MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

BRIEFING

Retail Payments System: Summary of submissions and initial decisions

Date:	04 March 2021	**Priority:**	High
Security classification:	**In Confidence**	**Tracking number:**	2021-2334

Action sought		
	Action sought	**Deadline**
Hon Dr David Clark Minister of Commerce and Consumer Affairs	**Note** the contents of this briefing. **Agree** to the proposed approach for regulation. **Forward** the attached to the Minister for Small Business and Minister of Finance. **Provide** feedback on the attached draft Cabinet paper.	8 March 2021
	Agree to discuss the financial implications arising from these proposals with the Minister of Finance.	15 March 2021

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Daniel O'Grady	Manager, Competition and Consumer Policy	04 470 2295	027 352 7290	
s 9(2)(a)	Senior Policy Advisor		s 9(2)(a)	✓
s 9(2)(a)	Policy Advisor	s 9(2)(a)		

The following departments/agencies have been consulted (if required)
Commerce Commission, Financial Markets Authority, Reserve Bank of New Zealand, Treasury, Te Kawa Mataaho Public Service Commission, Department of Prime Minister and Cabinet (PAG)

Minister's office to complete:

- ☐ Approved
- ☐ Declined
- ☐ Noted
- ☐ Needs change
- ☐ Seen
- ☐ Overtaken by Events
- ☐ See Minister's Notes
- ☐ Withdrawn

Comments:

BRIEFING

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Purpose

To provide you with a summary of the submissions on the issues outlined in the discussion document, *Regulating to reduce merchant service fees*, and provide you with advice on the regulatory approach to resolve these issues.

Executive summary

1. In December 2020, the Ministry of Business, Innovation & Employment (MBIE) released an Issues Paper seeking submissions on our understanding of the issues and problems concerning card payment products and approaches to regulation. Public consultation has now closed, and we have received 36 submissions reflecting perspectives of a broad range of submitters.

2. The review was triggered by the Labour Party's manifesto commitment to regulate merchant service fees (**MSF**) payable on debit and credit card transactions. This review builds on findings from an earlier review of RPS in 2016 carried out by MBIE which found inefficiencies in the system but called on the industry to take steps to provide greater transparency around interchange fees and progress initiatives that will provide competitive pressure to reduce fees.

3. Information gathered from the Issues Paper consultation suggests:

    a. since 2009, RPS participants have taken some steps towards offering more transparent MSF pricing structures and reducing fees for some transactions since the 2016 review

    b. 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 some card products (specifically credit cards and online debit cards)

    c. MSF pricing is having adverse impacts on small businesses, and some consumers as cardholders.

Some card products with high MSF have adverse impacts on merchants and consumers

4. Following voluntary reductions of MSF in 2020, the average MSF across all card products in New Zealand are now 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. Data provided by the five main banks shows MSF remains higher than Australia for a majority of card products – including online transactions and credit cards.

5. We believe MSF for some card products remains high due to:

   a. An apparent lack of competition in some aspects of the system. Large banks dominate both sides of the RPS – as they tend to provide issuing and acquiring services – and therefore have little incentive to reduce fees. Submissions identified a number of barriers to competition which include:

      i. Limited ability, and willingness, of acquirers to negotiate lower fees with schemes and issuers. The market dominance of banks and Visa and Mastercard means non-bank acquirers have very little negotiating power and bank acquirers have little incentive to negotiate lower scheme and interchange fees. Furthermore, due to the comparatively small scale of the New Zealand market, it is difficult for non-bank acquirers to enter the market and achieve the critical mass necessary to be viable

      ii. Paymark dominates the switch market which forces all new entrants to negotiate a connection with Paymark[1]. Due to the costs involved in establishing payment infrastructure, Paymark remains the only switch with links to all issuers and acquirers in the New Zealand market.

   b. The system incentivises the use of higher-cost payment methods which are funded by interchange fees. Issuers rely on interchange fees to provide rewards and inducements that encourage consumers to use their card products. The system encourages merchants to pass on the costs of accepting higher-cost payment methods to consumers which is resulting in a regressive wealth transfer from those that use lower cost payment methods to those that benefit from the rewards and inducements.

6. Small merchants are impacted more than larger merchants – not only are they charged more, 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.

Regulatory intervention is necessary

7. While submitters' views around direct regulation vary significantly, there is broad agreement across the sector that government oversight is necessary to facilitate innovation that will deliver long-term benefits to merchants, consumers and the RPS overall.

8. Non-regulatory options have proven to have little effect in influencing meaningful change. Despite some efforts to reduce fees, there continues to be a lack of innovation, transparency around MSF and competitive pricing.

9. The Australian experience illustrates that payment system regulation has technical difficulties, with multiple parts and players, resulting in unintended consequences if the 'system' as a whole is not taken into consideration.

10. As such, we recommend introducing legislation to allow the Commerce Commission to regulate designated classes of RPS participants. Primary legislation should include a broad set of tools to put pressure on the various parts of the RPS to reduce MSF and improve consumer outcomes. While the designation itself will be set out in regulations, the process for designation and objectives of regulation will be set out in primary legislation to give the regulator, and industry, a clear indication of Parliament's intent. Such an approach will enable the regime to respond to issues that may arise in the future and ensure the regulatory regime is flexible enough to respond to developments in the RPS as they occur. For

[1] A switch is a key intermediary in the payment system that that sends transaction information to the issuer or acquirer.

example, submissions indicate that buy-now, pay-later products may have adverse impacts on merchants in the future when they become a more mature and dominant feature of the RPS.

11. While price regulation of interchange fees will be a key tool for regulation, submitters have encouraged the Government to also consider other tools and coordination across the payments system to create incentives that will reduce MSF in the long-term. We consider this to be necessary to avoid the unintended consequences that may result from targeting one part of the system.

These policy proposals will need funding

12. Introducing a new regulatory regime will have financial implications which you will need to personally discuss with the Minister of Finance before seeking policy approvals from Cabinet. At a high-level, if the Commerce Commission is appointed as the regulator, we estimate the financial implications of these proposals will be in the realm of up to $15 million per annum. We are still in the process of costing these proposals and exact figures will be provided at a later date. Because policy decisions are being sought in April 2021, these proposals will need to secure funding from the between-Budget contingency.

13. We recommend that you personally consult the Minister of Finance on these funding proposals ahead of receiving the Cabinet paper to ensure the Minister is comfortable with the proposed approach.

Next steps include providing you with a draft Cabinet paper and targeted consultation

14. Subject to your feedback we will provide you with a draft Cabinet paper, on 18 March, to take to Cabinet before Easter. If this approach is agreed to by Cabinet on 29 March, then we will carry out targeted consultation on the following issues:

    a. The complete set of tools for the regulator

    b. Design of regulation – specifically how the designation model should operate

    c. Governance structures to enable payment system regulators to take a coordinated approach.

15. Following targeted consultation on further policy issues, we will provide you with a further Cabinet paper seeking final policy decisions in June 2021.

16. While we continue to work towards drafting and introducing the Retail Payments System Bill by s 9(2)(f)(iv) [redacted], there are considerable risks to the regime resulting from the condensed policy development process and drafting process. Any issues impacting the regulatory quality of the Bill may need to be addressed by a Supplementary Order Paper or legislative amendments which would ultimately delay the commencement of the regime.

Recommended action

The Ministry of Business, Innovation and Employment recommends that you:

a **Note** the Labour Party Manifesto and Speech from the Throne includes a commitment to regulate MSF payable on debit and credit card transactions to bring them in line with overseas jurisdictions

Noted

b **Note** that MBIE consulted on the operation of the RPS in 2016 which received 46 submissions representing views from card schemes, banks, merchants, consumer representatives, and other industry representatives

Noted

c **Note** that since the 2016 consultation, participants in the retail payment sector have taken steps towards offering more transparent pricing structures for MSF and reducing the fees for some transactions

Noted

d **Note** that due to roughly half of card transactions not attracting MSF, overall, the average MSF across all card products in New Zealand are now comparable with Australia

Noted

e **Note** that lack of competition and benefits associated with the use of higher-cost payment methods may be contributing to higher MSF for credit card and online card payments

Noted

f **Note** that high MSF for some card products in New Zealand is having adverse impacts on small businesses and some consumers

Noted

g **Agree** that government intervention, through regulation, is required to create incentives to reduce MSF as industry-led solutions have not been effective to reduce MSF to levels comparable to Australia and other jurisdictions

Agree / Disagree

h **Note** that regulating MSF directly will have adverse impacts on the retail payment system as it will disproportionately impact non-bank acquirers, further removing competitive pressures that have contributed to high MSF

Noted

i **Agree** that, rather than regulating MSF directly, regulation should take a systems approach to put downward pressure on multiple aspects of the retail payment system (eg interchange fees and scheme fees) to reduce MSF while preserving and promoting competition over MSF

Agree / Disagree

j **Agree** that the regulation should be a designation model in order to future-proof regulation to allow for regulation to be imposed (on a case by case basis) on other classes of retail payment system participants, their providers and any associated infrastructure operators (including secondary infrastructures), that meet the prescribed thresholds

Agree / Disagree

k **Agree** that in order to deliver better outcomes for merchants and consumers, the designation of retail payment systems and their participants should occur through regulations or by the regulator, under processes to be specified in primary legislation (rather than designating parties in primary legislation)

Agree / Disagree

l **Agree** that the Commerce Commission should be the regulator for the new regulatory regime

Agree / Disagree

m **Note** we will continue to explore regulatory structures that promote coordination between the Commerce Commission and the Reserve Bank of New Zealand to payment system oversight

Agree / Disagree

n **Agree** that the primary legislation will empower the regulator with tools to:

i. impose limits on the financial rewards available to card issuers

ii. set information disclosure requirements

iii. impose and vary scheme rules (such as relating to surcharging) on designated parties

Agree / Disagree

o **Note** that the regulator will require additional tools to foster competition, innovation and a resilient retail payment system which we will provide further advice on in June 2021

Noted

p **Note** that introducing a new regulatory regime will have financial implications that need to be addressed when seeking policy decisions

Noted

q **Agree** to discuss funding the new regulatory regime outside the Budget cycle, from the between-Budget contingency, with the Minister of Finance before seeking Cabinet policy decisions

Agree / Disagree

r **Agree** to forward a copy of this briefing to the Minister for Small Business and the Minister of Finance for their information

Agree / Disagree

s **Note** that, subject to your feedback, we will provide you with a draft Cabinet paper on 18 March 2021, which will seek initial policy decisions for regulation

Noted

t **Note** that we are working towards this Cabinet paper being taken straight to Cabinet on 29 March 2021 to enable the Government to make an announcement on this policy before Easter

Agree / Disagree

u **Note** that further advice to seek final policy decisions, together with a draft Cabinet paper, will be provided following targeted consultation, in June 2021

Noted

v **Note** that further advice to seek final policy decisions, together with a draft Cabinet paper, will be provided following targeted consultation, in June 2021

Noted

w **Note** that officials will be available to discuss this briefing at the weekly officials meeting on Monday 8 March.

Noted

s 9(2)(a) [redacted]

Daniel O'Grady
Manager, Competition and Consumer Policy

04 / 03 / 2021

Hon Dr David Clark
Minister of Commerce and Consumer Affairs

..... / ...... / ......

Background to review

17. In December 2021, the Ministry of Business, Innovation & Employment (**MBIE**) initiated a review of merchant service fees (**MSF**) in New Zealand [Briefing 2021-1184 refers]. The review was triggered by the Government's commitment to regulate MSF payable on debit and credit card transactions to bring them in line with overseas jurisdictions.

18. As part of the review, MBIE released a discussion document, *Regulating to reduce Merchant Service Fees* (the **Issues Paper**), for public consultation. The paper explored issues and options to place downwards pressure on MSF. The Issues Paper gathered information from key stakeholders on:

    a. our understanding of the issues and problems concerning the retail payments system (**RPS**)

    b. the objectives for the RPS

    c. the likely impacts of direct regulation of interchange fees

    d. which body/entity should be responsible for regulation

    e. supplementary options for intervention in the RPS to address the issues of concern.

19. We have been advised that this work is a priority for the Government and you wish to make an announcement on the approach to regulation before Easter. With that in mind, this briefing identifies the problems and our recommended high-level regulatory approach to resolving them. Our analysis draws on the feedback we have received from the consultation and our engagements with key stakeholders so far.

20. A full timeline of the next steps for this review, up to the introduction of a Bill, is included at the end of this briefing at page 24.

21. As the Minister for Small Business joined you in releasing the Issues Paper, we recommend that you forward this briefing to him for his information.

Merchant service fee and the retail payments system

22. A MSF comprises of four costs incurred by the merchant's bank (the acquirer) to process credit or contactless and online debit card transactions: scheme fees[2], interchange fees[3], switch fees[4] and the acquirer's margin for providing the service.

23. Payments NZ requires issuers to bear the cost of providing EFTPOS and swiped or inserted debit transactions. ANZ bank estimates that this cost subsidy is in excess of $50 million per annum across the market. Given issuers bear this cost, there is also a risk that support for EFTPOS by these banks declines over time in favour of scheme debit and credit from which they can derive revenue.

24. A summary of the New Zealand RPS, and the impact it has on MSF, is set out in **Annex One**.

[2] Scheme fees are fixed fees paid for processing the transaction. They are paid by the acquirer to the card scheme. Some larger retailers earn a rebate on this fee from the card schemes.
[3] Interchange fees are paid by the acquirer to the issuer in exchange for clearing a payment.
[4] Switch fees are fixed fees used to cover the cost of using a switch provider to direct the payment request to the right source so that funds can be taken from the customer's account and delivered to the merchant.

Scope of the review

25. Rather than regulating MSF directly, we recommend taking a systems approach to regulation that targets multiple parts of the RPS to reduce MSF in the long-term. From the consultation, it is apparent that there are broader issues with the RPS that have contributed to the high MSF that we are seeing in New Zealand.

26. Submitters also emphasised the importance of taking a broader view of retail payments than just costs associated with the card payment system, to provide a regulatory environment which supports a range of payment methods and values the safety and security of the system.

27. Several submitters discussed the impact of buy-now, pay-later (**BNPL**) payment providers on the RPS. Submitters are concerned that the fee merchants are charged for accepting BNPL payments is higher than the MSF for accepting scheme debit or credit card payments. Consumer NZ noted that the lack of transparency may be resulting in the costs for providing these payment methods being passed on to consumers through increased prices. Providers impose a 'no surcharging rule' on merchants which precludes merchants from surcharging for the acceptance of a BNPL transaction.

28. Given the infancy of BNPL transactions in New Zealand, and other policy work around the impact these products are having on consumers, we are not specifically focusing on this payment method. There is a risk that regulation of new entrants providing price competition, as BNPL products are, may push new entrants out of the system.

29. On that basis, we recommend adopting a designation model that can take a systems approach to regulation. Under this approach, the regime would be designed in such a way that it can cater to a range of RPS models, with the ability to bring them in at a later point in time.

We think the objective of New Zealand's RPS should be to deliver long-term benefits for merchants and consumers

30. In the Issues Paper it was suggested the overall objective for the RPS is to deliver long-term benefits for New Zealand merchants and consumers. While we are still developing our analysis, we consider this requires that the system:

    a. enables efficient competition between payment providers and payment products

    b. incentivises beneficial innovation for consumers and merchants

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

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

31. In achieving these objectives, any regulation of RPS must work well within the wider payments landscape. This includes existing payment systems and tools, as well as future payment innovations which could include new forms of money, new ways to pay, and new interface providers. An end-to-end consideration of payments more broadly will encourage system resilience to deliver long-term benefits for all New Zealanders.

32. All of the submitters that submitted on this issue agreed with the objectives identified in the Issues Paper and also noted the importance of soundness of the payment system more broadly. Those submitters that agreed in principle urged the Government to aim higher to address broader issues in the RPS to bring New Zealand in line with other jurisdictions (Goldfinch Advisory and Woolworths) while others emphasised incentivising innovation should be the primary objective the Government should focus on (ASB and Visa).

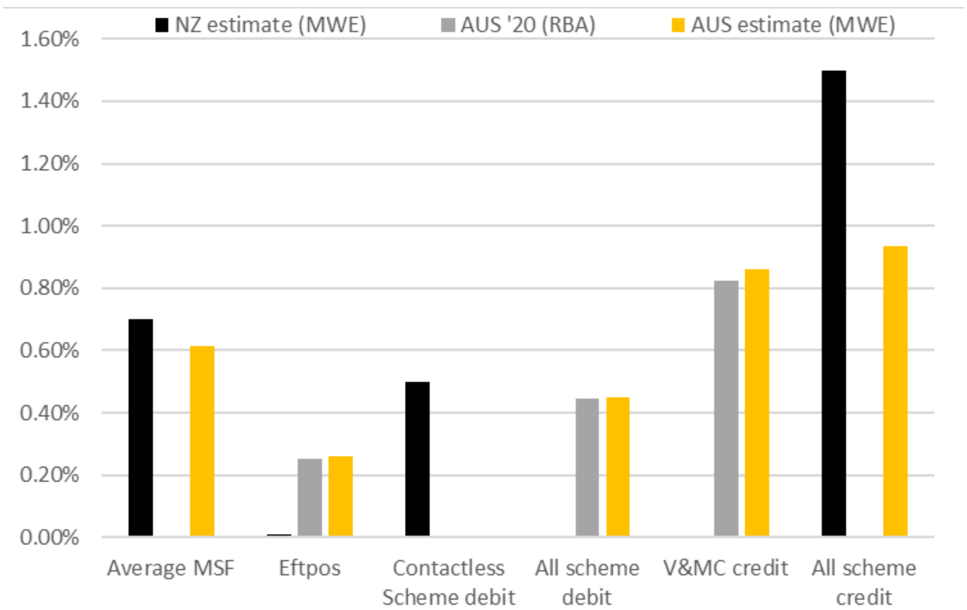
High MSF for some card products are having adverse impacts on merchants and some consumers

MSF are high for some card products in New Zealand compared with Australia…

33. Many submitters noted that because merchants in New Zealand are not only directly charged for each switch-to-issuer transaction (EFTPOS or contacted debit card transactions which are approximately half of all card transactions in New Zealand), the overall cost of accepting card transactions in New Zealand is on par with countries such as Australia. Some participants went so far as to suggest that overall fees in New Zealand are lower than in some other markets.

34. BNZ and American Express commissioned analysis from MWE Consulting to compare MSF between Australia and New Zealand. This analysis shown in the below chart (**Figure 1**) indicates that the average MSF across all card transaction (including fee free EFTPOS) is marginally more expensive in New Zealand. s 9(2)(ba)(i) [redacted]

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



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

35. Besides EFTPOS, New Zealand has higher MSF for the other card products – MSF for scheme credit cards is more than 0.50 per cent higher than Australia. Online scheme debit MSF (not shown in Figure 1) are also higher in New Zealand and are closer to the scheme credit rate estimated by MWE Consulting for New Zealand.

36. One non-bank acquirer which operates across a number of countries noted in their submission that the difference in MSF that their merchants pay across these markets is primarily due to differences in interchange fees.

… despite fee reductions over the past five years

37. In line with expectations set by previous Ministers, there have been reductions in MSF since 2017, but as noted above MSF are still higher in New Zealand than Australia for some card products. An economic consultancy, on behalf of the New Zealand Bankers' Association, calculated that on average MSF for the large bank acquires have declined by 17.7 per cent from 2017 to 2020.

38. One change, which has helped smaller merchants in particular, is that in late 2020 the major banks reduced MSF on contactless debit card transactions to a maximum of 0.6 - 0.7 per cent. One bank noted in their submission that this has resulted in this MSF reducing by more than half for their smaller merchants.

39. One of the reductions in MSF has come from a reduction in interchange fees for scheme debit and credit card transactions. Overall interchange fees have reduced by roughly 8 per cent for credit transactions and 20 per cent for debit transactions since the first half of 2017. Shown in the below charts (**Figure 2** and **Figure 3** respectively) this has primarily come from reductions in contactless debit (30 per cent) and in-person credit (15 pre cent) interchange fees since 2017.

s 9(2)(ba)(i)

[redacted]

Factors causing high MSF

40. Feedback received from consultation confirms there are three key factors contributing to high MSF in New Zealand:

    a. an apparent lack of competition in some aspects of the system, especially in the switching and acquiring market

    b. the system incentivises the use of higher-cost payment methods which are funded by interchange fees

Lack of competition in some aspects of the market

41. Competitive pressures in New Zealand (as elsewhere) do not appear to be sufficiently strong enough to bring MSF in line with expected outcomes. Based on the submissions we have received, we understand that there may be the following barriers to greater competition:

a. There are very few acquirers that are not also issuers in New Zealand. This means that the bank-acquirers have little incentive to negotiate for interchange fees lower than the caps set by the schemes.

b. There appears to be limited ability for acquirers to negotiate scheme fees with the schemes due to the power the scheme holds over each acquirer's ability to acquire. This is particularly an issue for acquirers that do not also issue cards as they have no countervailing leverage.

c. Paymark dominates the switch market as it is the only switching service provider with links to all banks. We have been advised that the banks prefer to maintain technical links with only one switch, due to the very high ongoing running costs. As long as the banks are not charged too much for switching they are not likely to be incentivised to build links to a second switch. This leads to the following issues:

    i. Switch fees for merchants may be higher than expected in a competitive market.

    ii. All terminals in New Zealand need to meet Paymark's standards to connect to their switch, which we understand differ from common international standards. This creates additional hurdles to offering new terminals within New Zealand. A non-bank acquirer that is yet to enter the New Zealand market argued that this is the reason merchants are not offered new terminals.

    iii. Due to the costs involved in establishing a switching service, Paymark has virtually monopolised the switching market which some stakeholders consider impedes innovation and increases costs to merchants (through the switch fee).

    iv. Less competition in the acquiring market for instore transactions. We have heard that barriers to creating switching links make it difficult for international acquirers (that operate in Australia) to acquire instore transactions.

d. Due to the comparatively small scale of the New Zealand market, it may be difficult for new acquirers to achieve the critical mass necessary to be viable.

42. As cardholders and merchants have no direct influence over the system, they rely on the issuers and acquirers to represent their interests. However, in the absence of greater competition, banks and schemes continue to dominate the RPS and have little incentive to press for lower fees to achieve better outcomes for merchants and cardholders.

Consumers are incentivised to use higher-cost payment methods

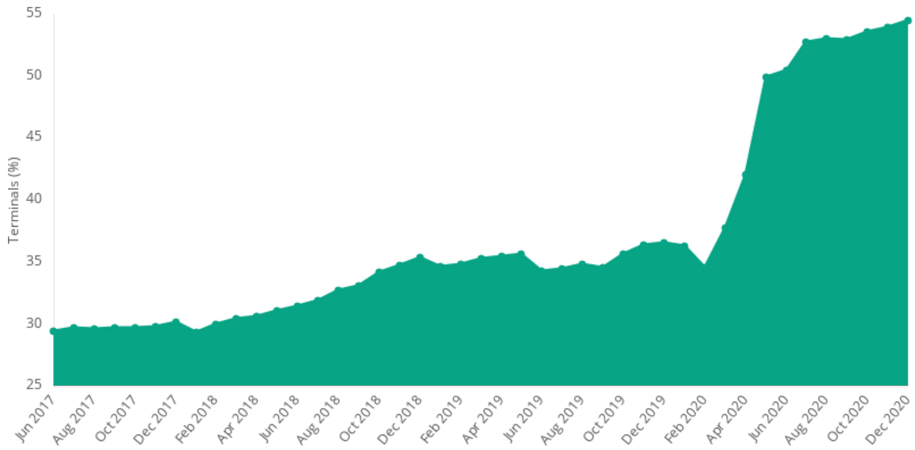
43. When using higher-cost payment methods (such as contactless debit cards and credit cards) consumers enjoy a net-benefit (either in the form of rewards, added security, credit or convenience). This is particularly true due to the limited use of surcharging and steering in New Zealand (discussed in greater detail below).

44. Given that consumers choose which payment method to use based on the costs and benefits that they face, use of higher-cost payment methods has inadvertently increased MSF. The impact of benefits on consumer payment behaviour became apparent during the COVID-19 pandemic, where there was a surge in preference for contactless payments for health reasons among consumers. As shown in **Figure 4** and **Figure 5** below, we have seen consumers move towards higher-cost payment methods like contactless debit payments, and online payments. 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 enabled increasing from around 35 per cent to nearly 55 per cent over the same period.

s 9(2)(ba)(i)

[redacted]

Figure 5: Share of terminal with contactless payments enabled



Source: Payments NZ

45. Submitters almost unanimously (except a few banks) agree that rewards, amongst other benefits like low interest rates and security features, play an integral role in influencing a consumer's payment method and the uptake of card payment methods in New Zealand. The submissions confirm credit card-based reward programmes, in particular, have been a highly effective way to enhance consumer loyalty.

46. Issuers benefit from the use of higher-cost payment methods as they generate revenue – both through interchange fees paid by merchants (through acquirers) and interest paid by consumers. However, as the cost of rewards and inducements is recovered from interchange fees, issuers have little incentive to reduce these fees.

The impact of high MSF is felt by small businesses…

Small businesses are paying more in MSF

47. Data provided by the five main acquirers in New Zealand shows small businesses are paying higher MSF than larger, more strategic, merchants. Some submitters note that small to medium size businesses do not meet the criteria set by the card schemes for "Strategic Merchant Rates" and as such do not have access to this benefit.

48. Schemes and acquirers submit that the difference in MSF is justified as merchant pricing is influenced by various market forces such as merchant volume, merchant category, average

ticket size and payment channel (eg face to face, online, etc.). As the costs, risks and benefits of businesses vary so does the MSF.

49. Acquirers also note that there are fixed costs that acquirers' face with all merchants in setting up merchants and providing customer support. However, with small merchants these costs are spread over a lower volume of transactions, which acquirers argue results in the cost deferential we see. It is unclear from the data we have been provided if this cost differential is what we would expect in a competitive market. However, from the data we have received, the gap between small and large merchants appears comparable with that in Australia.

50. Westpac noted that while the individual rates may be higher for small businesses, they "generally have a very much higher proportion of EFTPOS transactions, which means that the overall cost of card acceptance between small and large merchants is not necessarily as significant as comparative merchant fees on their own may suggest". While this may be true, it distorts the impact high-cost payment methods have on small merchants. We assume the reality is that smaller merchants accept a higher proportion of EFTPOS transactions as a result of steering or surcharging consumers for the use of high MSF products. In doing so, businesses encourage consumers to use lower-cost payment methods (like EFTPOS).

Small businesses lack bargaining power and resources to obtain lower fees

51. Due to the small volumes and values of transactions they deal with, small businesses lack bargaining power and resources to find cheaper rates. Almost all the submitters that responded to this issue acknowledged the lack of bargaining power for small merchants, with some noting that the lack of transparency and inconsistency of terminology used makes it difficult for small businesses to make informed decisions or shop around.

52. Moves by the banks to offer merchants unblended and unbundled[5] MSF have paved the way for merchants to have greater choice in the way their fees are structured. For some businesses it is likely that this will lower the cost of payments and provide greater benefits from any steering that occurs. However, the rate at which these payment structures have been rolled out by the banks, and taken up by small businesses varies significantly between banks. This may be due to the cost of changing acquiring arrangements, or a lack of understanding and predictability around unbundled pricing. For smaller businesses, the savings of lower MSF from unbundled rates may not seem worth their while.

53. Another cost from the system for businesses is that the retail interbank settlement system (settlement before interchange), does not settle seven days per week. This means that a retailer who makes a sale on a Friday in some cases has to wait until Monday for the money to appear in their account. Some acquirers fund this gap for merchants with same day settlement. However, this still comes at a cost to the acquirer which is passed onto the merchant.

Merchants risk losing customers through steering or surcharging

54. Steering and surcharging can be a costly decision for merchants as they risk losing customers, and therefore revenue. This risk is especially prevalent in e-commerce where customers can shop around to find businesses that accept a more suitable payment method with lower costs. While this risk is not unique to small businesses, the high MSF incurred by small businesses means they are more likely to rely on steering or surcharging to cover the cost of higher-cost payment methods.

55. While terminals and online payment gateways can be customised to accept specific payment methods or apply a surcharge, many small businesses are reluctant to do so as higher-cost payment methods (like contactless) are highly valued by consumers. Merchants have indicated in their submissions that steering has become especially difficult since the COVID-19 pandemic as consumers expect contactless payments to be accepted due to public health

[5] Payment structures in which the merchant pays a different rate for each different card product.

benefits. Hospitality NZ and Retail NZ submit that their members have felt immense pressure, and in some cases backlash, for removing contactless payment facilities after initially enabling them following the first lockdown.

56. Instead, merchants have been relying on surcharges to recover the costs of higher-cost payment methods. According to Consumer NZ, the use of surcharging is increasing. However, the competitive disadvantage of a surcharge can be detrimental to small business owners who risk losing customers.

57. Furthermore, due to the limited functionality of EFTPOS, merchants are forced to accept scheme debit or credit transactions if they want to engage in e-commerce. MSF for online transactions is very high, especially for small merchants. Given the prevalence of e-commerce in the modern economy, small businesses risk losing customers, and growth, if they do not have an online presence.

…and some consumers

58. Where surcharging does not occur, as previously indicated at paragraph 43, consumers that use higher-cost payment methods generally experience a net-benefit in the forms of rewards and inducements for their payment choice. Where surcharging does not occur the costs associated with accepting card payments are passed on to all consumers, so users of lower-cost payment methods pay more for goods and services and are ultimately disadvantaged for using a lower-cost payment method. Rewards-bearing credit cards are generally only available to higher-income earners, so we consider this regressive wealth transfer may be having a larger impact on lower income consumers.

59. Where surcharging does occur, merchants appear to be benefiting from consumers use of higher-cost payment methods. Anecdotal evidence from the submissions suggests merchants are profiteering or recovering additional costs through surcharges – over and above the actual cost of the transaction. Consumer NZ submitted that surcharges do not always reflect the real cost faced by merchants with many merchants over-recovering through the disguise of credit-card surcharge. Retail NZ notes that it is difficult for merchants to accurately price surcharges, especially if they are on an unbundled rate. Some bank submitters noted they have come across situations where consumers are charged a 5% surcharge for credit card or contactless debit-card transaction, which is well outside the range their bank charges in MSF. Submitters also noted that surcharges cannot be priced based on card type. As a result, the net-impact on users of higher-cost payment methods may also vary – for example users of contactless platinum credit cards may still experience a net-benefit whilst the user of a contactless debit card will incur a loss from a surcharge for contactless payments.

60. We consider these wealth transfers to be regressive because it unfairly disadvantages one group of consumers at the benefit of others. What this means in the long-term is that some parts of the population will experience better outcomes as a result of the way the RPS is structured.

61. A common point made by submitters who disagreed with our position was that merchants provide other services which are taken up by only a proportion of consumers, such as free parking or loyalty programmes, which are effectively cross-subsidised. Banks also noted that cross-subsidisation is not unique to card payments as merchants also incur costs for accepting cash and cheque which is passed onto all consumers in the price of goods and services. We are aware that other forms of cross-subsidisation do occur but note that they do not generally result in regressive wealth transfers.

Government intervention is required to achieve better outcomes for merchants and consumers

There is very little oversight of the RPS

62. To date, New Zealand has taken a relatively light touch approach to oversight of the RPS. The RPS is largely self-regulated, with the following entities playing a role in overseeing aspects of the system:

    a. 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.*

    b. Payments NZ plays a role in developing rules, standards and procedures for payment systems. However, Payments NZ considers the setting of MSF to be outside of its constitutional objectives. Payments NZ is owned by the banks and feedback from the consultation suggests it has very little incentive to oversee issues relating to pricing and competition in RPS.

    c. The Commerce Commission can investigate anti-competitive behaviour in markets under the *Commerce Act 1986*. However, the Commission's ability to oversee the operation of the RPS 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.

63. Overall, submitters agree that the government should play a role in promoting competition and should provide regulatory direction in the RPS. Engagement with stakeholders indicates that there is a gap in the oversight of schemes which has allowed the New Zealand RPS to evolve to its current state.

64. Visa and Mastercard are international organisations that dominate the New Zealand scheme debit and credit card market. In the absence of regulatory oversight, the schemes have been left to develop their own standards of operation and interchange caps which are commercially focused and not always consistent with the public interest objectives outlined above at paragraph 30.

65. However, ANZ, Business NZ, Visa and Westpac submitted that the government should not intervene by way of regulation. These submissions 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 influenced our analysis and recommendations for regulation.

Non-regulatory options and enforcement under the Commerce Act has had limited impact

66. The government has been relying on industry-led solutions to increase competition and incentivise reduction in MSF. However, the pace of change in New Zealand has been slow compared to other jurisdictions where regulatory measures have been adopted.

67. In 2009 financial institutions entered into an agreement with the Commission to:

    a. reduce the average interchange fee charged on New Zealand credit card transactions

    b. offering retailers the option of unblended and unbundled service fees, enabling retailers to have visibility of the costs of accepting each scheme's credit cards

c. refraining from any standard contracting practices that prohibit retailers from surcharging Visa and MasterCard credit cards as a condition of receiving credit card acceptance services.

68. While institutions continue to give effect to the agreements reached in the 2009 settlement, the agreement has not resulted in meaningful change to deliver the tangible benefits of competition that the Commission envisaged. Adoption and implementation of unbundled and unblended fees in particular has varied between institutions, with some banks only beginning to offer unblended rates in 2020. While the Commission has not reopened investigations, it believes its ability to effect meaningful and long-term change under the Commerce Act is limited.

69. Since 2016, the previous Minister of Commerce and Consumer Affairs has tried to influence Payments NZ to adopt initiatives that promote interoperable, innovative, safe, open and efficient payment systems. Various Ministers have set firm expectations for Payments NZ, as the industry body, to engage with financial technology start-ups and merchants to promote innovation and improve the transparency of information being provided to merchants. More specifically, in 2017 your predecessor asked that banks publish annual weighted-average interchange fees for each card and transaction type and set the expectation that credit card and debit card fees should not increase any further.

70. This approach has had very little impact on the industry. While some fees have decreased, there is still a lack of competition within the RPS which will continue to impact future outcomes. While banks have complied with the agreement to publish interchange fees, the communication of this information varies between acquirers. For example, terminology used by acquirers is inconsistent, which makes it difficult for merchants to compare pricing across acquirers.

71. Banks were also asked to accelerate the development of industry-led solutions to facilitate open banking, which could help reduce MSF. Safe and secure sharing of customer banking data can drive competition and efficiency into the RPS, leading to a reduction in the costs passed on to merchants and consumers. Industry-led developments on open banking have been slow which has prompted you to commission work from officials to establish on establishing a Consumer Data Right. As we have previously briefed you, a consumer data right would allow for greater benefits than just open banking but could provide a credible regulatory lever to speed up the development of open banking [Briefing 2021-1666 refers].

Proposed model for regulation

72. We recommend introducing legislation to enable the Commerce Commission to regulate designated RPS with a broad set of tools. This would put pressure on the various parts of the RPS to reduce MSF.

We recommend a dynamic regulatory solution

73. We have considered two main options for the design of legislation and how participants can become subject to regulation.

a. **Option 1:** A designation approach where the primary legislation would define participants in RPS in a broad sense, and set out a process and criteria to determine which RPS or class of participants are designated for regulation. A designation approach has been adopted in the Financial Markets Infrastructure Bill and Part 4 of the Commerce Act. This would future-proof the legislation to adapt to changes in the RPS over time.

b. **Option 2:** A static approach where the primary legislation identifies the parties, or classes of parties, that are subject to the regulatory regime.

74. Given the wider issues with the RPS, and the approaches to regulation in other jurisdictions, we think a dynamic designation approach would be the most suitable option for regulation.

75. However it is important to note that, under the designation approach, the Retail Payments System Bill will only be a part of the regulatory solution. Additional regulations will establish the participants or classes of participants, and the nature of the designation. We note that while this increases the speed at which the Bill may be passed it may not necessarily increase the overall speed at which the regime comes into force. Despite significant parts of the regime being delegated to regulations, policy work will still be required to create the regulations. This approach has the added risk that the regulation-making powers in the legislation may not provide for all of the issues that may arise in the process of making those regulations.

76. In order to get the regime underway, the legislation could include the initial designations. While this may speed up implementation and reduce uncertainty, further consultation will be necessary before we can advise Cabinet on which participants should be designated in legislation. Our current proposed timeline for this review does not allow for the additional time necessary for effective consultation. If such an approach is taken, introduction of the Bill may need to be delayed.

77. The RPS is a rapidly evolving system with multiple participants and connections. Effective regulation needs to be able to respond to current problems as well as issues that may arise in the future (eg new payment products like BNPL, Alipay or WeChat). The designation model will ensure the regime has sufficient flexibility to adapt with the evolving system to regulate different payment models and ownership structures as required.

78. 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 in Australia where interchange caps targeting the Visa and Mastercard issued card products resulted in banks issuing cards through the American Express scheme. In doing so, Issuers effectively avoided the intended consequences of regulation and merchants were subsequently faced with even higher MSF associated with accepting American Express cards. If Australia were to regulate BNPL merchant fees they would need to retrofit their current framework, which inadvertently limits their ability to regulate these products which do not include an interchange fee component.

79. If a designation model is adopted in New Zealand, consideration needs to be given to what role the regulator would play in designation, and the threshold and process for designation. We will provide further advice on how the designation model could work in June 2021 following further consultation with the proposed regulator and stakeholders.

Tools for regulation

80. The Issues Paper proposed introducing caps on interchange fees as a potential option to reduce MSF. In addition to this, to future proof the regime and avoid unintended consequences, the regulator will need a wider suite of tools and instruments.

Regulation of interchange fees will be required…

81. Price regulation in the form of setting limits on interchange fees charged by issuers will be an effective way to put downward pressure on MSF. This is the approach taken by most jurisdictions that regulate RPS.

82. Direct regulation of MSF does not address the root cause of the problem (which is a lack of competition within the RPS) and is likely to have unintended consequences on non-bank acquirers providing competition in the acquiring market.

83. As noted by non-bank acquirers, 70 per cent of the overall MSF is comprised of interchange fees and scheme fees which are passed on to issuers and schemes. If MSF is regulated and capped, non-bank acquirers will be obliged to reduce acquiring fees, thus reducing their margins. With reduced margins, purely acquiring businesses will be driven out of the market, leaving banks with both issuing and acceptance branches to dominate the acquiring market.

We consider this outcome to be anti-competitive and undesirable for the payment ecosystem.

84. We recommend:

   a. Enabling price regulation in the primary legislation to empower the regulator to set limits on financial rewards available to card issuers. While this is, in essence, a price cap, regulation that refers to rewards will ensure parties do not circumvent regulation by arguing interchange fees are a transfer – not a 'price'. The primary legislation will also include principles that guide how the regulator should set caps and the types of limits that can be set.

   b. The regulator sets the limits guided by the principles set out in primary legislation.

85. Merchant and consumer focused submitters expressed support for the proposal in the Issues Paper to introduce hard caps on interchange fees (Consumer NZ, Retail NZ, Thorn, Windcave and Woolworths).

86. Some submitters offered suggestions on the different ways the caps could be cut. ASB noted that hard caps on interchange would be easier to administer, while a mix of hard caps and average weighted interchange would be harder to differentiate between transaction types and products. The proposal to target different classes of merchants could be difficult to administer as merchants might move between classes. Retail NZ, on the other hand, supported this proposal.

87. A handful of submitters expressed opposition to the proposal to regulate interchange fees (Business NZ, FSF, Humm Group, Visa). These submitters noted the risk of adverse consequences from regulation and referenced the impact of regulation overseas. Some of the risks identified include reduction of cardholder benefits which drive smaller card issuers (who are not also acquirers) out of the market, or promote the use of American Express and Diners Club cards which do not rely on interchange fees. While these concerns are warranted, they should not be overstated as these risks can be managed.

88. We recognise that regulation of interchange fees alone will be insufficient to achieve the objectives of this review and recommend supplementing price regulation with a range of tools to target different parts of the system and address other issues that may arise from different business models and ownership structures.

… as will a range of additional tools to target different parts of the system

89. Based on our assessment of the problems and the risks associated with limiting interchange fees, we anticipate the regulatory regime will need to include some, or all, of the following:

   a. **Price regulation:** of other aspects of MSF (eg scheme fees or surcharging).

   b. **Access regimes:** Facilitating access to certain infrastructure, such as switches, that could be inhibiting competition in some markets which might have flow on impacts for promoting competition.

   c. **Setting industry rules or codes:** Codifying rules and practices that would support greater transparency and incentives in the system. This could include rules around changes to surcharging and steering allowed by merchants, limiting the extent of rewards and loyalty schemes, prohibiting of bundling of certain services (eg acquirers not offering other services to merchants), changes to honour all cards rules, or least-cost routing for transactions. Under a designation approach, this could include approving or directing amendments to scheme rules on a case by case basis (rather than on an industry-wide level).

   d. **Information disclosure:** A requirement for acquirers to disclose information to their merchants, a regulator or the public on the MSF they are charging merchants. This could be used to provide merchants with an understanding of the levels of MSF that they should be paying and/or monitor MSF in more depth.

e. **Enforceable undertakings:** Where a scheme, operator or service provider could offer an undertaking to the Commerce Commission as an alternative to being designated, or if designated, as an alternative to having particular conditions imposed.

f. **Disputes regime:** An avenue for merchants, or consumers, to raise and address disputes with parties in the RPS. This could include expanding the applicability of the existing financial dispute resolution schemes or creating a bespoke regime to cater to the RPS.

g. **Offences and penalties:** Remedies or sanctions on parties that fail to comply.

90. The Issues Paper sought initial feedback on some of these additional tools which some submitters were supportive of. Submitters also suggested exploring price regulation of surcharging (Consumer NZ) and acquiring fees (Retail NZ).

91. Submitters emphasised the need to take other regulatory options into consideration to implement meaningful change and minimise unintended consequences. As identified in paragraph 78, the Australian experience indicates expanding the regulators toolkit after implementation is difficult as it forces the government to retrofit the tools to a framework designed to cater to a specific product.

92. As there are merits and risks associated with any regulatory approach, the suitability of these tools for this specific regime, to achieve the specified objectives, is yet to be determined. We have not had an opportunity to test these options with stakeholders in detail. We will provide further advice on the full suite of tools required in June 2021, with the Cabinet paper for final policy decisions, following targeted consultation with stakeholders and engagement with the prospective regulator.

The Retail Payment System regulator

93. New Zealand does not have a regulator that could easily be responsible for the regulation of retail payments [Briefing 2020-1184 refers]. RPS are part of the financial markets regulatory system. This system is largely based on the twin-peaks model of prudential and conduct based regulatory oversight, with:

a. the RBNZ providing the lead for prudential oversight at a system level, and

b. the Financial Markets Authority (**FMA**) providing the lead for conduct oversight, including the business to consumer interface.

94. However, the Commerce Commission (with a competition and consumer focus) and Payments NZ (a consensus-based industry body governed by banks which plays a key role in RPS) also have an interest in the efficient and effective operation of the RPS.

95. Together with the RBNZ, the Treasury, the FMA and the Commerce Commission, we identified the criteria for selecting the appropriate regulator to be:

a. **Degree of independence**: Relationship with government, the industry and the proper exercise of powers to impose to mandatory rules or enforce rules.

b. **Skillset:** The regulator should have relevant skills of the regulatory toolkit. The skillset will likely require competition regulation (regulating commercial behaviour and access to infrastructure), economic regulation (regulation of prices or returns) and consideration of public interest in the treatment of businesses and consumers.

c. **Knowledge:** The regulator should have relevant knowledge of the retail payment sector and payment systems more broadly. This might include: knowledge of other payment systems (like cash payments); technology/engineering expertise and other competencies such as standing/influence skills.

d. **Fit with other functions**: The objections of regulation should not conflict with the core objectives of the organisation.

e. **Ease of implementation**: The time and costs (both operational and capital) associated with the implementation of a new regulatory regime.

96. Having considered the criteria, we consider the regulator should be an independent Crown Entity as it would have an appropriate degree of independence from the sector and from Ministerial influence, and therefore better placed to maintain public confidence.

97. We have also ruled out Payments NZ as it is owned and controlled by the banks whose interests may not align with the objectives of regulation. In addition, under such an approach, the industry body would need to be supported by a regulatory backstop function within government to ensure the body is acting in the public interest. Given the complexities of establishing a co-regulatory regime, we consider an independent Crown Entity would be a more effective regulator.

98. On that basis, our high level analysis of the suitability of each entity, assessed against the remaining criteria, is set out below:

	FMA	RBNZ	Commerce Commission	New standalone independent crown entity
Skillset	Low	Medium	High	Medium
Knowledge	Low	Medium	Medium	High
Fit with other functions	Low	Medium	High	High
Ease of implementation (costs and time required)	Medium	Medium	Medium	Low
Overall suitability	**Low**	**Medium**	**High**	**High**

99. Feedback from submissions did not indicate a clear preference for a particular entity to regulate the RPS. 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.

MBIE recommends the Commerce Commission should be the regulator

100. Following our analysis against the criteria set out above, we consider the Commerce Commission to be best placed to regulate the RPS.

101. The Commerce Commission is the general competition and economic regulator and has a high level of expertise in access regimes (telecommunications and raw milk) and price regulation (electricity distributors). The Commission has some knowledge of the dynamics of

the RPS as it was involved in the 2009 settlement with the card schemes and relationships with banks, retailers and consumer representatives. As an established regulator with a consumer and competition focus the Commission already has some of the necessary tools and functions that can be adapted to regulate this sector.

102. In the absence of a new standalone crown entity, the Commission agrees they could be the regulator for this regime. However, the Commission considers their experience in payments systems to be relatively dated (the review of the Commission’s investigation into card payment systems ended in 2013) and would require substantial up-skilling in this area prior to the commencement of the regulation.

103. Furthermore, the Commission is broadly supportive of the general regulatory approach proposed above but notes that detail of the regulatory development will be key to set-up of a regime which meets the objectives outlined in this paper (for example, if limits are set, the criteria for setting the limit and how to differentiate between transaction types, will be a particularly important). The Commission also notes that, depending on the legislative model, it is possible that some of the tools may differ from those the Commission currently has. The Commission is willing to play a role in the development of the policy to ensure the workability of the regime, and in doing so, help inform the final policy decisions in June 2021.

104. We do not recommend appointing the RBNZ as the regulator of MSF as this regulatory function could conflict with their current roles. While RBNZ is involved in regulation of payments infrastructure through the Financial Market Infrastructures Bill 2019, its role will be focused on systemic risks/financial stability and prudential regulation. Furthermore, there are two potential conflicts:

   a. Their role as the agency responsible for cash payment systems could conflict with the proposed regulatory oversight of other payment systems. As issuer cash and steward of New Zealand’s payment systems, the RBNZ has an interest in ensuring the longevity of the cash payment system – a key product in RPS. Given their interests, roles and responsibilities, economic and competition regulation of specific RPS may not fit with their current functions.

   b. There are a number of competition issues that have led to the exacerbation of MSF which will need to be addressed to deliver long-term benefits to merchants and consumers. This competition regulation could conflict with the RBNZ’s broader prudential regulation of the banks.

105. In addition to these potential conflicts, the RBNZ does not have a consumer focus and skillset (which the Commerce Commission has), which as outlined earlier is core to the proposed objectives of the RPS.

106. Whilst the Reserve Bank of Australia (**RBA**) is the regulator of RPS in Australia, there are systemic differences between the two organisations that make RBNZ unsuitable for this role. Unlike the RBNZ, the RBA has a role in promoting competition and efficiency in payment systems, giving the RBA the relevant sectoral and technical expertise to regulate the RPS. Furthermore, the RBA does not have the role as the prudential regulator of banks (a role that is played by the Australian Prudential Regulation Authority), removing a key conflict of functions that is of concern for RBNZ.

107. We have also considered the suitability of establishing a new independent Crown entity with the sole function of regulating the RPS. Whilst such an entity would be fit for purpose and appears to be highly suitable, we do not consider a new entity to be appropriate given the need for coordination with other agencies, and the implementation costs involved in setting up, a new entity. Given the Government’s intention to implement this regime in this Parliamentary term, we do not consider establishing a new regulator would be feasible in the current timeframes. Our analysis was supported by the agencies consulted. Te Kawa Mataaho Public Service Commission in particular supports hosting regulatory functions within

an existing entity, as opposed to the creation of a new entity, in order to prevent further fragmentation of the system.

Ensuring the governance structure enables coordination between regulators

108. Regardless of who is appointed to regulate the RPS, coordination between parties with roles and responsibilities in the wider payment systems will be necessary. The regulation of retail payments intersects with wider money and cash policy issues. The strong interconnections across different payment systems (a fall in MSF that drives and increase in contactless payments is likely to drive a fall in the use of cash, for example) mean that broad cross-agency coordination will be necessary to promote a holistic approach that is the best for New Zealand.

109. Coordination may include consultation with RBNZ before commencing designation, cross-appointment of an RBNZ person to the Commerce Commission, or some form of delegation from Commissioners to a new or existing governance group of which the Commerce Commission and RBNZ would be members. While RBNZ may not be suitable to be the primary regulator, their role in overseeing payment systems more broadly (and the currency system in particular) means their advice, guidance, and leadership on the end-to-end payments system will be integral to the operability of this regime. A similar approach has been taken by Australia in the establishment of a Payment Systems Board which has some delegated functions.

110. There may also be a role for some industry stakeholders (like Payments NZ) as part of these governance arrangements.

111. This suggestion was echoed in submissions, with Retail NZ, Hospitality NZ and Woolworths supporting the establishment of either a new independent government body or a separate unit within an existing government body. Woolworths said that a governance structure that allowed for participation from different classes of retailers would be important.

112. Once Cabinet agrees on the entity with primary responsibility for regulation, we will undertake further consultation to explore statutory and non-statutory mechanisms for coordination between regulators. As part of this exercise, we will also explore forms of decision making structures within the Commission that will reduce the regulatory burden currently being placed on Commissioners. Recommendations on governance arrangements will be provided in the second Cabinet paper.

Financial implications

113. Introducing a new regulatory regime will have financial implications which you will need to personally discuss with the Minister of Finance before seeking policy approvals from Cabinet.

114. While the Commission has recently had a baseline increase, the Commission anticipates additional funding will be required to deliver this regime. The different aspects that may require funding, include:

    a. set up phase to cover project and set up costs during development and year one (eg software development and business analysts)

    b. ongoing implementation costs to cover the cost of running the regime longer term.

115. At a high-level, if the Commerce Commission is appointed as the regulator, we estimate the Commission will need between $5 and $15 million per annum. The exact financial implications of these proposals will depend on the model for regulation, the tools required, and the regulatory scope. We are working with the Commission to appropriately scale these financial implications and will provide further details on this in the June Cabinet paper.

116. If you choose to establish a new Crown entity to regulate RPS, the capital and operational costs will be significantly higher.

These proposals need to be funded from the between-Budget contingency

117. The timeline for seeking Cabinet agreement to these proposals falls outside the Budget cycle. In order to seek high-level policy approvals by April 2021, these proposals will need to be funded from the between-Budget contingency.

118. In line with the Cabinet manual and Cabinet Office Circular (18)2, the Minister of Finance must personally be consulted before submitting a paper with financial implications. Between-budget contingency funding proposals need to demonstrate that the proposal cannot be:

a. funded through reprioritisation of lower-value activities from within existing baselines; or

b. deferred until the next Budget.

119. If the Minister of Finance does not agree to fund these proposals from the between-Budget contingency, the chosen regulator will not be able to begin work to implement the legislation s 9(2)(f)(iv) [redacted] This will delay the anticipated benefits to New Zealand consumers and businesses and s 9(2)(f)(iv) [redacted]

120. The absence of confirmed funding may also raise questions about the materiality of the public announcements that are planned for early April.

121. We recommend that you consult the Minister of Finance on these funding proposals ahead of receiving the Cabinet paper to ensure the Minister is comfortable with the proposed approach. We will provide you with further information to support these discussions.

Reprioritisation within baselines is not feasible

122. Despite the funding required being relatively small, these proposals cannot be funded from within MBIE baselines. s 9(2)(g)(i) [redacted] In addition we are expected to absorb a number of costs associated with the Te Kawa Mataaho Public Service Commission's Gender Pay Gap Action Plan and the costs associated with becoming a carbon neutral public service. This will require reprioritisation in our existing baseline.

123. Reprioritisation of funds within the Commerce and consumer Affairs portfolio is also not possible as around half of the total appropriations in the portfolio are funded by third-parties. The only appropriations that have significant Crown funding components are the Commerce Commission's competition and consumer multi-category appropriation (which received Budget 2020 funding following a baseline review) and the policy advice category is currently forecast to be in deficit.

124. Reprioritising the Commission's competition and consumer work would undermine the importance that the Government has put on robust enforcement of competition and consumer law (specifically enforcement of the *Credit Contract and Consumer Finance Act 2003* reforms) through recent letters or expectations and the Budget 2020 process.

Next steps

Initial policy decisions will be sought from Cabinet on 29 March…

125. Once we receive your feedback, we will finalise a draft Cabinet paper and Regulatory Impact Statement (**RIS**) for you to take to Cabinet by the end of March. The Cabinet paper will seek agreement on:

  a. The nature and scale of the problem

  b. Objectives for regulation

  c. The high-level regulatory model

  d. Price regulation of interchange as a key tool for reducing MSF

  e. The regulatory function sitting with the Commerce Commission

  f. Delegated authority to approve the release of a targeted consultation document

  g. Funding these proposals through the between-Budget contingency

126. Given the tight deadlines, we anticipate the following next steps:

Task/Action	Proposed date
Receive your feedback on briefing	8 March 2021
Interagency consultation on the draft Cabinet paper and RIS	12-18 March 2021
Provide you with the draft Cabinet paper for high-level policy decisions and RIS	18 March 2021
Receive your feedback on the draft Cabinet paper and RIS	23 March 2021
Finalise and lodge Cabinet paper	25 March 2021
Cabinet paper considered by Cabinet	29 March 2021

…detailed policy decisions will be sought in June and drafting of the Bill will begin thereafter

127. Once high-level policy decisions are secured, we will:

  a. carry out targeted consultation on the possible additional regulator tools need to reduce MSF, regulatory design and governance arrangements that will support coordination between agencies with roles and responsibilities in payments systems more broadly.

  b. provide you with the second Cabinet paper, seeking approval for final policy proposals, to take to DEV and Cabinet by the end of June 2021.

  c. s 9(2)(f)(iv) [redacted]

128. s 9(2)(f)(iv) [redacted]

Risks

129. Due to the ambitious timeframe of this review we may have imperfect evidence regarding the problems in the market. This could lead to a misunderstanding of the real issues and unintended consequences from intervention. In addition, this may lead to the RIS for the Cabinet paper/s not meeting the requirements.

130. Should the RIS not meet the requirements the Cabinet paper will only be able to be submitted to Cabinet with the Minister of Finance's approval. While this may not be a significant barrier in this instance, a RIS that does not meet the requirements could jeopardise the integrity of this review.

131. There are a number of New Zealand specific issues we have identified so far and developing regulatory tools to overcome them will be a challenge in the timeframe provided. Following consultation with stakeholders, we remain of the view that any regulation to reduce MSF could have unintended consequences that shift costs to another part of the payments system. Without a systems approach (ie all the issues addressed) it is likely that any intervention will require regular amendments.

132. The shortened drafting time may result in regulatory quality issues which the Parliamentary Council Office (**PCO**) has indicated may impact the quality of the Bill. We will also have a limited opportunity to test our approach with the Legislative Design Advisory Committee which would be advantageous for this Bill given the technical nuances it will contain.

133. To meet deadlines we will also need a four-week Select Committee process, which is significantly shorter than the usual six-month process. This creates a high risk that if there are issues with the policy or drafting of the Bill (due to the condensed policy development process and drafting process), there will be insufficient time to address them. The drafting of this Bill will be highly involved. If unexpected issues arise that are unable to be resolved at select committee they will need to be resolved through Supplementary Order Papers – which would ultimately delay the passing of the legislation and the commencement of the regime.

134. To reduce the likelihood of these risks eventuating we will endeavour to work closely with the Commerce Commission on the design of the regime and engage as early as possible with PCO. However, the risks will still remain.

Consultation

135. Consultation on the Issues Paper closed on 19 February 2021. We received 35 submissions on the Issues Paper and we informally engaged with two other organisations during the consultation period. A list of all the stakeholders engaged in the review is provided for your information in **Annex Two**.

136. Stakeholders were largely supportive of our proposed approach. Where differing views were expressed, these were noted in the briefing.

137. The Commerce Commission, Department of Prime Minister and Cabinet (PAG), FMA, RBNZ, Te Kawa Mataaho Public Service Commission, and the Treasury, on this briefing. Agency feedback has been incorporated into our analysis and the body of the briefing.

138. While supportive of the proposed approach, RBNZ considers coordination between agencies across all relevant policy areas will be integral to ensuring the New Zealand payment system is resilient. RBNZ notes that they now have a stewardship role of the cash and payment system which they assume will include monitoring innovations in the payment system more broadly. We have agreed to work closely with officials in the Cash and Money Department in developing options for coordinating governance arrangements.

Communications

139. MBIE understands that the Government wants to make an announcement of the Cabinet decisions before Easter. We will work with your office in preparing material for this announcement.

140. Submissions on the Issues Paper will be published on MBIE's website following this announcement.

141. We will provide you with separate talking points for any engagements you have with industry in meeting briefings and the weekly Hot Topics.

Annexes

Annex 1: Background on RPS in New Zealand

Annex 2: List of stakeholders consulted on the Issues Paper

Annex 1: Background on Retail Payment Systems in New Zealand

1. This review focuses primarily on debit and credit card payment schemes. Card payments can include both card-present (where a card is physically presented to a terminal) and card-not-present transactions (eg payments using mobile wallets or online purchases).

2. Benefits of accepting card payments for merchants include:

    a. guaranteed payment – funds settled on the same day

    b. faster transaction times – especially with contactless payments

    c. reduced cash handling costs

    d. higher average transaction sizes

    e. ability to accept online payments to engage in e-commerce

    f. fraud prevention – merchant liability shift and investment in card number security

    g. customer insights – understand customer loyalty or spending behaviour

3. However, not all card payments are treated equally as acceptance some cards costs merchants more than others due to the fees and security risks involved.

What is the Retail Payment System?

4. The Retail Payment System (**RPS**) transmits, clears and settles financial transactions between consumers and merchants in return for goods and services. The RPS is part of a wider payment system which includes a broader web of technical infrastructure, arrangements and standards that allow consumers, businesses and other organisations to transfer funds by facilitating the movement of cash, cheques, bank transfers and, most commonly, card payments.

5. The RPS is a two-sided market which requires an intermediary or platform to coordinate the interface between the customer and merchant.[6] The two sides of the market are closely related as they create 'network effects'. That is, consumers prefer a payment method that is widely accepted by merchants, and merchants prefer cards that are widely used by consumers. The wider the use and acceptance of a card, the more efficient the RPS is. With two sided markets, such as this, the revenue mix for the intermediaries comes from a combination of the two sides. For example, the source of revenue may be heavily skewed to one side of the market in order to attract users on the other side of the market.

6. In the case of RPS, there are five key intermediaries in New Zealand between the consumer and the merchant:

    a. **Issuer**: An organisation, typically a bank, which issues cards and provides debit and/or credit services to consumers.

    b. **Acquirer**: An organisation, typically a bank, which provides access to the payments system on behalf of merchants for the clearing and settlement of funds in a transaction. An acquirer may, or may not, also be the bank that provides other services to a merchant (such as lending).

    c. **Scheme**: Organisations that develop technology and base product features. They also play a role in setting commercial model and card system rules. They may issue cards

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

and attract merchants through banks (open system – Visa and MasterCard) or directly (closed system – American Express, Diners Club, etc).

d. **Switch**: Infrastructure that sends the transaction information 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. Switching functions can be performed by various parties, including stand-alone switches (most notably Paymark), schemes, and vertically-integrated terminal providers and customer gateways (such as Verifone and Windcave).

e. **Customer interface**: Either the terminal hardware and software (for card-present transactions) or digital customer gateway (for card-not-present transactions) through which the customer makes a payment to a merchant.

Main business models

7. There are two main business models for RPS in New Zealand:

a. **The switch-to-issuer model** which is used for EFTPOS and swiped or inserted debit card transactions. Under this model, the switch sends the payment information directly to the issuer (ie the customer's bank) before clearing a payment. The switch-to-issuer model does not involve the acquirer or the scheme and therefore the merchant does not incur a merchant service fees (**MSF**) for processing these transactions. The only costs incurred by merchants to accept these transactions are the terminal fee and network fee (switch fee) which are charged by the terminal and switch providers. These fees are generally monthly fixed fees that depend on the number of terminals connected. The issuer in this model is charge a switch fee for each transaction.

b. **The switch-to-acquirer model** which is used for all credit cards (swiped, inserted and contactless), contactless debit cards and card-not-present transactions (eg online transactions). 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. 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.

8. Under both models, the issuer offers inducements to customers to encourage them to use their card product, however, this is more common for credit cards which only use the switch-to-acquirer model. These inducements are generally funded through revenue from interchange fees or interest. In New Zealand, the *Credit Contract and Consumer Finance Act 2003* makes it difficult for banks to use account fees or card fees to fund rewards.

Figure 6: Fees and inducements in switch-to-issuer transactions

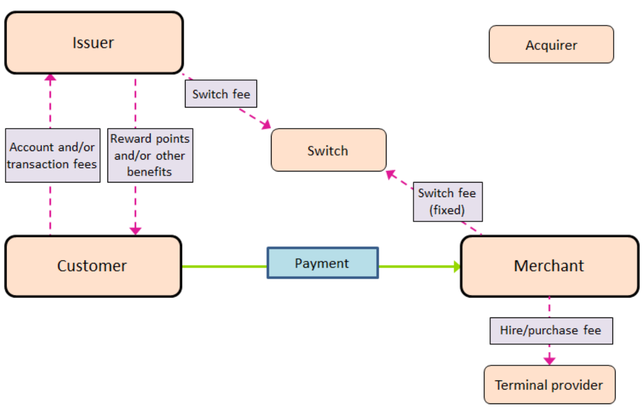
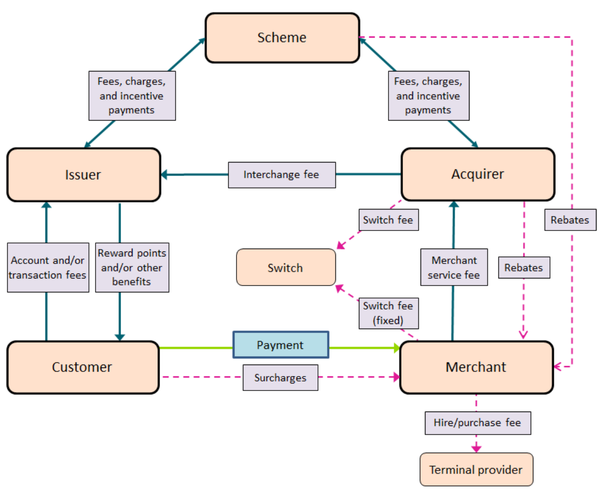


Figure 7: Fees and inducements in switch-to-acquirer transactions



9. There are a number of variations to these two models including cases where:

   a. the terminal provider also acts as the switch

   b. the transaction bypasses a stand-alone switch to be switched purely by a scheme

   c. the scheme is both the issuer and the acquirer (eg American Express). In this case, there is no interchange fee, and the scheme sets the MSF directly.

   d. There is also an increasing use of other payment methods such as digital wallets (eg Apple Pay, Google Pay, PayPal) or buy-now, pay-later products (eg Afterpay, Laybuy, Humm Group etc). However, many of these new payment methods still operate over scheme rails (ie the customer still uses a scheme debit or credit card to make the transaction). In order to accept some of these payment methods, the merchant may need to pay an additional fee to the payment provider.

10. Other electronic payment methods which do not rely on existing scheme rails include:

    a. **direct entry** to a consumers' bank account, otherwise known as a bank-to-bank transfer

    b. **purchased payment platforms** that hold stored value for a person that can be used for payment at participating merchants, such as 'smart cards' (eg public transport cards Snapper or AT Hop) or mobile payments platforms (eg Alipay)

    c. **digital currencies**, such as Bitcoin, also continue to develop and find new applications.

11. Many of the emerging scheme-based payment methods utilise what is known as 'tokenisation'. This supports greater security, as only the scheme and the issuer have information about both the person and the transaction. In other countries, EFTPOS-like cards have also been tokenised, which allows for 'switch-to-issuer' type transactions for online debit card purchases among other things.

Merchant Service Fees

12. MSF are payments made by a merchant each time certain payment transactions (switch-to-acquirer) are processed. The fee may be fixed or a percentage of the sales transactions value. Typically, MSF for card payments in the switch-to-acquirer model comprises of:

    a. **Scheme fees:** fixed fees paid for processing the transaction from the acquirer to a scheme. Some larger retailers earn a rebate on this fee from the card schemes.

    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 and the customer's banking costs. The interchange fee is generally the largest component of the MSF.

    c. **Switch fees:** fixed fees used to cover the cost of using a switch provider to direct the payment request to the right source so that funds can be taken from the customer's account and delivered to the merchant.

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

13. Following a Commerce Commission enforcement action which resulted in a 2009 settlement[7], acquirers are required to offer merchants choice in the structure of their MSF. The choices are:

    a. **A 'blended' rate**, which averages out the cost of accepting payment types into a fixed percentage per transaction regardless of the mix of products used in a particular month. These blended rates are percentages fixed for a given period of time.

    b. **Unblended rates**, which are separate fees for each of the scheme's (ie Visa, MasterCard) transactions, thereby enabling the merchant to see the cost of accepting each scheme's cards.

    c. **Unbundled rates**, which are separate fees for all types of scheme's transactions, enabling the merchant to see the cost of accepting each type of product. In practice, the acquirer may only separate credit and debit fees, or classes of products. Unbundling is generally known as cost-plus pricing, in that acquirers pass along the interchange fee that they are charged plus a margin.

14. Consultation with the banks suggests the roll out and uptake of the unbundled rates has not been consistent across all acquirers. Some banks only began offering unbundled rates to customers last year.

15. Some of the major merchants may also directly negotiate with the schemes (or their acquirer) to obtain an additional rebate off their MSF. Larger merchants are able to do this due to their higher transaction volume. As a consequence, MSF varies substantially between different merchants.

Passing on MSF

16. Many merchants recover the cost of MSF through the price for goods and services sold. However, as the MSF varies by each card type, it can be difficult for merchants to accurately recover these costs.

17. Merchants may also influence consumers in their choice of payment through:

    a. **Steering:** merchants can refuse to accept or discourage some forms of payment either generally or in specified circumstances (such as in the case of low value transactions). For example, some merchants have signs saying they do not accept credit or contactless payments, or do not accept cards from particular schemes such as Diners Club, or do not accept a payment method for transactions below a specified value.

    b. **Surcharging:** merchants can add an additional charge on the price of goods or services for accepting some forms of payment and classes of card. Surcharging is more commonly used by some sectors, such as airlines and utilities providers.

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[7] https://comcom.govt.nz/case-register/case-register-entries/visa-international-service-association,-and-others . Note the settlement expired in 2013, but has continued to shape commercial arrangements.

Annex 2: Summary of submissions related to the issues discussed in this briefing

Participant group	Individual submitters
Banks (Issuer and acquirer)	ANZ, ASB, BNZ, New Zealand Banking Association, Westpac
BNPL provider	Afterpay, Humm Group
Consumer	Andrew Arthur, Consumer NZ, Rob Dowler
Consultants and researchers	CMSPI, s 9(2)(ba)(i), Magnet, s 9(2)(ba)(i)
Payment-related Fintechs	Merco, Revolut
General	Business NZ, Gareth Vaughan (interest.co.nz)
Loyalty provider	Air New Zealand
Merchants	Hello Club, Hospitality NZ, Karl Christensen (small business owner), Motor Trade Association, Restaurant Association of New Zealand, Retail NZ, Woolworths NZ (Countdown) We also met with Foodstuffs who did not submit
Non-bank acquirers	Adyen NZ, Windcave We also met with Till Payments, who did not submit
Non-bank issuer	Financial Services Federation, Ruralco - Ashburton Trading Society, Thorn Finance
Rules body	Payments NZ
Scheme	American Express, Mastercard, Visa
Switch	Paymark We also met with Verifone who did not submit