheme fees. Furthermore, due to the comparatively small scale of the

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New Zealand market, it is difficult for non-banks to offer merchants services or new payment schemes to enter the market and achieve the critical mass necessary to be viable and compete.

16.2 Paymark dominates the switch market, which is the infrastructure that connects the participants of the retail payments system. This forces all payment system providers and new acquirers entering the New Zealand market to negotiate a connection with Paymark.

17 Given that, in the absence of surcharging, consumers do not face the direct costs of the payment method that they use. Reward programmes and other benefits encourage their use of higher-cost payment methods, which increases the total amount of MSF that merchants pay. In addition, as issuers benefit from the use of higher-cost payment methods, and rely on interchange fees to provide rewards and inducements that cardholders value, there is little incentive to reduce MSF. In fact, competition between the issuing banks for cardholders may put pressure on issuers to increase the interchange fee (and subsequently the MSF) to allow them to offer better rewards and incentives.

18 The real impact of high MSF is being felt by small merchants who are paying more than larger, ‘strategic’, businesses. As small merchants lack bargaining power and resources to obtain lower fees, and the risks involved in steering or surcharging consumers, they are forced to recover the cost of MSF in the price of goods and services. These increased costs place New Zealand merchants, and particularly smaller merchants, at a disadvantage making it harder to compete and grow.

19 As some consumers who use higher-cost payment methods (ie credit cards) benefit from higher MSF through more generous reward programmes, consumers not paying with these methods end up cross-subsidising them through paying higher prices. This is a regressive wealth transfer due to higher-cost payment methods generally only being issued to cardholders having high levels of income or wealth. In the long-term, some parts of the population will experience poorer outcomes as result of the inefficiencies in the retail payments system.

The Retail Payments System Bill will establish a new regulatory regime

Regulatory intervention is required to address the issues raised

20 To date, New Zealand has taken a relatively light-touch approach to oversight of retail payments. Retail payments are largely self-regulated, with the Reserve Bank of New Zealand (**RBNZ**), the Financial Markets Authority (**FMA**), Commerce Commission and Payments NZ overseeing discreet aspects of the system.

21 I propose to introduce a new regulatory regime that will oversee the efficient operation of the retail payments system and place pressure on the system to reduce MSF. In the absence of specific regulatory oversight, Visa and Mastercard have largely been left to develop their own standards of operation and interchange caps which are commercially focussed. While previous Ministers have encouraged the schemes and banks to increase transparency and measures to reduce fees, and there have been some improvements since 2016, consultation has confirmed that this progress has been slow.

22 Overall, of the 36 stakeholders that made a submission to the Issues Paper, a significant majority agreed that the government should play a role in promoting competition and providing regulatory direction in the retail payments system. This

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view was also expressed by some stakeholders who have benefited from the current system – a strong indicator in support of government intervention.

23 However, Visa, ANZ, Business NZ and Westpac submitted that the government should not intervene by way of regulation. These submitters noted that market forces have been and can continue to drive competition. Should the profits available within the payments system be reduced by regulation, these submitters note that their ability to develop new services that will benefit merchants and consumers will be adversely impacted. These concerns are acknowledged and have been taken into consideration in the recommendations for regulation. However, I note that the card schemes are large multi-national corporations and it is my view that their New Zealand subsidiaries are more likely to be receivers of innovation from elsewhere within their global operations than generators of innovation.

Objectives of regulation

24 In developing a regulatory regime, I consider that the overall objective for the retail payments system should be to deliver long-term benefits for New Zealand merchants and consumers. This objective was tested in the Issues Paper and submitters generally agreed, adding that the soundness of the payment systems more broadly should also be considered.

25 Based on the submissions and the advice I have received, I propose that the Bill set out the following principles (subject to any drafting recommendations from Parliamentary Counsel Office) to ensure the retail payments system delivers on its overall objective:

25.1 enables efficient competition between payment providers and payment products

25.2 incentivises beneficial innovation for consumers and merchants

25.3 is efficient in allocating resources through clear price signals, where prices are cost reflective for the system as a whole

25.4 is fair in its distribution of costs, particularly in its treatment of small merchants and low income consumers.

26 It is also vital that the retail payments system is sound, secure and subject to appropriate prudential supervision. As such, careful consideration will be required to manage any potential boundary issues that might emerge with establishment of the *Retail Payments System Bill* and the RBNZ's role, including under the forthcoming *Financial Markets Infrastructures Bill,* which establishes a prudential and market conduct regime for systemically important payment systems.

The regime should include a designation model to future-proof regulation

27 I have considered two main options for the design of legislation:

27.1 **Option 1**: A designation approach where the primary legislation would define the retail payments system in a broad sense, and set out a process and factors to determine which retail payments method or participants in the retail payments system or class of participants are designated for regulation. A designation approach has been adopted in the *Australian*

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Payments System (Regulation) Act 1998 and in New Zealand in the *Financial Market Infrastructures Bill*.

27.2 **Option 2**: A static approach where the primary legislation identifies the retail payments methods, parties, or classes of parties in the retail payments system, that are subject to the regulatory regime and how they would be regulated.

28 In an effort to future-proof the regime, I propose the Bill should adopt a designation approach as it provides the flexibility necessary to respond to new issues and payment models, ownership structures and products that develop over time. Buy-Now, Pay-Later products (eg Afterpay, Laybuy, Humm etc) and mobile wallets (eg Google Pay, Apple Pay, Alipay etc) are becoming increasingly prevalent in New Zealand with new products and businesses entering the market each year.

29 The designation model will also enable the technical details of regulation to be considered by an independent regulator who has expertise in the retail payments system, as recommended by the Legislation Design and Advisory Committee.[1] The Legislation Guidelines state that the person exercising a power must have sufficient expertise in the area in which they are exercising the power.

30 I do not consider the static approach will be effective for a system that is rapidly evolving. Adopting a static approach would likely allow system participants to find loopholes to avoid the intended effects of regulation, and this approach will limit the government's ability to respond to new issues. This was the case when regulation was first introduced in Australia where interchange caps targeting the Visa and Mastercard issued card products resulted in banks issuing cards through the American Express scheme. It is also my understanding that Australia, should it want to, cannot regulate Buy-Now, Pay-Later products' impact on merchants under its current framework, thus significantly limiting the scope and regulatory options available.

31 In establishing a designation model, I envisage that the Bill will set out the criteria, principles and process for designation. Whether designation will take place through an Order in Council or by a notice issued by the regulator is yet to be determined as these policy issues require further consultation with the regulator and stakeholders.

Regulatory responsibility should be held by the Commerce Commission

32 Following detailed analysis and advice provided by MBIE, I recommend the Commerce Commission should be the regulator for the new regime.

33 MBIE's advice was based on a multi-criteria analysis which considered the suitability of the Financial Markets Authority, the RBNZ, the Commerce Commission and a new independent crown entity for the role of the regulator. The criteria considered included the entity's degree of independence (from government and industry), skillset for competition and economic regulation, knowledge of the retail payment sector, fit with other functions and ease of implementation (specifically time and costs).

34 Having considered the analysis, I propose the regulator should be the Commerce Commission, which is an independent Crown Entity with an appropriate degree of independence from the sector and from Ministerial influence, with a strongly relevant skillset and knowledge of the sector. Given the objectives of regulation are consistent

[1] *Legislation Guidelines* (2018), Legislation Design and Advisory Committee.

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with the Commission's existing functions and consumer focus, this makes the Commission the best fit for this role.

35 Feedback from submissions did not indicate a clear preference for a particular entity to regulate the retail payments system. Several submitters commented on the need for a multi-faceted body which would have a holistic view of the payments system to ensure the regulator has access to experts and advisory groups in developing and carrying out of regulation.

36 On that basis, I propose to explore ways in which the Bill can facilitate greater coordination between the various agencies (eg RBNZ) with responsibilities over payment systems.

37 I will report back to Cabinet on the details of the institutional arrangements for the regulator that will facilitate coordination and increase the effectiveness of the regulation.

Key features of regulation

38 The proposed regime will provide flexible and durable regulation to oversee retail payments for the foreseeable future. I envisage the regime will have three tiers:

38.1 A transitional downward price path to require reductions in interchange fees as soon as possible

38.2 Direct intervention by the regulator, in the form of price regulation and scheme rules that target particular participants or classes of participants (this would eventually override the transitional price path)

38.3 Disclosure and reporting requirements that enable the regulator to monitor the retail payments system.

Transitional downward price path to reduce interchange fees

39 Given the time required to establish a regulatory regime of this nature, I propose to introduce a transitional downward price path. This transitional downward price path will work as an interim measure to require reductions in interchange fees ahead of the full regime coming into force. This transitional price path will be in place until the regulator makes a determination in respect to interchange fees.

40 The problem of high MSF for online debit and credit card schemes has been relatively long-standing and I consider it necessary to seek immediate relief for some merchants. As discussed throughout this paper, interchange fees are a key component of MSF and stakeholders indicated interchange fee regulation will have a positive impact by reducing MSF for small merchants. Depending on the size and type of the transaction, the portion of interchange fee payable to the financial institution that issued the card, can vary. For example with a $10 contactless debit card purchase the interchange fee is 25-35% of the total MSF whereas for a $50 credit card transaction it is closer to 80% of the total MSF.

41 To reduce these fees in the short-term and benefit small merchants, the transitional downward price path will target card products issued by Visa and Mastercard – because they cover the largest share of the New Zealand scheme market. While other scheme cards are also present in the market (such as American Express and UnionPay), they have a relatively minor share of the New Zealand market and, in

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some cases, have a unique business model which does not include interchange fees. Imposing a transitional requirement on them will have little benefit for merchants and consumers.

42 To that end, I propose the Bill should include:

42.1 a requirement for Visa and Mastercard to reduce the caps for interchange fees for credit cards to 0.80 per cent (being the same cap as currently applies in Australia) within six months of the Bill being enacted

42.2 a requirement for Visa and Mastercard to reduce the caps for interchange fees for debit cards to 0.60 per cent within six months of the Bill being enacted

42.3 a requirement to cap interchange fees that are currently at or lower than the prescribed levels at their 1 April 2021 levels to prevent these fees from increasing

42.4 a requirement that any new Visa or Mastercard credit card product types must have an interchange fee of 0.80 per cent or less

42.5 a requirement that any new Visa or Mastercard contacted in person debit product types have an interchange fee of 0.00 per cent

42.6 a requirement that any new Visa or Mastercard contactless in person debit product types have an interchange fee of 0.20 per cent or less

42.7 a requirement that any new Visa or Mastercard online debit product types have an interchange fee of 0.60 per cent or less.

42.8 a power for the regulator to seek documents and monitor compliance with the requirements

42.9 an offence or penalty for breach of the requirements set out in subparagraphs 42.1 - 42.7 or failing to provide documents requested by the regulator.

43 This transitional regime has three benefits:

43.1 Provides a clear requirement in line with the Government's commitment to reduce MSF to benefit small businesses.

43.2 Enables MSF to be reduced significantly before the full regime is in force. Estimates are that the new transitional price path will lead to savings for New Zealand merchants of approximately $74 million per annum within the first year of operation.

43.3 If passed on by merchants to consumers, reduces the regressive wealth transfer between users of lower-cost payment methods and high-cost payment methods.

44 To ensure these reductions are passed on to merchants, I propose to write to acquirers asking them to notify merchants of these changes and advise merchants as to how they can financially benefit from different pricing methods.

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45 While there are a number of risks associated with a rapid reduction in interchange fees, I remain of the view that a transitional downward price path is necessary to provide relief to small merchants. MBIE has identified some risks, including:

45.1 The possibility of increases in other fees associated with card products (such as annual card fees or interest rates impacting cardholders or scheme fees impacting merchants).

45.2 Reductions in reward programmes (such as Airpoints or cashbacks) Confidential advi Confidential advice to Government

45.3 Reductions in interest free periods as banks try to recoup costs by reducing the amounts they are owed. This could have a significant impact on some consumers.

45.4 Reductions are not fully passed on to all merchants either due to inaction by acquirers or merchants.

46 Officials will continue to work with stakeholders and the regulator to identify other mechanisms to mitigate the risks identified. These are secondary policy issues on which I will report-back to Cabinet after receiving further advice.

Direct intervention targeting participants or classes of participants

47 Guided by international experience, I propose to empower the regulator with a comprehensive suite of regulatory tools and powers that can place downward pressure on the evolving retail payments system to reduce MSF. Direct intervention is intended to be a regulatory backstop – used only when there is clear evidence an aspect of the retail payments system is not operating as intended to achieve the objectives of the regime.

48 Reflecting the approach taken in Australia, I propose that the toolkit will also include:

48.1 a power to set pricing principles or limits on fees (or components of fees) within the designated payment system

48.2 the power to make directions to designated payment systems to amend the rules of the system, such as relating to surcharging or steering by merchants.

Disclosure and reporting requirements that enable the regulator to monitor the retail payments system

49 The regime will include a broad suite of powers to enable the regulator to oversee the retail payments system. Ideally, a large part of the regulator's role will be to monitor retail payments system participants and the level of fees being charged within the system.

50 To enable the regulator to do this, I propose the Bill will include:

50.1 the ability to enter into enforceable undertakings as an alternative to regulation or to remedy non-compliance

50.2 the ability to impose information disclosure requirements to improve transparency of fees.

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51 Overseas experience indicates that the monitoring role of the regulator will be critical to ensuring fees are at an appropriate level and the regime continues to deliver long term benefits to merchants and consumers. The exact nature and scope of these powers are secondary policy issues which require further consultation with stakeholders and the regulator.

52 Given the breadth of the retail payments system, and the different business models and operating structures that are being developed, I propose to include in the Bill other regulatory tools which may be necessary to respond to inefficiencies as the retail payments system continues to mature. During consultation, submitters emphasised the need to take other regulatory options into consideration to implement meaningful change and minimise unintended consequences. I will report-back on the full suite of tools that will be available to the regulator Confidential advice to Government following some targeted consultation.

Further consultation necessary

53 Stakeholder engagement so far has focused on the issues contributing to high MSF and on high level regulatory tools. While the proposals in this paper set out a path forward for regulation, a number of key elements of that regulation, such as the details of the regulatory toolkit, have not yet been consulted on.

54 To build on the high-level decisions sought in this paper, my officials will develop, and conduct some targeted consultation on, a range of secondary policy issues, including:

54.1 the criteria and process for designation to be included in legislation,

54.2 institutional arrangements to enable coordination with the relevant agencies with responsibilities in payment systems,

54.3 the nature and scope of the Commission's regulatory powers,

54.4 additional tools the Commission may require to effectively address inefficiencies in the retail payments system now and in the future (eg, whether there should be an exemptions process, and any fees associated with that),

54.5 a monitoring and enforcement regime which will include offences or penalties, and

54.6 a commencement date.

55 I will report-back on the outcome of consultation, and seek further policy decisions, Confi
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Financial Implications

56 Confidential advice to Government

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Legislative Implications

58 The proposals in this paper will be given effect through the *Retail Payments System Bill* which currently holds Confidential advice to Government [redacted]

59 Confidential advice to Government [redacted]

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61 The Bill will bind the Crown.

Impact Analysis

62 A quality assurance panel with representatives from the Regulatory Impact Analysis Team at the Treasury and MBIE have reviewed the Regulatory Impact Statement “Regulating the retail payments system” produced by MBIE. The panel considers that it meets the Quality Assurance criteria.

63 The Regulatory Impact Statement demonstrates a clear understanding of the regulatory gap in the retail payments system and provides clear and comprehensive examination around options for regulatory design and tools. Time constraints in policy development have limited the depth and scope of consultation with stakeholders, although this will be mitigated by further targeted consultation intended to be conducted prior to final Cabinet decisions being made. MBIE anticipates that further regulatory impact analysis will be completed with refined policy design which will reflect feedback from wider consultation. It is noted that an evaluation of the regulatory changes three years after they come into effect and periodically thereafter is expected. As the proposed regulator, the Commerce Commission will need additional resources to support its new functions.

Population Implications

64 The proposals in this paper will not disproportionately impact distinct population groups (such as Māori, children, seniors, disabled people, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities).

Human Rights

65 There are no human rights implications arising from the proposals in this paper. Consistency with the *New Zealand Bill of Rights Act 1990* and the *Human Rights Act 1993* will be discussed with the Ministry of Justice during the drafting process.

Consultation

66 MBIE received 36 submissions to the Issues Paper reflecting perspectives of a broad range of submitters. MBIE has also engaged with the Reserve Bank of Australia and three other organisations in the retail payments system during the consultation process.

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67 MBIE has consulted with the Commerce Commission, the RBNZ, the FMA and the Treasury throughout the policy development process as well as the Department of the Prime Minister and Cabinet (Policy Advisory Group) and Te Kawa Mataaho Public Service Commission.

Communications

68 I expect to announce the Government's intended approach to reduce MSF soon after Cabinet decisions are made.

Proactive Release

69 I propose that this Cabinet paper be proactively released, with any redactions as appropriate under the Official Information Act 1982, on the MBIE website, within 30 business days of decisions being confirmed by Cabinet.

Recommendations

The Minister of Commerce and Consumer Affairs recommends that the Committee:

Background

1 **note** that in November 2020, in the Speech from the Throne, the Government committed to regulate the merchant service fee payable on debit and credit card transactions to reduce costs on retailers and the resulting costs on consumers;

2 **note** that in December 2020, the Government released a discussion document [CAB-20-MIN-0510 refers];

3 **note** that high merchant service fees are having inequitable impacts on some businesses and consumers;

4 **note** that high merchant service fees is a symptom of inefficient competition and consumer preferences for high-cost payment products that offer rewards and inducements;

The regulatory regime

5 **agree** regulatory intervention is required to reduce the adverse impacts of high merchant service fees resulting from the economic inefficiencies in the retail payments system – specifically card products;

6 **agree** that the *Retail Payments System Bill* will introduce a regime to regulate (on a case by case basis) classes of retail payments system participants, their providers and any associated infrastructure operators (including secondary infrastructures), that meet the prescribed thresholds;

7 **agree** the overall objective of the regime is to ensure the retail payments system delivers long term benefits to merchants and consumers;

8 **agree** that the regime should be broadly scoped to potentially apply to any retail payment method (excluding cash) that is important to merchants and consumers;

9 **agree** that, in doing so, the regime will aim to:

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9.1 enable efficient competition between payment providers and payment products;

9.2 incentivise beneficial innovation for consumers and merchants;

9.3 be efficient in allocating resources through clear price signals, where prices are cost reflective for the system as a whole;

9.4 be fair in its distribution of costs, particularly in its treatment of small merchants and low income domestic consumers.

10 **agree** that the regulation should adopt a designation model to provide flexibility and future-proof regulation;

11 **note** that the proposed process and relevant factors for designation are secondary policy issues that require further consultation with stakeholders and the regulator;

Regulatory responsibility

12 **agree** that the Commerce Commission be empowered as the regulator for the new regulatory regime;

13 **note** that there will need to be coordination between the various regulators of payment systems and this will be considered in the design of the legislation;

14 **note** that more detailed institutional arrangements are secondary policy issues that require further policy work and engagement with the relevant agencies with regulatory responsibility for the retail payments system;

Regulatory tools

15 **agree** that the Bill will include a transitional price path, that will be in place until the regulator makes a determination to alter the limits, which will:

15.1 set a requirement for Visa and Mastercard to reduce the caps for interchange fees for credit cards to 0.80 per cent (being the same cap as currently applies in Australia) within six months of the Bill being enacted

15.2 set a requirement for Visa and Mastercard to reduce the caps for interchange fees for debit cards to 0.60 per cent within six months of the Bill being enacted

15.3 set a requirement to cap interchange fees that are currently at or lower than the prescribed levels at their 1 April 2021 levels to prevent these fees from increasing

15.4 set a requirement that any new Visa or Mastercard credit card product types must have an interchange fee of 0.80 per cent or less

15.5 set a requirement that any new Visa or Mastercard contacted in person debit product types have an interchange fee of 0.00 per cent

15.6 set a requirement that any new Visa or Mastercard contactless in person debit product types have an interchange fee of 0.20 per cent or less

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15.7 set a requirement that any new Visa or Mastercard online debit product types have an interchange fee of 0.60 per cent or less

15.8 provide a power for the regulator to seek documents and monitor compliance with the requirements

15.9 prescribe an offence or penalty for breach of the requirements set out in recommendation 17.1-17.7 and failing to provide documents requested by the regulator;

16 **note** that the Minister of Commerce and Consumer Affairs will write to acquirers to seek voluntary actions to pass on interchange fee reductions to merchants;

17 **agree** that the Bill will empower the regulator to impose pricing principles or limits on fees (or components of fees) on designated participants or classes of participants in the retail payments system;

18 **agree** in principle, subject to targeted consultation and the report-back referred to in recommendation 35, the Bill will empower the regulator (in relation to designated payment systems) to:

18.1 introduce information disclosure requirements to improve transparency of fees,

18.2 have the power to make directions requiring designated parties to amend their rules or processes (such as rules relating to surcharging or steering by merchants),

18.3 enter into enforceable undertakings as an alternative to regulation or to remedy non-compliance;

19 **note** that the proposed set of tools broadly reflects the approach taken in Australia;

20 **note** that targeted consultation will seek feedback on these and any additional tools that may be required to avoid the unintended consequences that have arisen in other jurisdictions;

Financial implications

21 Confidential advice to Government

22

Legislative implications

23 **note** that the proposals will be given effect through the *Retail Payments System Bill*,
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Additional matters

24 **note** that the Minister of Commerce and Consumer Affairs will conduct targeted consultation on a range of secondary policy issues, including:

24.1 the criteria and process for designation to be included in legislation,

24.2 institutional arrangements for coordination between the various regulators of payment systems,

24.3 the nature and scope of the tools available to the regulator,

24.4 an enforcement regime,

24.5 commencement dates, and

24.6 any additional matters that may be required to ensure an effective regulatory regime – such as any additional tools that should be available to the regulator to future-proof the regime;

25 **invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet in Confidential advice to Government on the secondary policy issues outlined above, following targeted consultation;

26 **note** that the Minister of Commerce and Consumer Affairs intends to announce the Government's proposed approach to reduce MSF shortly after Cabinet decisions are made;

27 **agree** that the Minister of Commerce and Consumer Affairs proactively release a copy of this paper within 30 working days of decisions being confirmed by Cabinet.

Authorised for lodgement

Hon Dr David Clark

Minister of Commerce and Consumer Affairs

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Appendix 1: Background on card payments and the retail payments system

1 The proposals in this paper focus, primarily, on debit (including EFTPOS) and credit card payment products. These products are the most common retail payment methods in New Zealand. Card payments include both in person (where a card is physically presented to a terminal, either contactless or in a contacted manner) and online purchases.

2 Card retail payment methods are a part of the wider retail payments system which includes other payment methods like cash, cheques, bank transfers, digital wallets and Buy-Now, Pay-Later.

3 The retail card payment system transmits, clears and settles financial transactions between consumers and merchants in return for goods and services. It is a broad web of technical infrastructure, arrangements and standards that allow consumers, businesses and other organisations to transfer funds. Unlike the cash payment system, this is a two-sided market which includes a number of intermediaries that play a role in transferring funds between the customer and merchant.[1]

Participants in card transactions

4 There are five key intermediaries in a New Zealand retail card payment transaction between a consumer and a merchant. Some participants like the banks may play multiple roles while others only play one role:

a. **Issuer**: An organisation which issues cards and provides debit and/or credit services to consumers. Issuers in New Zealand are either:

i. Banks: the largest being ANZ, ASB, BNZ, Kiwibank and Westpac but also includes the smaller banks such as the Co-operative Bank, Heartland, Southern Building Society and TSB.

ii. Non-bank issuers: these include credit issuers such as Flexi Group Limited (providers of Q card) and debit card issuers such as NZCU, United Credit Union and Nelson Building Society.

b. **Acquirer**: A financial institution which processes credit and some debit card payments on behalf of the merchant. Due to the technical infrastructure required to provide acquiring services, the acquiring market in New Zealand is relatively small. Acquirers in New Zealand are either:

i. Bank acquirers: Most commonly, ANZ, ASB, BNZ and Westpac but also includes Kiwibank who have a relatively small share of the acquiring market.

ii. Non-bank acquirers: these include Windcave (previously known as Payment Express) Stripe and Ayden. Non-bank acquirers tend to acquire online payments only resulting in most in-person transactions being acquired by bank acquirers. Non-bank acquirer may offer other services to

[1] Two-sided markets are different to traditional markets where buyers and sellers transact directly.

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merchants such as a customer interface but they generally aren't issuers and thus do not benefit from interchange fees.

c. **Scheme**: Organisations that develop technology and base-product features. They also play a role in setting the commercial model and card system rules. There are two types of schemes:

   i. Open schemes such as Visa, MasterCard, JCB or UnionPay offer their technology and cards to issuers.

   ii. Closed schemes such as American Express and Diners Club can act as Issuer, Scheme and Acquirer for their card transactions.

d. **Switch**: Infrastructure or 'links' that send the transaction information from the customer interface to the correct card issuer or acquirer (depending on the type of transaction) so the funds can be taken from the consumer's account and delivered to the merchant's account. There are two sets of switch infrastructures in New Zealand and acquirers need to be connected to both in order to acquire payments from all card types. These transactions flows are described below:

   i. switch-to-issuer infrastructure to direct certain debit card payment transactions directly from the payment interface to the issuer. To do this, the switch provider needs to create 'links' with each issuer. Paymark is the main provider of this service and their competitors, Verifone and Windcave, rely on wholesale access to Paymark's infrastructure.

   ii. Switch-to-acquirer infrastructure to direct certain payment transactions from the customer interface to each merchant's acquirer. Unlike with switch-to-issuer infrastructure, as long as the switch has a link with its merchants' acquirers, it can offer them payment services. This enables the switch to scale up over time to connect to more acquirers as it provides services to more merchants. Currently, Paymark, Verifone and Windcave offer this service with the latter two less reliant on access to Paymark's infrastructure than for switch-to-issuer transactions.

e. **Customer interface**: The terminal hardware and software (for in person transactions) or digital customer gateway (for online transactions) through which the customer makes a payment to a merchant. Large terminal hardware providers in New Zealand include Verifone, Windcave and Smartpay. Digital customer gateway providers include Windcave, Stripe, PayPal, and Paystation by Trademe. Many of the banks and Paymark also offer these services.

Types of card transactions

5 There are two main business models for card payments:

a. **The switch-to-issuer model** (ie the domestic rails) which is used for EFTPOS and contacted (swiped or inserted) debit card transactions (refer figure 1 below). Under this model, the switch sends the payment information directly to the issuer (ie the customer's bank) before clearing a payment, bypassing the acquirer and scheme. No MSF is payable. The only costs incurred by merchants to accept these transactions are the terminal fee and network fee (switch fee) which are

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generally monthly charges from the terminal and switch providers. The issuer in this model is charged a switch fee for each transaction.

b. **The switch-to-acquirer model** (ie the scheme rails) which is used for all credit cards (swiped, inserted and contactless), contactless debit cards and card-not-present transactions (ie online transactions). Refer figure 2 below. Payment information flows between four intermediaries before being cleared – the switch, acquirer, issuer and the scheme. In most instances, processing these transactions relies on Visa and Mastercard infrastructure – what are known as 'scheme rails'. In return for clearing the payment, the acquirer is charged a 'switch fee', an 'interchange fee' and a 'scheme fee'. The acquirer fully recovers this cost from the merchant through the MSF.

Figure 1: Fees and inducements in switch-to-issuer transactions

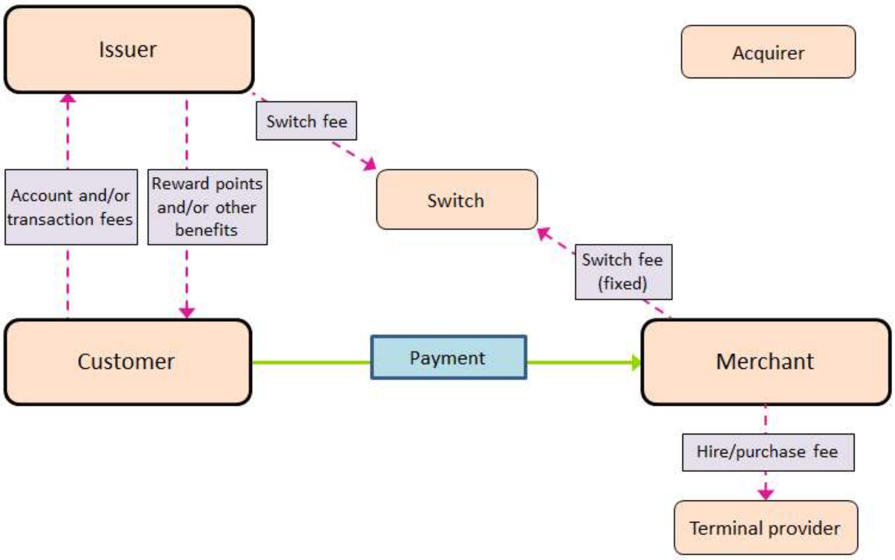

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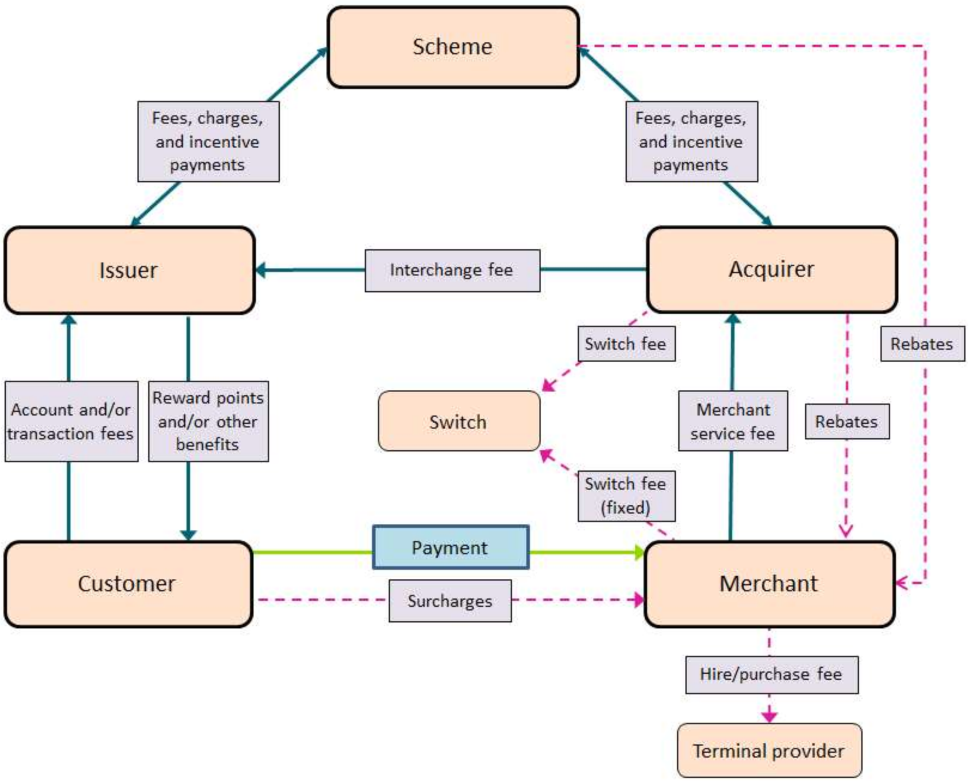
Figure 2: Fees and inducements in switch-to-acquirer transactions



Merchant Service Fees (MSF)

6 As shown in figure 2, the MSF charged to the merchant for switch-to-acquirer transactions is generally one fee but comprises of the following inputs:

a. **Scheme fees:** fixed fees paid by the acquirer to a scheme for processing a transaction on the scheme's rails. Some larger merchants may be able negotiate rebates on this fee directly from the card schemes thereby discounting the overall MSF.

b. **Interchange fees:** a percentage of the transaction value paid by the acquirer to the issuer in exchange for clearing a payment. Issuers use revenue from interchange fees to cover the cost of reward programmes, investment in technology, fraud costs, the customer's banking costs and to provide some margin to the issuer. The interchange fee is generally the largest component of the MSF for most transaction types.

c. **Switch fees:** fixed fees used to cover the cost of using a switch provider to direct the payment request to the right source depending on the card and transaction

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type so that funds can be taken from the customer's account and delivered to the merchant.

d. **Acquiring costs:** covers fraud risk, systems and people required for acquiring transactions and any foreign exchange costs. This fee also includes the acquirer's profit margin.

7 The MSF payable for each transaction varies on four metrics:

a. card product type

i. consumer or commercial

ii. debt, credit or prepaid debit

iii. card benefit level (classic, gold, platinum or signature)

b. card authentication method (contacted, contactless or online)

c. merchant type (strategic, utility, small retailer or large retailer – categories vary significantly between acquirers)

d. payment structure with some merchants paying a single rate for all switch-to-acquirer transactions (blended rate), a different rate for each scheme or authentication type (a partially unbundled rate), or fully unbundled cost-based rates, relating to actual costs of accepting different cards (interchange plus).

8 Due to these variances, the overall MSF payable by a merchant can vary significantly. The following are some illustrative examples of how these variances can impact different participants in the retail card payment system.

Example 1: In-person credit card purchase from an independent boutique on a town's high street

9 Alex makes an in-person $100 credit card transaction from an independent boutique (the merchant). The credit card was issued to Alex by Bank A (the issuer) and each transaction receives a 1% cashback reward.

10 The merchant charges a 2% surcharge for credit card transactions. The merchant conducts its transactional banking with Bank B and Bank B (the acquirer) acquires in person transactions for the merchant. The merchant has opted to pay a blended rate for their merchant service fees. This means that regardless of the type of credit card or the way Alex uses it (contactless or contacted) the merchant will be charged the same merchant service fee.

11 When Alex makes the payment at the terminal, they insert their card into the terminal and input their pin. The payment information is passed through the switch-to-acquirer

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model to bank A (the issuer). Once the payment is cleared, Bank B (the acquirer) deposits the final payment to the merchant.

12 At the end of the month, the merchant is billed for the total merchant service fees payable for all transactions they accepted in the month. The 2% surcharge covers most of the merchant's costs for accepting the payment.

13 For Alex, however, despite paying a 2% surcharge, the real cost of the surcharge was $1 due to the $1 of cashback rewards.

Example 2: Online debit card purchase from a franchise shoe store in a shopping mall

14 Alex makes a $100 debit card transaction online to purchase a pair of shoes. The debit card is issued by Bank B and has no associated rewards.

15 The merchant (in this case a franchise shoe store) charges a 3% surcharge for all card payments online. The merchant acquires online transactions with a non-bank acquirer (eg Windcave) but holds its transactional bank account with Bank C. The merchant has opted to pay a bundled rate (where the merchant service fee varies based on whether the card is a debit or credit card and contacted or contactless) for their merchant service fees.

16 When Alex makes the payment at the store's online payment gateway, the payment information is passed through the switch-to-acquirer system. Due to the bundled rate, the fact that Alex payed with a debit card means that the merchant will be charged a lower merchant service fee than if a credit card was used – a fee which is lower than the 3% surcharge. Once the payment is cleared, the non-bank acquirer deposits the final payment to the merchant's account with Bank C.

17 At the end of the month, the merchant is billed for the total merchant service fees payable for all transactions. Due to the surcharge, the merchant may profit from this transaction.

18 Because Alex paid with a debit card, Alex incurred a 3% additional cost for the payment, without receiving any corresponding rewards, other than the convenience of being able to purchase online.

Example 3: Large scale big box retail chain

19 Alex makes a $100 credit card transaction by inserting their card in the card reader machine at a large scale big box retail chain. The card is a basic credit card issued by Bank B and earns no rewards points per transaction.

20 The merchant does not surcharge for credit card use. The merchant acquires in-person transactions with Bank A, which is the bank they use for their transactional bank account. The merchant has opted for Interchange plus pricing (where each transaction type has a different rate) for their merchant service fees. The merchant

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has also negotiated a rebate with the schemes, which further decreases their overall merchant service fee.

21 When Alex makes the payment at the terminal, the payment information is passed through the switch-to-acquirer system. Once the payment is cleared, the acquirer (Bank A) deposits the final payment into the merchant’s account.

22 At the end of the month, the merchant is billed for the total merchant service fees payable for all transactions.

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