



Regulatory Impact Statement: Regulating the retail payments system

Purpose	
Decision sought	<i>Analysis produced for the purpose of informing Cabinet decisions.</i>
Advising agencies	<i>Ministry of Business, Innovation and Employment</i>
Proposing Ministers	<i>Commerce and Consumer Affairs</i>
Date	<i>30 March 2021</i>
Problem Definition	
<p>There are economic inefficiencies in the retail payments system which are resulting in poor outcomes for many consumers and merchants. Most merchants participating in the system bear disproportionate costs, which are passed on to all consumers in higher prices, while only some of these consumers receive disproportionate benefits. Some payment providers are likely earning excess returns. Weak price signals to consumers about the cost of payments, and the lack of countervailing bargaining power by merchants, means that resources are not put towards the most productive uses for the economy as a whole. Over the past few years, voluntary industry initiatives have been relied on to address the issues; however, slow progress has been made and some of the underlying market dynamics leading to the problem have not been addressed. We have come to the conclusion that government intervention is required.</p>	
Executive summary	
<p>Current levels of competition in retail payments markets (eg systems for clearing EFTPOS, debit and credit card transactions), and the application of generic competition law, have been insufficient to constrain unreasonably high merchant service fees (MSF), which imposes inequitable costs on some segments of consumers and businesses. While various agencies are responsible for overseeing prudential, conduct and competition regulation in the system, there is a gap in overall regulatory oversight of the retail payments system specifically, which is constantly evolving with no single regulator with the capacity and responsibility to keep up.</p> <p>The proposals seek to establish a regulatory framework to ensure the retail payments system delivers long-term benefits for consumers and merchants in New Zealand. The proposals involve establishing a designation model, which will set the parameters of regulation in primary legislation</p>	

to give the Commerce Commission a mandate to regulate designated parts and participants of the retail payments system. The Commission will have a package of tools, including the ability to regulate interchange fees, information disclosure powers and regulation of other price aspects in the retail payments system. To ensure more immediate benefits for merchants and consumers, the proposals involve interim interchange fee regulation for credit and certain debit transactions which would come into effect six months after legislation is passed, and expire once the Commission makes an interchange fee determination.

This assessment is to be used to support Ministerial decision-making on whether regulatory intervention is required, the model for regulation and the tools available to the regulator.

The proposals are likely to reduce the profit margins of banks and debit/credit card schemes in New Zealand, but not on a significant scale. The proposals will involve a cost to government to cover new regulatory functions of approximately \$5 million - \$15 million per annum.

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

Limitations or constraints on analysis

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

There are also significant time constraints on this project, which impact the advice we can provide as well as the options that we can recommend in the timeframe. The Minister of Commerce and Consumer Affairs indicated to the Ministry of Business, Innovation and Employment (MBIE) that this work is a priority in the portfolio. The release of an issues paper on *Regulating to reduce merchant service fees* was a first 100 days priority and was released in the first two months. The Minister also indicated to MBIE that he would like initial Cabinet agreement in March 2021. Our advice is therefore constrained to analysing options that draw from similar overseas regimes, with a particular focus on Australia.

Another impact of the time constraint is that it limits the extent and quality of consultation we can undertake with interested parties. We consulted publicly to test the problem in an issues paper released in 2020, which received 36 submissions from banks, card schemes and organisations representing businesses and consumers. On the whole, submissions generally agreed with the case for greater regulatory oversight. However, we will not be able to test the preferred options with the public before initial decisions are made. As such, this assessment has not been informed by public consultation on the detail of the options canvassed below. This is a significant limitation on our analysis. However, we aim to reduce the risks involved with this by undertaking targeted consultation with affected parties on the detailed options prior to final Cabinet decisions being made. We intend to update this Impact Statement once further details are developed and to take into account feedback from consultation.

MBIE holds a reasonably good level of data on the evidence of the problem. We have up-to-date data from system participants on the level of interchange fees and MSF and can compare these to international levels. This informs our understanding of issues such as high levels of MSF and the

fact that small businesses in particular face higher MSF. However, the data for assessing the likely impact of the various options relative to the status quo is limited. This is because our proposal involves providing a regulatory framework to equip the regulator with various tools that can be imposed on designated participants in the retail payments system. This leaves scope for determining how much of the retail payments system is regulated and how they are regulated. The scale of the impacts will vary depending on the parties that are regulated and how, which we do not make recommendations on given the proposal is to create the regulatory framework but not to designate specific participants in the primary legislation.

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

Responsible Manager

Dan O’Grady
 Manager
 Competition and Consumer Policy
 Ministry of Business, Innovation and Employment
 30/03/2021

Quality Assurance

Reviewing Agency: The Treasury, MBIE

Panel Assessment & Comment:

A quality assurance panel with representatives from the Regulatory Impact Analysis Team at the Treasury and the Ministry of Business, Innovation and Employment have reviewed the Regulatory Impact Statement “Regulating the retail payments system” produced by the Ministry of Business, Innovation and Employment. The panel considers that it **meets** the Quality Assurance criteria.

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. The Ministry of Business, Innovation and Employment 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.

Regulatory Impact Statement: Regulating the retail payments system

Section 1: Outlining the problem

Context

Background to the retail payments system and nature of the market

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

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

The following are participants in the system:

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

delivered to the merchant's account in the acquiring bank. Used in EFTPOS and debit and credit transactions.

The two main electronic retail payments systems used in New Zealand are switch-to-issuer and switch-to-acquirer:

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

There are variations on these systems, as well as emerging payment methods, such as digital wallets (eg Apple Pay) and buy-now-pay-later. More often than not these make use of the scheme rails, meaning that scheme debit or credit cards are required for payment.

Financial markets regulatory system

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

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

Participants in the system are also subject to competition regulation by the Commerce Commission. 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 retail payments system as a whole is limited. The Commerce Act does not empower the Commission to take action to reduce high MSF if they are not the product of collusion between the parties.

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

MBIE has primary responsibility for maintaining, monitoring, evaluating, and improving the financial markets conduct regulatory system. MBIE is directly accountable to the Minister of

Commerce and Consumer Affairs. A regulatory charter for the wider financial sector has been put in place under the auspices of the Council of Financial Regulators. A regulatory system assessment is expected to take place every five years.

Regulatory gap

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

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

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

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

Background to the review of the retail payments system

The November 2020 Speech from the Throne made a commitment to regulate MSF to reduce costs to retailers. This commitment is based on concerns raised that MSF are high relative to overseas jurisdictions, with Retail NZ estimating that in 2019, New Zealand retailers paid nearly twice as much as their Australian counterparts.

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

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

- a. The banks (through the New Zealand Bankers' Association) undertook to provide greater transparency of fees to merchants. This had the potential to help merchants' decision-making and improve merchants' bargaining power when negotiating fees with banks and schemes.
- b. Payments NZ outlined its intention to work on initiatives that could allow for new entrants and enhanced payment methods. In early 2018, Payments NZ formally began work to facilitate the development of a shared Application Programming Interface (API) to support new and improved

methods of payment and easier, standardised ways of sharing banking data. This is sometimes referred to as industry-led 'open banking', and culminated in the launch of the Payments NZ API Centre in May 2019. Open banking is expected to, among other things, provide competition through new payment options for consumers and merchants which may be less expensive. Similar projects, at a much larger scale, were also underway in Australia and the United Kingdom at that time.

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

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

Related government workstreams

Ongoing workstreams that relate to this project are:

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

What is the policy problem or opportunity?

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

As a result, MSF for some payment methods in New Zealand are high.

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

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

This assessment of the problem is based on submissions received on the MBIE 2020 issues paper,

data received from acquiring banks and card schemes, and conversations with stakeholders.

MSF for some payment methods in New Zealand are high

Background

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

MSF are comprised of four main components:

- *Scheme fees* are fixed fees paid by the acquirer to the card scheme for processing the transaction from acquirer to card scheme. Some larger retailers earn a rebate on this fee from the card schemes.
- *Interchange fees* are paid by the acquirer to the issuer. This is generally the largest component of the MSF, particularly for credit card transactions where it can be around 70 to 80 per cent of the MSF. The card schemes independently set caps on interchange fees. The card schemes do not directly receive revenue from interchange fees, but can use interchange fees to indirectly expand the use of their networks. Banks generally prefer higher interchange fees and generally charge in line with the caps set by the card schemes. This is because higher interchange fees allow banks to collect more revenue from merchants, which can be used to provide rewards to cardholders (and contribute to bank revenues). These rewards provide consumers with additional incentives to use credit cards in place of other payment options.
- *Acquirer fees* cover the cost of processing the transaction and include some margin for the acquirer.
- *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.

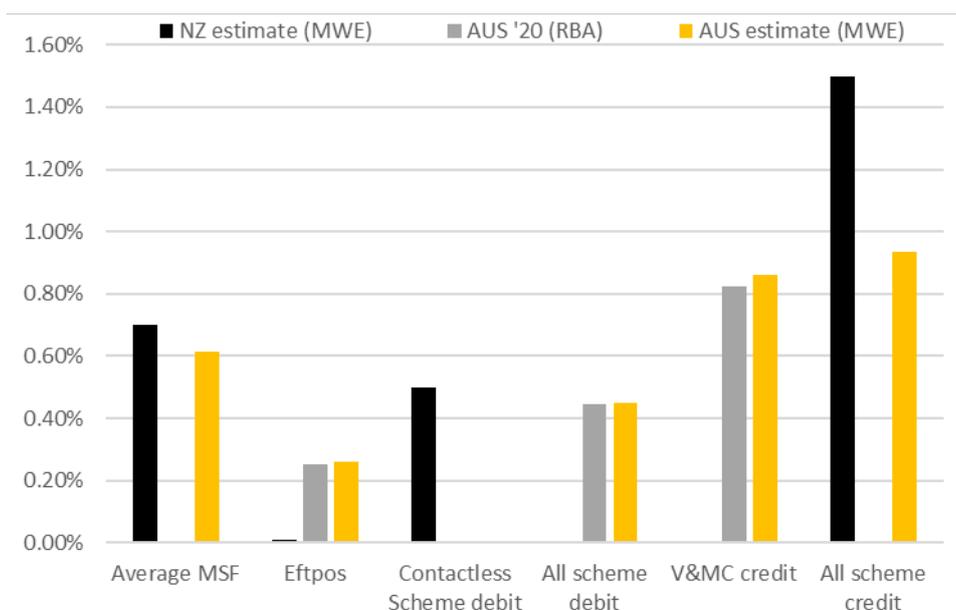
Since 2016, there has been some concern that MSF are high relative to overseas jurisdictions that we compare ourselves to and which generally regulate these fees. The types of payment methods which attract high MSF are in-store credit and contactless debit and online debit and credit transactions. (Contacted debit is routed via the switch-to-issuer route and does not incur MSF because it is treated the same way as EFTPOS).

A study commissioned by BNZ and American Express¹ identified that:

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

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

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 Australia²

Many submitters noted that because merchants in New Zealand are not directly charged for switch-to-issuer transactions (about half of all transactions), the overall cost of accepting card transactions in New Zealand is on par with countries such as Australia. Confidential data provided to MBIE by the five main acquiring banks in New Zealand suggests that the average MSF in New Zealand may be close to Australia’s. However, as the chart above shows, besides EFTPOS New Zealand has higher MSF, with MSF for scheme credit being more than 0.50% higher than Australia. MSF for online scheme debit (not shown above) are also higher in New Zealand and are closer to the scheme credit rate estimated by MWE Consulting for New Zealand.

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

Why is this a problem?

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

Lack of competition in some aspects of the market

Background

Competitive pressures in New Zealand (as elsewhere) have not been sufficiently strong to bring interchange fees into line with costs. As a result, the users of these services—consumers and

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

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

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

- There are few acquirers that are not also issuers and therefore there is a conflict between the acquiring and issuing parts of the bank in negotiating interchange fees.
- There is limited ability for acquirers to negotiate scheme fees with the schemes.
- Paymark dominates the switch market as it is the only switch with links to all banks and there are very high technical barriers to competition. While other switches exist, stakeholders have informed us that the banks prefer to maintain technical links with only one switch, due to the very high ongoing running costs. Paymark has substantial market power. Some stakeholders consider Paymark is impeding innovation and is charging excessive fees.
- Due to the comparatively small scale of the New Zealand market, it is difficult for new card schemes to establish the infrastructure in New Zealand and achieve the critical mass necessary to be viable.

Additionally, in some parts of the market competition can drive costs up, for example schemes using interchange to compete for the business of acquiring banks.

EFTPOS is unlikely to act as a significant competitive constraint for a number of reasons. Innovation has been focused on schemes, meaning that the use of EFTPOS for online purchases is limited, for example. Issuers also bear the cost of EFTPOS transactions, rather than merchants, which provides issuers incentives to promote the use of scheme cards instead. As such, the competitive constraint that EFTPOS may have provided, and any downward pressure on fees for scheme payments, is likely to decline.

Why is this a problem?

As a result of these barriers, innovation in the retail payments system is limited to payment products over the scheme rails, requiring the use of scheme debit or credit cards for payment. This limits the extent of competitive constraints that may be introduced by emerging products. Visa and Mastercard have established standards with which new entrants must comply if they want to use their infrastructure. Not only are new entrants forced to impose MSF, but they are incurring additional compliance costs which they will be forced to incorporate into their margins, thereby driving up MSF.

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

Background

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

generates greater revenue.

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

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

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

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

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

Where surcharging does occur, Consumer NZ submitted that surcharges do not always reflect the real cost faced by merchants with many merchants over-recovering through surcharges. Some bank submitters noted they have come across situations where consumers are charged a five per cent surcharge for credit card or contactless debit transactions, which is well outside the range the bank charges in MSF. On the other hand, Retail NZ noted that it is difficult for merchants to accurately price surcharges, especially if they are on an unbundled rate.

How does this contribute to the problem?

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

Consumer preferences for higher cost payment methods impose higher costs on merchants which they choose to recoup by increasing prices on goods and services or surcharging. This is a problem

because it means that all consumers pay the same higher prices even when they use lower cost payment methods.

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

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

Background

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

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

It is unclear how much merchants shop around to get the best deals on merchant services, particularly beyond the larger strategic merchants. Moves by the banks to offer merchants unblended and unbundled MSF have paved the way for merchants to have greater choice in the way their fees are structured. However, the range of fees by payment method creates considerable complexity for many merchants. Differences in terminology and the communication of information vary between banks, making it difficult for merchants to shop around, and changing acquirers can be a costly and lengthy process for some merchants. Despite unbundled offerings, we have not yet seen reductions or competitive pressure on fees in New Zealand (as were seen in Australia).

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

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

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

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

to be spread over smaller total sales, and therefore have less bargaining power.

Almost all the submitters that responded to this issue acknowledged the lack of bargaining power for small merchants.

How does this contribute to the problem?

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

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

Section 2: Options identification and impact analysis

What objectives are you seeking in relation to this policy problem or opportunity?

The overall objective for the retail payments system is to deliver long-term benefits for consumers and merchants of the retail payments system within New Zealand.

This requires that the system:

- enables healthy competition between payment providers and payment products
- incentivises beneficial innovation for consumers and merchants
- is efficient in allocating resources through clear price signals, where prices are cost reflective for the system as a whole
- is fair in its distribution of costs, particularly in its treatment of small businesses and low income consumers.

We consulted on these objectives in our issues paper. Submitters generally agree with the objectives and also noted the importance of soundness of the payments system more broadly.

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

The criteria we use to evaluate the options are:

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

The above criteria are of equal weighting.

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

The criteria have not been tested with stakeholders. We intend to test these with stakeholders representing consumers, businesses and financial institutions in targeted consultation.

What scope are you considering options within?

Non-regulatory options

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

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

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

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

Encouraging industry initiatives to establish open banking

Open banking would promote competition in retail payments. In 2019 the then Minister of Commerce and Consumer Affairs asked the banks to accelerate the development of APIs to facilitate open banking. Progress on the infrastructure and processes needed to implement efficient and effective open banking services have been slow. MBIE's work on a consumer data right is underway to provide a viable regulatory pathway for open banking.

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

Even if the government regulated to enable open banking, it would take a few years for the opportunities to be fully realised.

Promoting alternative payment solutions

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

Alternatively, this option could involve boosting the functionality of domestic EFTPOS. However, it would likely require legislation to change the current rules for EFTPOS to require innovation. Paymark recently adapted its online EFTPOS product for contactless use in-store, however it is more expensive than contactless scheme debit and there has been limited uptake of this by the banks, which reduces the likelihood that this can provide a significant competitive constraint.

Other jurisdictions

We have considered the experience of similar jurisdictions that regulate retail payments systems, such as Australia, the EU, Canada and the US. Australia regulates interchange fees and other rules for specific card schemes and types. The Australian regulator has the power to designate payment systems and to set standards and access regimes for those systems (currently Visa, Mastercard, American Express companion card scheme and Australia's EFTPOS). Apart from regulating interchange fees, Australia also has rules relating to merchant surcharging and 'honour all cards' rules. The schemes also have to provide merchants with information on the cost of acceptance for each designated scheme.

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

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

In the US, debit card interchange rates are regulated by the Federal Reserve, while the rules around credit have evolved out of competition law litigation: Visa and Mastercard can no longer impose contractual 'no-surcharge' rules on merchants or contractual restrictions on no-minimum purchase rules and must allow merchants to discount payment types.

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

Describe and analyse the options

The status quo

The status quo describes what we expect is likely to happen in the future if there is no regulatory intervention and there continues not to be a regulator responsible for oversight of the retail payments system.

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

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

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

While there are new emerging payment methods, at the moment we do not consider these to be significant competitive constraints to the card schemes because typically these products operate using the scheme rails. If products are developed which do not use the scheme rails, it would be difficult to get them off the ground and into widespread usage, because of the network effects that

currently benefit the card schemes.

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

As such, we consider that government intervention is required to achieve better outcomes for New Zealand merchants, consumers and the economy overall.

Options for design of regulatory framework

The options for the design of the regulatory framework are mutually exclusive.

The options for regulatory tools to address specific problems, some of which are considered in this assessment and some of which will be assessed in a later update, are not mutually exclusive. The regulatory tools could be applied in either of the options for regulatory design and could be implemented as a package of some or all options. This is because some of the options address only a subset of the issues that present a problem, and different options address the issues to different degrees.

Option 1: Static model

This option would involve identifying regulated parties and setting out the rules they are subject to in primary legislation. This would include the regulation of interchange fees and any supplementary tools required, such as restrictions on merchant surcharging for regulated payment methods. It would be designed to regulate the specific transaction types of contactless and online scheme debit transactions, and all types of scheme credit transactions, given this is where the problem of high MSF lies. It would identify Mastercard and Visa card schemes specifically and regulate the card schemes, issuers and acquirers involved in the provision of those. The Commerce Commission, as regulator, would have the ability to apply a range of tools to the regulated parties.

Benefits

This would go some way towards addressing the problem of inefficiencies in the retail payments system which are leading to high MSF for certain transaction types. By providing a regulatory framework designed to ensure greater oversight of scheme transactions and the key players in those, this option would have a targeted focus on addressing the most prevalent issues associated with these transaction types.

A focus on regulating these payment methods would help to reduce MSF for merchants and would reduce the disparity in prices paid between classes of merchants. By reducing these costs, in theory fewer costs would be passed on to all consumers. If regulating these transaction types indirectly reduces the benefits to individual cardholders, it could lead consumers to choose lower cost payment methods and reduce the effects of cross-subsidisation.

The benefit of a static approach is that it creates greater certainty for the regulated parties as to their obligations and makes it easier to gauge the likely impacts of regulation.

Costs and risks

The risk with this option is that it has a narrow focus on the problems related to scheme transactions only. If issues arise with existing or new retail payments systems that are not regulated, or there are

negative impacts in other retail payments systems that are not regulated as a result, it is difficult to address these with this model. This model is unlikely to be competitively neutral. The legislation would have to be retrofitted to address these problems should they arise. We consider this risk to be high, given the dynamic nature of the retail payments system (for example, we have heard anecdotally that cards could become obsolete in the medium term as digital wallets increase in popularity, which would make the legislation redundant but would not provide an avenue to regulate new payment methods).

A significant disadvantage of this option is that it is unlikely to address all of the identified problems, and in fact may create new problems as a result of regulation. With such a narrow focus on regulating certain card scheme transactions, parties may seek to avoid the intended effects of regulation by preferring other forms of payment, and simply increase prices for the latter. This would transfer the problem and create an uneven playing field for parties in the system. This was the case in Australia where interchange caps targeting the Visa and Mastercard 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.

This option would involve moderate implementation costs for government in setting up a regulator with new functions and ongoing operating costs of these functions. This option would be more costly to implement than the status quo, but would be less costly than the designation model considered below. This is because the regulatory framework would have a much narrower focus.

This option would increase compliance costs for regulated parties relative to the status quo, but given the narrower scope for regulation it would have lower compliance costs overall for system participants than the designation model. It would also likely result in decreased profit margins for regulated parties.

Option 2: Designation model (preferred)

This option would involve a designation model. Under this model, the legislation would define participants in the retail payments system in a broad sense and set out a process and criteria to determine which parts of the system and participants are to be designated for regulation. This would allow for the legislation to be robust as the retail payments system changes overtime and new entrants come into the market. This would be similar to the designation approach in Australia.

The legislation would set out a threshold in order for regulated parties to be designated. This would be a principles-based test, for example, a particular retail payments system and parties in the system could only be designated where deficiencies in the system would be likely to have serious consequences for end users (similar to the designation threshold in the UK). The Commerce Commission, as the regulator, would then have the ability to apply a range of tools to those regulated parties.

This model is similar to that in Part 4 of the Commerce Act, which sets out a process for the Commerce Commission to investigate particular markets where there is little or no competition, and for imposing regulation on goods and services which meet the threshold. The Financial Markets Infrastructures Bill also uses a designation approach to regulate “systemically important” infrastructures.

Benefits

The retail payments system is a rapidly evolving system with multiple players 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 buy-now-pay-later, 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. This is in line with the *Government's Expectations for the Design of Regulatory Systems*, which set out that regulatory design should be flexible enough to adapt the regulatory approach to the attitudes and needs of different regulated parties, and have scope to evolve in response to changing circumstances or new information on the regulatory system's performance.⁴

It would also provide a multi-faceted approach to regulating retail payments, ensuring that no one part of the system is looked at in isolation, but the broader consequences on other parts of the system are carefully considered when regulating one part of the system. The advantage of this approach is that it is more likely to address most or all of the identified problems because it avoids a narrow focus on interchange fees regulation for certain transaction types.

This option would likely result in regulation which would ultimately reduce costs for merchants and would reduce the disparity in prices paid between classes of merchants. As with the option above, in theory fewer costs would be passed on to all consumers and could reduce the effects of cross-subsidisation. We would expect these benefits to be realised to a greater extent than the static model because the scope of regulation would be greater.

Costs and risks

The biggest risk is the fact that the regulatory model relies on providing the regulator with powers and tools via primary legislation, but the practical application of these powers and tools will be delegated to either the Commerce Commission or prescribed in regulation. This provides more limited checks and balances than if all parties and systems subject to regulation were in primary legislation. This presents the risk that it is difficult to presently assess the impacts of future regulation when key matters such as who will be regulated, and the nature of the regulation, will be broadly set out in primary legislation but given effect through designating particular parties. The *Government's Expectations for the Design of Regulatory Systems* suggest that regulatory design should set out legal obligations and regulator expectations and practices in ways that are clear and easy to understand.⁵ We think this expectation can still be achieved under the designation model because the legislation will clearly define the types of activities that the legislation can apply to, but it will not have effect on relevant parties unless they are designated.

This option bears the risk that no part of the system is regulated, if it is decided that no parties meet the designation threshold. We think this risk is low however, given the problems we have identified with the system. This risk can be mitigated by the fact that the designation threshold could be changed if necessary.

Another potential risk is that regulated parties may challenge designation, which is not a risk under the static model. It will therefore be important to provide a robust threshold in the legislation and process for designation to ensure appropriate parameters are placed around the exercise of designation powers.

⁴ New Zealand Government, (2017). *Government expectations for good regulatory practice*, p. 2. Accessed at: <https://www.treasury.govt.nz/sites/default/files/2015-09/good-reg-practice.pdf>

⁵ New Zealand Government, (2017). *Government expectations for good regulatory practice*, p. 2. Accessed at: <https://www.treasury.govt.nz/sites/default/files/2015-09/good-reg-practice.pdf>

This option would involve moderate implementation costs for government in setting up the Commerce Commission with new functions and ongoing operating costs of these functions.

This would involve greater compliance costs for regulated parties because the number of regulated parties would likely be greater. The framework would also likely result in decreased profit margins for regulated parties.

Key differences in options for design of regulatory framework

	Status quo	Static	Designation
Adaptability	N/A	Fixed	Flexible
Legislation	No legislation	Primary	Primary and secondary
Regulator	No single regulator	Commerce Commission	Commerce Commission
Regulated parties	No parties are directly regulated, except under other legislation	Identifies the regulated parties	Provides a framework for identifying regulated parties

Options for regulatory tools

Option A: Price regulation of interchange fees (preferred)

Price regulation through setting caps on interchange fees charged by issuers would put downward pressure on MSF.

Caps could be implemented in a number of different ways:

- hard caps on interchange fees
- soft caps on the average weighted interchange to allow for differentiation between transaction types and products
- caps based on different classes of merchants
- a price path for interchange fees.

Under our preferred designation model, the exact level of these caps would be decided by the Commerce Commission.

Benefits

This approach would be an effective way to put downward pressure on MSF. As interchange is generally the largest component of MSF, interchange regulation will go a significant way towards reducing MSF for certain payment methods. This is the approach taken by most jurisdictions that regulate retail payments systems and has been effective to some extent (although other jurisdictions implement this option alongside other measures). A 2020 Reserve Bank of Australia study concluded that there has been a general decline in average MSF in Australia since the introduction of regulation; however, there are still significant differences in MSF for different card networks. The EU also found that since regulation was introduced, interchange fees have decreased by 35 per cent between 2015 and 2017, MSF for card payments have declined, and that lower fees have resulted in an estimated annual cost savings of between €864 and 1930 million for consumers. In the US however, regulation of debit interchange rates has not been found to have significant effect.

This tool would not necessarily make MSF less complex for merchants to understand. However, we would expect MSF to differ to a lesser extent between acquirers and between classes of businesses,

which would improve outcomes for small businesses.

A reduction in interchange fees (and therefore in MSF) would mean that in theory fewer costs will be passed on to all consumers. However anecdotal evidence (and evidence from other jurisdictions) suggests these cost savings are not necessarily passed on so this impact is not guaranteed. If this option indirectly reduces the benefits to individual cardholders, it could lead consumers to choose lower cost payment methods.

The impact of this for New Zealand merchants and consumers will vary depending on what level the caps are set at. We envisage the caps being set by the regulator at levels that bring interchange fees into line with those in other jurisdictions where caps are regulated. We estimate that across annual retail sales of \$97.6 billion (in New Zealand to year end September 2020), a 20 per cent reduction in credit card interchange fees and a 30 per cent reduction in online debit interchange fees would equate to savings for consumers and businesses of \$74 million a year.⁶ A number of factors will go into estimating the value of these savings; it will depend on the number and type of payment methods which are regulated (as the proportion of the MSF made up by the interchange fee varies by payment method), and the extent to which savings are passed onto merchants and subsequently onto consumers. We may have a better idea following targeted consultation.

Costs and risks

There is a risk that regulating interchange in isolation will mean that issuers seek to recoup their costs in other ways. For example, they may choose to increase annual card fees, lower the rate at which rewards are accrued, or impose more restrictive requirements on cardholders. This may have some positive effects for consumers as a whole if it indirectly makes high cost payment methods less attractive and less accessible, which would go some way towards remedying the issue of cross-subsidisation by different classes of consumers. However, there may also be negative effects for consumers overall if there is a risk that caps prevent continued investment in innovation, safety and security, if set too low.

Regulation of interchange could create an uneven playing field as it excludes closed card schemes such as American Express and Diners Club, which do not involve an interchange fee. If only interchange caps are regulated, issuers may turn to non-regulated products. The effects of this in Australia have been described above. As such, we do not consider this option should be implemented in isolation, but it should include complementary solutions to address any flow-on effects (such as price regulation of other types of fees). Further complementary solutions will be considered in an updated Impact Assessment once we have consulted with stakeholders.

We consulted on regulating interchange in our 2020 issues paper. While it was supported by a handful of submitters (largely advocacy groups for retailers and consumers), others pointed out the adverse, and possibly unintended consequences, of regulating interchange. Submitters argued that a reduction in interchange fees will lead to greater reliance on interest as a revenue stream and increase cardholder fees (which will negatively impact consumers), would ultimately reduce investment and innovation in payments (to the detriment of consumers and businesses), and may force smaller card issuers who are not also acquirers to stop issuing cards. A buy-now-pay-later provider submitted that if interchange is reduced, they would not be able to offer their customers the same range of benefits and may have to withdraw some of their buy-now-pay-later products on which they do not charge interest or fees, which would reduce competition.

⁶ This is based on a cap of 0.8 per cent on interchange fees for credit card transactions and a cap of 0.6 per cent on interchange fees for online debit card transactions.

Option B: Price regulation of MSF

This option would be the most direct way of reducing MSF. It would be complex to regulate the whole merchant service fee given the number of factors that go into calculating MSF. This would be mitigated if MSF were subject to a principles-based requirement that fees charged to merchants must be closely connected to the activity for which the fee is charged and not be unreasonable. This is similar to provisions under the Credit Contracts and Consumer Finance Act 2003 which require that credit fees be “reasonable”.

Benefits

This would be the most direct way of bringing down MSF. It would benefit merchants through reduced MSF and make MSF easier to understand, as merchants would have the knowledge that the fees are reasonably connected to the services they receive. However, principles-based tests could still result in significant variation between MSF.

If MSF reduce, costs passed onto consumers could reduce in theory. If it indirectly reduces the benefits to individual cardholders and leads to consumers choosing lower cost payment methods, it could go some way towards addressing the fact that one group of consumers cross-subsidises another.

Costs and risks

This would involve additional costs to government to implement relative to the status quo, but higher costs compared to interchange regulation. This is because of the complexity of costs included in the MSF.

This option would likely decrease the profit margins of the regulated parties. It is likely to carry a greater risk of negative outcomes for consumers as result of this decrease because it is more likely than interchange regulation to result in higher cardholder fees, decreased rewards, restricted access to credit and increased interest rates. Given the complexity of MSF, there is a higher likelihood of ‘getting it wrong’. There may also be negative effects for consumers overall if caps prevent continued investment in innovation, safety and security, if set too low.

Option C: Package of tools (preferred)

This option would provide the Commerce Commission with a package of regulatory tools. This would include requiring information disclosure and the option of further price regulation (such as the ability to regulate scheme fees, cardholder fees, or merchant surcharging). The Commission would have the tools to require acquirers to disclose information to merchants, the Commission or the public on the MSF they are charging merchants. This would be similar to the toolkit available to the Australian regulator, whereby the regulator has information disclosure and other price regulation measures, including limiting the profits made by issuers, and prohibiting schemes from imposing ‘no surcharging’ rules on merchants or requirements for merchants to honour all cards from a scheme.

The regulator will likely need further supplementary tools, which we intend to consult on further.

Benefits

Providing supplementary tools to the regulator would help to address some of the identified problems as well as mitigate potential new problems caused by any adverse effects of interchange regulation. For example, requiring merchant surcharging for certain payment methods could mitigate the issue of consumers paying with lower cost options subsidising consumers that pay with higher cost options. If interchange fees are also regulated, surcharging for regulated payment methods may

no longer be justified as merchants are essentially charging to recoup costs which they may no longer incur. Requiring that merchants could only surcharge to recoup the costs of that payment method would mitigate this issue.

Similarly, with a broader scope to regulate other types of prices that are not interchange fees, the regulator will be able to deal with attempts to avoid the intended effects of regulation by looking at payment methods which do not incur interchange fees but which also may be high cost.

Information disclosure requirements would provide merchants with a greater understanding of the levels of MSF that they are paying and allow the regulator to monitor MSF in more depth.

Information disclosure is not likely to directly bring down MSF, but greater transparency for merchants could mean they are more easily able to shop around to get the best value for money in merchant services. Greater switching would increase competition in the market and is likely to put downward pressure on MSF.

Costs and risks

This would involve costs to government to implement. It would likely decrease the profit margins of the regulated parties; however, given the problem is that costs and benefits are currently inequitably distributed in the system, this is not necessarily a negative impact. It would also increase the compliance costs of regulated parties.

Multi-criteria analysis

	No action	Static model	Designation model	Interchange regulation	Regulation of merchant service fee	Package (information disclosure and other price regulation)
Minimises regulatory costs	0	- Moderate implementation and compliance costs.	-- Moderate implementation and moderate compliance costs.	- Low enforcement costs and compliance costs.	-- High implementation costs given complexity of MSF – for both regulator and regulated parties.	-- Moderate enforcement costs and compliance costs.
Merchants and consumers can transact with confidence	0	+ Reduces costs for merchants, which are passed on to consumers. Could increase competition in regulated aspects of the market, but would result in an uneven playing field.	++ Reduces costs for merchants across a greater range of payment methods, which are passed on to consumers. Promotes competition by ensuring a level playing field.	++ Reduces MSF and passes savings on to consumers. However, may be some costs for consumers eg reduced cardholder benefits, increased card fees. Could increase competition in acquirer market if merchant switching increases.	+ Most direct way of reducing MSF. Could increase understanding of MSF for merchants. Savings could be passed to consumers, but unintended costs could be greater. Could increase merchant switching and competition in acquirer market.	+ Increases transparency for merchants for service offerings. May indirectly reduce consumer prices if merchants can more easily shop around for best value. Higher levels of merchant switching could increase competition.
Supports innovation and security	0	0 Reduced profits for regulated parties could decrease investment in security etc.	0 Greater competition drives product innovation; however, reduced profits for	0 May reduce investment in innovation and security if interchange fees are	0 May reduce investment in innovation and security if interchange fees are	+ Higher levels of competition could increase innovation.

			regulated parties could decrease investment in security etc.	set too low.	set too low.	
Equity of outcomes	0	+ Would reduce price disparities between classes of merchants and reduce cross-subsidisation.	++ Would reduce price disparities between classes of merchants and reduce cross-subsidisation across a greater range of payment methods.	+ Indirectly reduces cardholder benefits and reduces cross-subsidisation. Reduces price disparities between merchants.	+ Indirectly reduces cardholder benefits and reduces cross-subsidisation. Reduces price disparities between merchants.	+ Merchant surcharging regulation may steer consumers towards lower cost options, resulting in lower levels of cross-subsidisation. Information disclosure results in more equal information between merchants.
Overall assessment	0	+	++	++	0	+

Key:

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

Conclusions

Preferred package of options

Preferred package

Our preferred option for the design of the regulatory framework is the designation model. While this option does carry the risk of increased uncertainty for regulated parties and makes it difficult to gauge the impacts of future regulation, we consider it to be preferable to the gap in regulation in the status quo, and appropriate given the ever-changing nature of the retail payments system. It will be important to ensure that the regulatory framework provides a robust process for designating regulated parties to mitigate this risk, such as by clearly defining the threshold for regulation.

Preferred option for regulatory tools

Our preferred option for tools available to the regulator is the ability to regulate interchange fees as well as a package of supplementary tools. While this is a less direct way of reducing MSF than regulating MSF specifically, we consider that the risks of regulating MSF directly are too high and unintended consequences are more likely to eventuate. No jurisdiction that we know of directly regulates MSF.

We acknowledge that regulating interchange in isolation also carries the risk of unintended consequences. Given the significant regulatory gap and numerous issues in the system, the regulatory regime needs to take a systems approach, and this is why we are recommending the package of a designation model combined with a range of tools for the regulator to use to regulate system participants.

The regulation will need to tackle multiple parts of the retail payments system to ensure regulation achieves its intended purpose and that there are not unintended consequences and ways for parties to avoid regulation. For example, other price regulation may be useful so that if interchange fees are regulated, issuers do not simply seek to transfer their revenue streams to other fees, such as card schemes which do not incur interchange fees, or merchants do not continue to surcharge for regulated transaction types.

Aside from the above recommended options, we will also be developing options for supplementary tools, consulting on these with stakeholders, and will update this Impact Statement accordingly before making recommendations to Ministers.

Further supplementary options may include:

- a) access regimes
- b) limiting the extent of rewards/loyalty programmes
- c) merchant education campaigns
- d) industry codes
- e) requiring discounts for low-cost transactions.

We expect the regulatory framework and package of regulatory tools to involve moderate initial set-up costs and ongoing implementation and enforcement costs. The proposals also involve costs for some parties in the system; in particular, they are likely to reduce the profit margins of certain parties. However, given that the problem is that the costs and benefits of participating in the system are inequitably distributed among different parties, we consider this to be an appropriate trade-off.

It is worth noting that the costs to regulated parties may be offset somewhat by increased costs to consumers through increased card fees, reduced rewards and reduced access to credit in some circumstances, although we consider these impacts are likely to be low.

As shown in the multi-criteria analysis, we consider that these options best meet the objectives for the retail payments system and result in improved outcomes for consumers and businesses in particular. However, as shown in the cost tables below, these proposals appear to result in significant implementation and enforcement costs for the regulator. The greatest benefit of regulation will most likely be in producing equitable outcomes, so we consider these costs justified.

Some uncertainty over impacts of preferred options

Given the preferred option involves setting out the types of activities that will be regulated in legislation and then designating certain participants in the system for regulation, there will be some uncertainty over which participants may be designated in future. Certain card scheme payments may be designated for regulation and subject to a combination of the regulatory levers, and in future other parties (eg buy-now-pay-later providers) may be designated for regulation and subject to some other combination of regulatory levers. This makes it difficult to assess the impacts of future regulation overall, if the decision to designate regulated parties and what levers to apply in each instance is made in future.

In the medium term, we envisage that regulation will be applied to the open card schemes' in-store credit and online credit and debit transactions, as these are the transaction types for which there is currently evidence of higher fees compared to other jurisdictions.

This Impact Statement is designed to support high-level Cabinet decisions on the tools available to the regulator. However, further detail will be needed on what the exact tools will entail, following targeted consultation. As such, stakeholder feedback will be important to inform the overall impacts of our preferred options.

Stakeholder views

We canvassed opinions on the problem, the need for regulatory intervention and the option of interchange regulation in our 2020 issues paper. Submitters generally agreed that the government should play a role in promoting competition and should provide regulatory direction in the retail payments system.

Submitters provided feedback on the specific proposal to regulate interchange fees. A handful of submitters expressed opposition, noting the risk of adverse consequences and referencing the impact of regulation overseas. While these concerns are warranted, they should not be overstated as we consider these risks can be managed.

We did not seek submissions on the options for the design of the regulatory framework or options for additional regulatory tools, as these were not developed at the time. We did seek views on any other feasible options that should be considered. Submitters emphasised the need to take other regulatory options into consideration to implement meaningful change and minimise unintended consequences. This is why we recommend supplementing interchange regulation with a range of tools to target different parts of the system and address other issues that may arise from different business models.

Summarise the costs and benefits of your preferred option

Affected parties (<i>identify</i>)	Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	Impact <i>\$m present value, for monetised impacts; high, medium or low for non-monetised impacts</i>
Additional costs of proposed approach, compared to taking no action		
Regulated parties	<ul style="list-style-type: none"> Ongoing reduction in profit margins equivalent to benefits to other parties One-off and ongoing compliance costs 	<ul style="list-style-type: none"> \$74 million per annum Low
Regulators	Initial and ongoing implementation and enforcement costs	\$5-\$15 million per annum
Wider government	N/A (the role of government as merchants is covered below)	N/A
Other parties	Ongoing increased card fees, reduced rewards	Low
Total Monetised Cost		\$79-89 million per annum
Non-monetised costs		<i>Low</i>

Additional benefits of proposed approach, compared to taking no action		
Regulated parties	Proposal may enable new entrants to benefit	Low
Regulators	Sets out an established institution with a mandate to manage issues in the retail payments system	N/A
Wider government	N/A (the role of government as merchants is covered below)	N/A
Other parties	<ul style="list-style-type: none"> Ongoing cost savings for consumers and merchants as a result of reduced MSF equivalent to costs to regulated parties Ongoing increase in ability for merchants to invest in business growth 	<ul style="list-style-type: none"> \$74 million per annum Medium
Total Monetised Benefit		\$74 million per annum
Non-monetised benefits		<i>Medium</i>

Further comments

Assumptions

A significant assumption underlying our analysis is that the regulator will make use of the package of tools to result in the above impacts. Otherwise, the assumption would be that the regulatory framework is set up but the regulator does not make use of the available tools, resulting in implementation costs to government but no additional benefits to New Zealand (and no additional costs to regulated parties).

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

Our assessment of the impacts includes an assumption about the likelihood of those impacts eventuating when considering how well the option achieves the objectives. For example, while information disclosure would, in an ideal world, provide merchants with the information they need to shop around for the best deal and switch providers to do so, in reality some merchants may not be motivated to do so or may find it more difficult to understand the information.

Robustness of evidence

Non-monetised impacts have been estimated by MBIE. We did not receive any data from stakeholders to help quantify impacts such as compliance costs and increased investment in business growth. As such, we do not have a high level of confidence in the estimates but may receive further data following targeted stakeholder consultation.

It is difficult to estimate the overall monetary value of benefits to merchants and consumers of a reduction in interchange fees, as this will depend on a number of factors including what product types are regulated, the level of regulated fees and the extent to which cost savings are passed on to merchants and then consumers.

Other impacts

An indirect impact of regulating retail payments systems is that it may have the effect of decreasing access to cash, if higher cost electronic payment methods become cheaper and more widespread. This would have implications for more vulnerable members of society who may rely on access to cash. These impacts will be mitigated by ensuring we work closely with the Cash and Money Department at RBNZ.

Section 3: Implementing the preferred option

How will it be implemented?

Who will be responsible for implementation?

We are proposing that the Commerce Commission (the Commission) will be responsible for regulating retail payments systems. We consider that the regulator should be an independent Crown entity, to be seen as independent from Ministerial influence and maintain public confidence in decisions. The Commission is the general competition and economic regulator with 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 system as it has been involved in a 2009 settlement with the card schemes and regularly engages with banks, retailers and consumer representatives. This is also a lower cost approach as it uses an existing body with established systems rather than creating a new body.

Submitters emphasised that it will be important for the regulator to take into consideration a broad range of views. The Commission also has access to external experts that can provide sector specific expertise which will enable them to be an effective regulator. As an established regulator with a consumer and competition focus, the Commission has experience in its other functions using similar tools to those being proposed.

How will the proposals be implemented?

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

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

As an interim measure to ensure more immediate benefits for merchants and consumers before the Commission sets up its new functions, the draft legislation will include a transitional price path to reduce interchange fees for Visa and Mastercard transactions as a form of interchange regulation. This will impose a hard cap of 0.8 per cent on interchange fees for credit card transactions (to bring these fees into line with Australia) and 0.6 per cent for online debit card transactions. This would come into effect six months after primary legislation is passed, and expire once the Commission makes an interchange fee determination.

Rapid interchange fee reductions are likely to result in the costs and benefits identified in the option of interchange regulation, but the speed of their implementation may impact consumer rewards programmes, interest rates and other fees to a greater extent as banks alter their business models in a shorter timeframe to try to offset the reduction in revenue.

When will the proposals come into effect?

The proposals will require primary legislation to be passed by Parliament. Following this, the regulator will need time to establish its new functions. We estimate that for most of the regime (apart from the transitional price path mentioned above) this will take at least 18-24 months. Regulated parties will then need to be given sufficient time from being notified of the regulations to them coming into effect. A clearer estimate of timing will be possible following final Cabinet policy decisions.

It will be important to provide sufficient time for regulated parties and others to comply with the

changes before they come into effect. Banks will need to make changes to their commercial arrangements, for example to adjust the structure of their rewards programmes for their customers and make changes to their contracts with merchants. Merchants may also need to make changes to their prices or to any surcharge schedules.

Communications

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

Implementation risks

The biggest risk is the fact that the regulatory model relies on providing the Commission with powers and tools via primary legislation, but the practical application of these powers and tools will be at the discretion of the Commission. While this limits the checks and balances over the use of these powers, the legislation will set clear objectives and principles for their use, which will reduce this risk.

Another implementation risk is the Commission not being adequately resourced for its new functions. There is a risk that the Commission will not enforce the regime if it does not have the resources. We consider this to be a low risk. MBIE will work with the Commission and Treasury to ensure the necessary funding arrangements.

Other implementation considerations

There are important design considerations for this regulatory approach, including:

- the threshold for designation, which is likely to be a principles-based test
- the process for designation, such as whether the decision to designate should be made by the regulator itself or by the Minister
- what safeguards there should be around decision-making, such as consultation requirements.

These considerations will be tested in targeted consultation. The Commission, RBNZ, the Treasury and FMA will also be involved in this process.

Offences and penalties will need to be incorporated to ensure that there are sufficient incentives to comply with regulation.

There is a risk is that regulated parties may challenge designation, which they would be able to do through the judicial review process. We will consider what processes might be appropriate to deal with this type of dispute. We also intend to consult on what dispute resolution mechanisms could be relied on to resolve disputes between participants in the system, for example between merchants and acquirers.

Monitoring, evaluation and review

As the lead policy advice agency for the retail payments system, MBIE intends to monitor, evaluate and review the regulatory framework in line with the Government's expectations for regulatory stewardship. The design of the designation model supports good regulatory stewardship, because it provides the ability to monitor, review and adapt the regulatory framework in response to emerging issues and trends to ensure it continues to be fit-for-purpose. As part of our regulatory stewardship role, we will take a proactive approach to identifying any issues by periodically consulting with key stakeholders on the impacts of the proposals and looking to overseas jurisdictions.

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

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

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

- reductions in interchange and merchant service fees, particularly for small businesses
- cost savings passed onto consumers
- continued safety and security of retail payments (eg data on levels of fraud).