

# THE BANKING ASSOCIATION

*South Africa*

27 October 2006

File Ref. 33438

The Banking Enquiry  
The DTI Campus  
Mulayo (Block C)  
77 Meintjies Street  
Sunnyside  
**PRETORIA**  
4000

Dear Sir or Madam

## **The Banking Association South Africa's submission to the Banking Enquiry**

Please find attached hereto The Banking Association South Africa's submission to the Competition Commission.

The submission has been structured into two core components. The first component addresses:

- The role and structure of The Banking Association South Africa.
- The role and structure of the Payment Strategy Division (PayStrat) of The Banking Association South Africa.
- A response to the research report regarding "The National Payment System and Competition in the Banking Sector" released by the Competition Commission in April 2006.
- The rationale behind interchange and the interchange determinant models considered to date by the Industry.

The second component of this submission, which was requested by the Technical Team of the Enquiry, comprises the submission made to the Portfolio Committee on Trade and Industry (the "Portfolio Committee") in 1999. The Portfolio Committee submission consists of four documents, namely:

- Bank Transaction Charges and Small Loan Originations
- Can Commercial Banking in South Africa earn a Satisfactory ROE?
- Arrangements to protect clients and some common misunderstandings as to how banks function
- KPMG Study on bank margins and related profitability in South Africa

These documents were prepared in response to an invitation by the Portfolio Committee to the then Banking Council, to make a written submission and oral presentation (which occurred on 2 March 1999) in respect of a public hearing on bank charges. Note that

the documentation is outdated and in a dynamic industry such as the Banking Industry, the conditions have changed significantly since the submission of these documents.

It is very difficult to capture, in a submission of this nature, all the nuances and intricacies of an environment as complex as that of the Banking Industry. The Association, however, hopes that its submission will constitute a platform from which further engagement with the Commission will occur with the objective of working together to promote the optimal efficiency of the Industry.

Yours sincerely

**Cas Coovadia**  
Managing Director

# THE BANKING ASSOCIATION

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*South Africa*

**Submission to**  
**the Banking Enquiry**

**October 2006**

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## **SECTION 1**

### **THE ROLE AND STRUCTURE OF THE BANKING ASSOCIATION SOUTH AFRICA**

#### **1. FORM AND FUNCTION**

The Banking Association South Africa (The Banking Association) is a section 21 not-for-profit association. Its membership is restricted to licensed banks and mutual banks as well as defined "associates" with a similar interest (e.g. Ithala "bank"). It currently has 35 members – 18 local banks, 16 international banks, and 1 associate, comprising the entire licensed banking sector.

It is the representative trade association for the banking sector, with voluntary membership by licensed banks.

#### **2. CORPORATE GOVERNANCE**

##### **2.1 Main Board**

The Board of Directors is elected annually at the AGM. The Board is structured on the following basis to ensure appropriate representation of the various sectoral interests:

- 1 director each from ABSA, Nedbank Ltd, First Rand Bank, Investec and Standard Bank ("largest 5")
- 2 directors representing the smaller, independent South African banks
- 2 directors representing the International Bankers Association
- The Managing Director of The Banking Association.

The Board meets twice a year. The quorum is three of the "largest 5" bank directors plus two other directors representing banks.

The Chair of the Board rotates annually.

##### **2.2 Operating Board**

The Operating Board functions under delegation from the main Board of Directors to deal with issues affecting the sector. The structure of the Operating Board is similar to that of the Main Board and comprises:

- The head of retail banking services for each of the "largest 5" banks
- Two directors (or their alternates) representing the smaller, independent South African banks
- Two directors representing the International Bankers Association
- The Managing Director of The Banking Association.

This Board meets every two weeks, with the same quorum as the Main Board.

### **2.3 Finances**

The budget is approved annually by the Main Board, on the recommendation of the Operating Board.

The annual financial statements are fully audited by external auditors, and submitted to the Registrar of Companies.

Members pay an annual contribution to the core operating costs of The Banking Association, on the following bases:

- any bank exceeding 1% market share (as measured by SA assets on balance sheet) pays pro-rata according to that market share
- banks with less than 1% market share pay a nominal annual contribution.

Any special projects approved by the Board/s are budgeted separately, and the designated expenditure is recovered from the banks impacted by the specific project, according to agreed ratios.

The Banking Association has internal controls over the signing of contracts by employees, and the authorisation of expenditure in excess of nominal operating expenses.

### **3. OPERATING STRUCTURE**

The structure and staffing of The Banking Association are as follows:

- Managing Director
- 7 General Managers
  - GM: Financial Markets
  - GM: Communications
  - GM: Banking Operations
  - GM: Market Conduct
  - GM: Stakeholder Management
  - GM: Payments Strategy
  - GM: Finance and Administration
- 5 Managers
- 11 support staff

All members of staff are employed by The Banking Association, not the banks.

### **4. MANDATE**

The mandate of The Banking Association is

"to establish and maintain the best possible platform on which member banks can do competitive, profitable and responsible banking in South Africa."

Key criteria impacting the mandate of The Banking Association include:

- Focusing on policy issues, with medium- to long-term impact. (The involvement of The Banking Association in the formulation of the National Credit Act is an example of this involvement).
- Being a catalyst for change in the Industry, in particular with regard to the socio-political impact of the banks. (The Financial Sector Charter and the Sizwe Housing Project are two useful examples).
- Maintaining, in its Industry role, a constructive balance between big and smaller banks, and between local and international banks. (This is of particular importance in the payments environment and to facilitate this a number of forums and activities are conducted via the Payments Strategy Division of The Banking Association).

In essence, The Banking Association strives to achieve a conducive environment for banking in the social-political and economic context within which banks operate.

## **5. STANDING COMMITTEES**

A number of advisory/consultative standing committees, comprising of bank officials and Banking Association staff, are managed by The Banking Association. These are continually evaluated to ensure that they continue to serve a useful purpose, in order to reduce the number of meetings that officials have to attend.

They are also an indication of the ongoing issues which need to be addressed by The Banking Association in order for it to fulfil its mandate.

### **5.1 Banking**

- Banks Act, Risk and Compliance
- Market Conduct
- Legal
- Property Finance
- Financial Intelligence Centre Act
- Industrial Relations
- Communications Policy
- Tax (direct and indirect)
- Assessors/ Valuers
- ATM Industry
- National Credit Act
- Debtor Finance
- Financial Markets

- Financial Advisory and Intermediary Services Act

## **5.2 National Payment Systems**

This area is addressed in more detail in Section 2 of the submission.

## **5.3 Basel II (as project managers for the SARB)**

- Steering
- Risk Management
- Regulatory Framework
- Disclosures
- Economic Impact

## **5.4 Financial Sector Charter Work Groups**

- Access
- Low-income Housing Finance
- Procurement
- SME
- Agriculture
- Human Resources
- Infrastructure
- Equity Finance

## **6. BANKING ASSOCIATION POSITIONS**

The Banking Association regularly develops "positions" to guide members on certain issues, e.g. on how to deal with dormant accounts or unclaimed balances, or the Code of Banking Practice. Such issues have an "industry" dimension and are non-competitive in their nature.

The typical process for developing these positions is illustrative of how The Banking Association operates:

- The process is executive-driven, i.e. a Banking Association executive, and not a committee, is held accountable for delivering the position
- The issue is identified and described
- Positions are developed, and relevant experts or committees are consulted
- This recommended position is tested with the banks/committee and any differences of views are taken to the Operating Board for consideration
- The position is tabled at the relevant Board for approval

- Once approved, the position is circulated to member banks as guidance or recommendation – with individual banks deciding whether to implement such recommendations in their institutions. (e.g. the Banking Ombuds Scheme, the Financial Sector Charter).

## 7. **CONCLUSION (1) – WHAT THE BANKING ASSOCIATION IS**

It is clear that The Banking Association is an independent not-for-profit trade association, with voluntary membership by all the licensed banks in South Africa. It is an advocacy organisation which, given the unique situation in South Africa, is also a catalyst for change within the banking sector.

The Banking Association is similar to the equivalent banking associations in most other countries, e.g. Britain, the European Union, Canada, the United States, Belgium, France, Italy, Japan, Turkey, Mexico, Germany, Australia, Hungary, Czech Republic (to name some of those that The Banking Association has come in direct contact with).

## 8. **CONCLUSION (2) – WHAT THE BANKING ASSOCIATION IS NOT**

In contrast with section (7) above, The Banking Association is not

- a bank or the representative of any specific bank
- a regulatory body
- a self-regulatory body (i.e. it has no powers of sanction; members agree to participate in certain schemes which are then regulated by third parties, e.g. the Code/Ombudsman, the Charter/Charter Council)
- a price setter, or even a forum for discussing the setting of prices to clients of banks
- a forum for discussing or agreeing competitive issues.

## **SECTION 2**

### **THE ROLE AND STRUCTURE OF THE PAYMENT STRATEGY DIVISION (PAYSTRAT) OF THE BANKING ASSOCIATION SOUTH AFRICA**

#### **1. INTRODUCTION**

The purpose of this section of the submission is to provide a high-level overview of the strategic intent, nature and functioning of the Payment Strategy Division (“PayStrat”) of The Banking Association South Africa .

#### **2. BACKGROUND AND HISTORY**

PayStrat has its roots in the formation of the South African Payment Strategy Association (SAPSA), an association not for profit which was established by the SA Interbank Payment Business Forum (IPBF) in 2004. The original intent was that SAPSA would be established as a separate entity, in order for it to be able to accommodate both bank and non-bank participation with the specific intent of addressing business related aspects pertaining to interoperability and payments, as the industry already had a body which addressed risk (i.e. PASA) but not one which addressed payments business strategy in the co-operative banking space.

In late 2005 SAPSA was for practical purposes incorporated into The Banking Association as the PayStrat Division. Whilst the ideal of representing both bank and non-bank interests remains, the incorporation was to reduce the number of meetings that the banks’ CEOs had to attend and the fact that the membership of SAPSA was at that time limited to banks. This incorporation also met the requirements of the SARB to have easier access to the most senior levels in the banks. The payment business forums which were established by SAPSA have remained the same, subsequent to their incorporation into The Banking Association.

#### **3. WHAT THE PAYSTRAT DIVISION IS**

PayStrat can best be described by reviewing its mandate, vision, mission and its primary objectives, each of which is addressed below.

##### **3.1 Mandate**

The Banking Association’s role is to:

*“establish and maintain the best possible platform on which member banks can do competitive, profitable and responsible banking“*

In support of this role, The Banking Association has allocated responsibilities to a number of divisions, one of which is PayStrat.

PayStrat’s role is to provide an environment in which the relevant member banks of The Banking Association can discuss their non-competitive interoperable<sup>1</sup> payment requirements, formulate proposals for industry-wide payment solutions and request project management or research for payment initiatives (such as the “Mzansi Money Transfer product) involving more than one of the members.

**3.2 Vision**

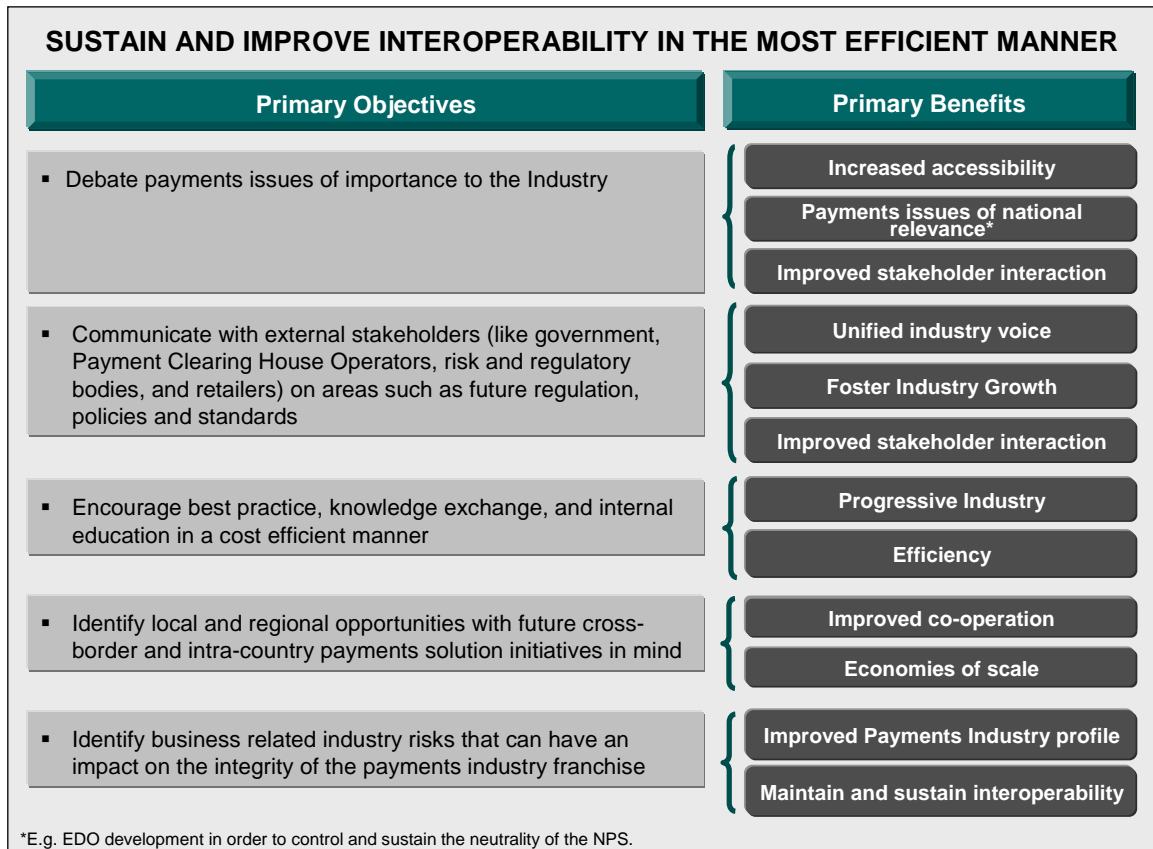
PayStrat’s vision is to promote an accessible, responsive, and progressive payments industry.

**3.3 Mission**

PayStrat’s mission is to facilitate initiatives within the payments industry guided by the local and global environment.

**3.4 Primary Objectives and Benefits**

The primary objectives support the vision and mission by expanding their meaning and are detailed below:



By way of illustration specific examples are provided below:

<sup>1</sup> Payments interoperability can be described as the ability for one participant to efficiently and effectively and without compromising the safeness and soundness of the payments system, exchange payment transactions with another participant. Interoperability requires technical compatibility between participants’ systems.

- The development of EDO (the early debit order payments system) was facilitated through PayStrat.
- PayStrat, through its involvement with non-banks, communicated and facilitated changes to the minimum standards requirements set by the SARB for cash recycling.
- PayStrat, through its relationships with similar international payment organisations, has conveyed world best practices to its members.

Apart from providing opportunities where non-competitive payments issues can be discussed and debated, one of the roles with which PayStrat has been mandated, is education and communication with the participants within the payments industry, as well as on a broader scale with stakeholders such as Government, system operators and retailers.

Given the call for increased transparency regarding the National Payment System (NPS), PayStrat is expected to assist with communication and education in relation to the NPS, in demystifying this environment.

#### **4. WHAT THE PAYSTRAT DIVISION IS NOT**

In line with the Banking Association, PayStrat is not:

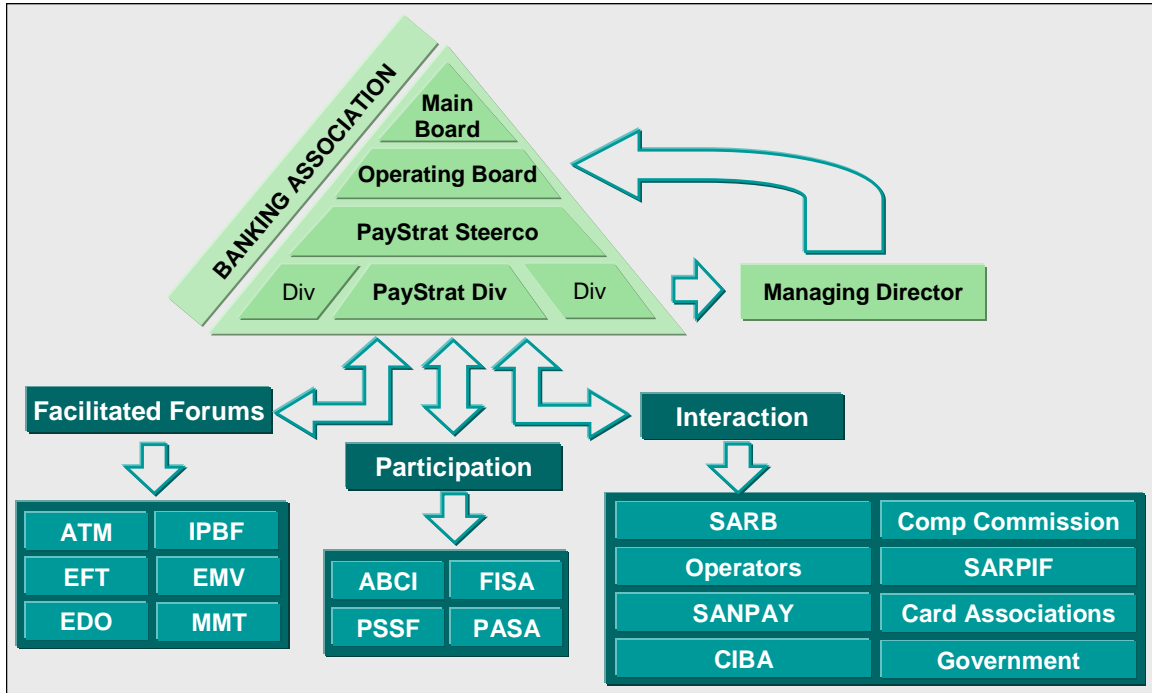
- a bank or the representative of any specific bank
- a regulatory body
- a self-regulatory body (i.e. it has no powers of sanction; members agree to participate in certain schemes which are then regulated by the Payment Association of South Africa (PASA))
- a price setter, or even a forum for discussing the setting of prices to clients of banks
- a forum for discussing or agreeing competitive issues.

#### **5. ORGANISATIONAL STRUCTURE AND INTERACTION**

##### **5.1 Stakeholders**

PayStrat interacts with all payment stakeholders to facilitate the generation of ideas, as well as the implementation of standards, solutions and products in the interoperable environment.

PayStrat's main stakeholders are set out below:



## 5.2 Banking Association Operating Board

The general direction, policy, and finances of PayStrat vest in The Banking Association, as mandated by the Operating Board, as per the powers delegated to it by the Main Board.

## 5.3 Facilitated Forums

PayStrat's facilitated business forums involve the Payment Participant Banks (PASA members).

Prior to the formation of SAPSA in 2004, the business forums existed in isolation and their output was not co-ordinated.

All these business forums are now facilitated by PayStrat and their output forms the basis of recommendations to be considered by The Banking Association Operating Board.

Business forum responsibilities currently are to:

- Identify, debate and define issues and best practices (to complement PASA rules) for the payments industry.
- Facilitate the implementation of existing and new business practices and interoperable issues, e.g. whether to implement cheque imaging within the industry given the overall declining levels of cheque utilisation.
- Evaluate ideas and conduct initial research into interoperable and technology related matters.
- Communicate with third parties in the payments industry in an impartial manner (e.g. Payment Stream Clearing House Operators, vendors) on non-competitive issues in order to improve their understanding of payments related issues.

- Identify the need to establish Working Groups to define product specifications for co-operative initiatives.
- Given the technical nature of the payments environment, the PayStrat Committee is encouraged to formulate proposals on what the most appropriate payment streams are to be used for proposed concepts.

In addition to the above objectives and in keeping with PayStrat’s mandate to communicate and educate, the forums have in recent years been used as a platform to keep members informed on issues and new developments around acceptable practices relative to competition legislation.

A typical slide utilised to convey appropriate behaviour in this regard is included below:

To prevent potential transgression of competition legislation, PayStrat presented and maintains a number of guidelines to the industry forums in terms of what is allowed and what not within the co-operative payment space, e.g. new transaction process

<u>Allowed</u>	<u>Not allowed</u>
<p><b>Discussion points</b></p> <ul style="list-style-type: none"><li>• Acceptance &amp; nature of the transaction</li><li>• Proposed rules</li></ul> <p><b>PayStrat facilitation</b></p> <ul style="list-style-type: none"><li>• Assist to establish 1-on-1 meetings</li><li>• Facilitate discussion to a point</li><li>• Can discuss areas around interoperability (the nature of the transaction &amp; benefits to industry)</li><li>• Sensitize i.t.o. key areas/issues which need to be noted from a competition perspective</li></ul>	<ul style="list-style-type: none"><li>• Any <b>pricing</b> discussions</li><li>• Discussions around <b>client specific issues</b>, e.g. Restrictions around specific client segments or specific clients being included or excluded</li><li>• Terms &amp; conditions with <b>third parties</b> (e.g. suppliers) – e.g. an agreement that parties are not allowed to use a certain third party to the exclusion of other third parties</li></ul>

Historically business forums were aligned with the Payment Clearing House Participant Groups (PCH PGs) of PASA. However, with improved technology in recent years, transactions which were only considered possible in one environment are now also possible in other payment streams, resulting in the blurring of boundaries. An example of this is the ability to purchase prepaid airtime via the EFT, ATM and POS payment streams. These systems are all managed through separate PCH PG’s.

Obviously the improvement of technology allows for greater innovation in the payment industry, but the requirement to retain regulation via the PCHs and their PGs through PASA, remains essential to ensure the safeness, soundness and stability of the systems. The SARB, in its Vision 2010<sup>2</sup> document, furthermore supports this view as it states that:

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<sup>2</sup> The National Payment System Framework and Strategy, Vision 2010 – Page 13, sect 3.6.4.

*“Regulation will follow innovation, where appropriate.”*

The activities of the forums are discussed in more detail below.

#### 5.3.1 PayStrat Steering Committee

The PayStrat Steering Committee is responsible for debating interoperable requirements of new business initiatives, resolving issues and approving the appointment of new Working Groups and Business Forums.

- The Steering Committee makes provision for 9 members:
  - 5 from Principal (or voting) members (one from each of the 5 major banks).
  - 2 lower volume banks' Principal members appointed through a voting process similar to that used in the PASA Council appointment of lower volume banks.
  - 2 advisory members (Payment System Management Body (PASA), PayStrat Divisional GM).
- Each advisory member is entitled to one representative. In the case of PASA, the COO will be the most likely representative.
- Members representing the views of a number of member banks (e.g. lower volume banks) are responsible for presenting the collective views and interests of these groups.
- The SARB may participate through invitation

PayStrat's Committee chairperson is elected from the Operating Board membership every two years.

#### 5.3.2 Interbank Payments Business Forum (IPBF)

The IPBF is a voluntary forum which can be attended by all NPS clearing banks.

With the formation of the PayStrat Steering Committee, many of the functions of the IPBF were transferred to the PayStrat Steering Committee. The IPBF was nonetheless retained to function as a communication and education mechanism for the Industry. It gives banks, and in particular the smaller/ lower volume banks which may not have the resources to attend all the individual forums, a single point of interface through which they are able to obtain a cross-section of activities and initiatives being conducted by the business forums, thus allowing them to stay current regarding the interbank environment.

The IPBF is also the environment in which members can table new payment innovations. The New Transaction Process was especially formulated in this regard to encourage innovation in the co-operative environment.

#### 5.3.3 Automated Teller Machine (ATM) Business Forum

The ATM Business Forum is a voluntary business forum which co-ordinates non-competitive business issues regarding interoperability and projects relating to cash and non-cash transactions in the self service environment. The self

service environment generally deals with ATMs and NADs (Non-ATM devices similar to POS or point of sale devices, also referred to as Mini ATMs ).

#### 5.3.4 Electronic Funds Transfer (EFT) Business Forum

The EFT Business Forum is a voluntary business forum which co-ordinates non-competitive business issues regarding interoperability and projects focusing on the EFT Debit and EFT Credit environments.

EFT Debits are debit-pull transactions which function under mandate from the client. The mandate is usually held by the corporate client initiating the debit-pull or debit order. Transactions are submitted to the acquiring bank who in turn submits the transactions to the Operator who “pulls” the transactions from the clients’ accounts.

EFT Credits are client initiated transactions and are also referred to as credit-push transactions or stop order as the client “pushes” the transaction to the beneficiary. This is usually an irrevocable transaction as it is generated from a client account after the bank has ensured that the account has sufficient funds.

#### 5.3.5 Europay MasterCard Visa (EMV) Steering Committee

This forum was established to project manage the implementation of EMV in South Africa and the resultant “chip and pin”<sup>3</sup> implementation (on Debit and Credit cards) similar to that in the UK and EU. The project is rapidly reaching fruition. It is, however, expected that a number of ongoing non-competitive business issues and projects will require that certain of the structures be retained.

#### 5.3.6 Early Debit Order (EDO) Business Forum

The EDO system went live on 18 September 2006. The system was developed as a solution to accommodate collections in the lower income markets, which have historically been problematic in the payments environment. EDO consists of the Authenticated Early Debit Order (AEDO) and Non-Authenticated Early Debit Order (NAEDO) systems. AEDO is a collections system authorised via debit card and NAEDO a paper mandated transaction. Transactions are randomised and then processed ahead of other traditional batch-based payment systems.

It was recently requested that a business forum be established as there are a number of business considerations which require focus, especially given the infancy of the payment system. The first meeting has been scheduled for 26 October 2006.

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<sup>3</sup> Financial institutions and retailers are adopting the use of smart cards to satisfy their customers' growing needs. The increased memory and processing capabilities of the chip interface will improve the customer's banking and shopping experiences through enhanced and more secure card applications and infrastructure. This could result in increased utility, convenience and products that are tailored to the customer's individual needs.

### 5.3.7 Mzansi Money Transfer (MMT) Transactional Workgroup

MMT is a person to person money transfer mechanism, created as a deliverable of the Financial Sector Charter. The product has experienced relatively low volumes since its inception a year ago.

Given the relative inactivity of the MMT environment, the voluntary forum meets on an ad-hoc basis.

## 5.4 PayStrat Participation

PayStrat participates in a number of industry bodies either as observer, non-voting engagement member or full member. The organisations include:

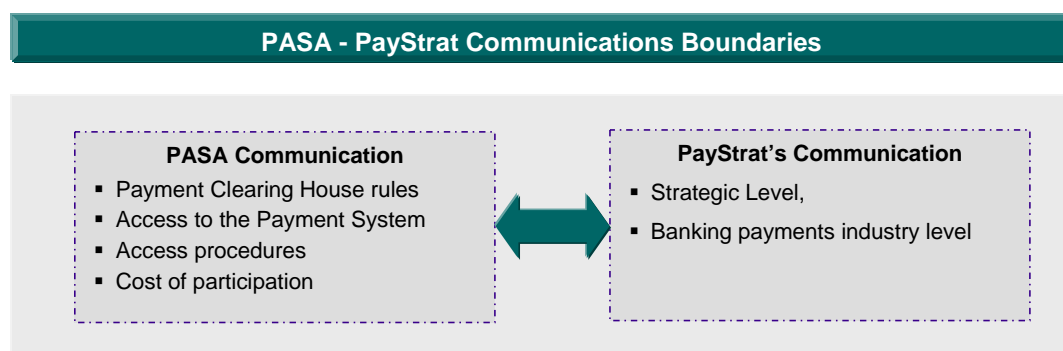
- Payments Association of South Africa (PASA);
- Payments System Stakeholder Forum (PSSF);
- Association of Bank Card Issuers and Merchant Acquirers (ABCI);
- Financial Industry Service Association (FISA).

These forums and PayStrat’s participation are discussed more fully below:

### 5.4.1 Payments Association of South Africa (PASA)

PayStrat’s interaction with the payment system management body, PASA, is via an understanding which affords the PayStrat GM observer status at PASA Council. PASA in turn shares a reciprocal status at the PayStrat Steering Committee. PayStrat interacts with PASA in the following ways:

- On issues relating to the payments industry, including future regulation, policies and standards.
- To achieve effectiveness and efficiency it is recognised that it is important to define clear boundaries between the bodies that are primarily responsible for communication within the payments industry. These are described below:



PASA retains focus on payments related risk, and PayStrat manages all communication in respect of strategic payments interoperability (non-competitive) issues.

5.4.2 Payments System Stakeholder Forum (PSSF)

The PSSF was recently formally constituted by the Collections Forum, one of the steering bodies responsible for the establishment of the EDO Payments system. The PSSF is a non-bank body of associations, the purpose of which is to regulate users (product providers such as micro lenders) and sanction delinquent members if necessary, e.g. where members introduce reputational risk to the system. PayStrat participates as a non-voting engagement member. Banks remain regulated and sanctioned through the PASA environment.

5.4.3 Association of Bank Card Issuers and Merchant Acquirers (ABCI)

The ABCI is one of the longest standing forums in the payments industry. PayStrat has observer status and conducts projects and initiatives on behalf of the Association.

The ABCI concerns itself with card related business issues of interoperability which include Debit, Credit and Hybrid card products.

5.4.4 Financial Industry Service Association (FISA)

Previously the Back Office Forum of South Africa or BOFSA, FISA focuses on the formulation and adoption of international payments standards. PayStrat is a full member of the association.

**5.5 PayStrat Interaction**

PayStrat interacts with a number of stakeholders at a macro level either directly or indirectly through participation on other forums.

5.5.1 Oversight and Governance Institutions (South African Reserve Bank (SARB))

PayStrat interacts with the SARB regarding issues relating to the payments industry, including future regulation, policies and standards. These interactions are mostly with the National Payment System Department of the SARB although the Registrar of Banks is also an area of interaction.

The Banking Association, through PayStrat, has a memorandum of understanding in place with the SARB. As a result, the SARB may request to have a consultation with the Operating Board (failing the outcomes of formal interactions at mutually recognised Business Forums as defined in the memorandum of understanding). The SARB may also attend PayStrat Committee and Operating Board meetings by invitation.

5.5.2 Currency Management Co-ordination Committee (CMCC)

PayStrat represents the Banking Association on the CMCC from a payments perspective, where issues pertaining to cash and cash related technologies are debated.

5.5.3 Operators – System Operators / PCH System Operators

PayStrat (or existing payments Business Forum members) may decide to involve PCH operators to participate in Business Forums (by invitation and when required) as and when a particular issue under discussion relates to their

respective competencies, especially when analysing and formulating technology and capacity requirements.

Payment Stream / Clearing House Operators (incl. BANKSERV, Visa, MasterCard) are able to take payment system enhancements up to the Payment Business Forums, or (where no appropriate Business Forums exist), to the PayStrat Divisional GM for consideration and inclusion in the most suitable payments environment.

In addition, Payment Stream / Clearing House Operators may respond to a request to implement a new product or solution for which PayStrat Business Forums / Working Groups have developed a value proposition.

#### 5.5.4 Interaction with non-bank Payment Interest Groups (includes the Retailers Forum, the Life Offices Association, CIBA and SARPIF via SANPAY)

PayStrat interacts with interest groups to communicate the Industry's position regarding payments at the Interbank level in consultation with member banks. These communications are usually of a reactive nature.

Non-bank payments interest groups can also introduce topics (for discussion and debate) through the Primary Stakeholder sponsorship.

Other areas of participation include:

- Government
- Competition Commission.

## 6. CONCLUSION

PayStrat performs a vital role dealing with issues of interoperability as well as co-ordinating non-competitive interbank activities in the payments environment.

PayStrat is well positioned to fulfil a number of proactive functions, including fulfilling a communication and education role regarding the National Payment System, thereby demystifying this environment.

## **SECTION 3**

### **RESPONSE TO THE RESEARCH REPORT REGARDING “THE NATIONAL PAYMENT SYSTEM AND COMPETITION IN THE BANKING SECTOR” RELEASED BY THE COMPETITION COMMISSION ON 20 APRIL 2006**

#### **1. INTRODUCTION**

In April 2006 the Competition Commission released a report regarding “*The National Payment System and Competition in the Banking Sector*”. The Report was compiled by an independent economic research company, FEASibility.

The Report found that “*the South African National Payment System (NPS) is a highly efficient and sound system and perhaps more advanced than similar networks in more economically developed countries.*” The Report, however, also highlighted a number of areas of concern.

This response to the Report has been compiled to address a number of factual concerns regarding the content of the report.

#### **2. REPORT FINDINGS**

The Report’s findings have been categorised into five core groupings, each of which is outlined below. The main findings as well as factual concerns relating to each of the groupings are specified below after which a number of comments are made relating to the specific findings and concerns.

##### **2.1 Cost and Revenue**

###### Main Finding

*“Based on the DI200 returns, transaction based fee income accounted for 38%, or R28.8 billion of banks’ joint income during 2004.” – FEASibility Report, Page 27, Paragraph 2, Line 4*

###### Considerations

The Report assumed that transaction-based fee income, as reported by the banks in the DI200’s, equates directly to payment system income. Transaction-based fee income, however, includes other sources of income in addition to payment related fee income, such as:

- Income from African and international operations;
- Fees and commissions from corporate advisory services and knowledge based activities;
- Foreign exchange trading income;
- Insurance income;
- Income from estate (wills and trusts) planning activities;

- Portfolio management income;
- Income from administration services;
- Guarantees and cash deposit fees.

According to an analysis of the 2004 financial year's DI200 figures as reported on the SARB's website, the total transaction-based fee income was reported as R21.3 bn as opposed to R28.8 bn quoted in the FEASibility report. Furthermore as mentioned above, not all the transaction based fee income is derived from the payments system alone. Although The Banking Association is not privy to the details, as they are competitive in nature, removing these items from the figure of R21.3bn will in all likelihood further lower the final figure attributable to payments specific revenue.

Key concern 1

*"... there is little apparent link between the costs directly attributable to making transactions (such as the BANKSERV processing fee, for example) and the fee the customer is charged by the bank ." – FEASibility Report, Page 4, Paragraph 4, Line 1*

Considerations

The payment-related costs taken into consideration in the Report are limited to Interbank operational costs as well as the cost of participation in the NPS. Additional costs that should also be taken into consideration when calculating the payment system related costs include, for example:

- i) Individual banks' supporting infrastructure costs, e.g. branches, call centres, ATMs, cards, point of sale terminals, networks, R&D and operational costs.
- ii) Staffing costs required for support and facilitation of payment related activities.
- iii) Compliance costs, e.g. FICA and FAIS.
- iv) Fraud losses and other risks (e.g. default risk).
- v) Funding costs (e.g. credit card).

In the competitive environment banks determine their end-user pricing based inter alia on the above costs which differ from bank to bank, as well as the fact that they have different customer acquisition, retention and pricing strategies.

Key Concern 2

*"... whether the level of bank charges is cost-related and competitive or whether it is a pricing consequence of the dominance of the retail banking sector of the big banks through their account holding needs further investigation." – FEASibility Report, Page 4, Paragraph 4, Lines 5 – 7*

### Considerations

According to a study conducted by Genesis on behalf of Finmark Trust (the study is available on the Finmark Trust website), entitled “An inter-country survey of the relative costs of bank accounts”,

*“...South African transaction costs are not out of line with the other middle income countries, and may provide a higher degree of functionality given the level of electronic payments ...”<sup>4</sup>*

Comparing customer fees of different countries directly with one another is difficult. There are indirect costs which exist that may not be taken into consideration when doing a direct one to one pricing comparison. An example of an indirect cost is the earlier payment of interest to the beneficiary as a result of the faster payment clearing time. The clearing period is the time it takes for funds to be transferred or cleared between one account and another, subsequent to the payment instruction being given. This period is generally less in South Africa than for example in the United Kingdom. Banks in the United Kingdom are likely to benefit from the interest turn generated from the funds held in their own books during the longer clearing period.

#### Key Concern 3

*“A big bank that issues debit and credit cards and which has an extensive ATM network is likely to be a net receiver of interchange, relative to a small bank that does not issue cards and has few (if any) ATMs.” – FEASibility Report, Page 3, Paragraph 2, Lines 12 – 15*

*and*

*“...interchange fees are likely to be a cost for small players but are in fact a significant revenue stream for large banks who dominate both the issuing and acquiring of payments ” – FEASibility Report, Page 26, Paragraph 1, Lines 4 – 6*

### Considerations

Interchange fee income flows are not exclusive to big banks. As interchange is driven by volume, in cases where a small bank is a larger player in a particular payment stream than a larger bank, there can be cases where smaller banks are also net receivers of interchange. The multilateral negotiation process followed in the past also levels the interchange benefit as the actual interchange fee per transaction does not differ depending on the size of the bank.

Interchange is designed to compensate both issuers and acquirers for the cost of facilitating transactions and the associated risk across the interbank networks. International principles have historically been utilised as the primary basis for the determination of interchange in South Africa.

- ATM: Interchange flows to compensate the acquirer for the investment in infrastructure including cash-handling.

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<sup>4</sup> Genesis: An inter-country survey of relative costs of bank accounts, Page 43, Paragraph 1, Lines 9 to 11

- POS: Interchange flows to compensate the issuer for: fraud losses, credit loss, operational costs, capital investments, free funding period, etc.

## 2.2 Access and Non-Banks

### Main Finding

*“Not only the banks, but all the present participants in the NPS appear to find their activity in this regard profitable – indeed this might be the motivation for the clamour to gain access to the system. Only the SAMOS system operated by the NPSD appears to work on a cost recovery basis.” – FEASibility Report, Page 5, Paragraph 3, Bullet 2*

### Considerations

Currently only banks are permitted to be direct participants, given the regulatory and compliance constraints regarding access to the National Payment System, as clearing is currently limited to banks by the NPS Act. The SARB, however, indicates in its document entitled “The National Payment System Framework and Strategy (Vision 2010, section 2.4.3.3)” that:

*“Development paths exist for non-banks to become clearing and settlement banks in the payment system ...”*

Should non-banks become directly involved in the NPS, it is important that entry criteria as well as the level of regulation of such participants be relative to the risk introduced to the payment system. This will also ensure the sustainability of the safeness and soundness of the National Payment System which is considered to be equal to and in some instances better than more economically developed countries.

### Key concern 1

*“Legislation and regulation have focused on banks. This has left a regulatory gap in terms of the rules of participation for non-banks and highlights the need for an overall strategy.” – FEASibility Report, Page 6, Bullet 3*

### Considerations

The SARB has indicated in its recently released Vision 2010 document, that one of its main strategic objectives is to *“Create a level playing field for participants (who are treated on an equal and non-preferential basis) while simultaneously adhering to sound payment system risk principles”*<sup>5</sup>. In support of its vision, the SARB is considering a number of ways in which to accomplish this.

### Key concern 2

*“The governance concerns about self-regulation of the payment association can be addressed by allowing broader membership of appropriate non-bank participants to PASA...” – FEASibility Report, Page 30, Paragraph 4; Lines 1 – 3*

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<sup>5</sup> The National Payment System Framework and Strategy, Vision 2010 – Page 7, bullet 2

### Considerations

As the banks are currently the only officially legislated clearing participants, membership of PASA is limited to banks as well as the SARB which participates on a non-voting basis.

Existing engagement by non-banks is possible via the following forums:

- SANPAY
- EMV Forum (e.g. SARPIF (South African Retailers Payments Issues Forum) is involved in the EMV Sub Project 4 dealing with retailers and merchant acquirers)
- Payment System Stakeholder Forum (PSSF).

## 2.3 Pricing (Interchange)

### Main Finding

*“... the pricing arrangement for each payment stream falls outside the remit of regulation and in the past has been negotiated on a multilateral basis.”* – FEASibility Report, Page 5, Paragraph 3, Bullet 3

### Considerations

The rationale for Interchange is discussed in section 4.

### Key concern 1

*“It is the understanding in the industry that the Competition Act (s4(1b)) precludes multilateral negotiations (the banks have not sought an exemption).”* – FEASibility Report, Page 173, Paragraph 5, Lines 3-5

### Considerations

The Banking Association is aware of competition law concerns having been raised and, accordingly prompted the Industry to proactively investigate alternative interchange determinant models. This process has been underway for an extended period (two and a half years). The options which have been considered during the period of analysis and investigation are covered in Section 4, item 4.

### Key concern 2

*“... further consideration is needed as to whether interchange benefits large banks.”* – FEASibility Report, Page 3, Paragraph 2, Lines 8 – 9

### Considerations

As mentioned in section 4, part 2; the current levels of card interchange by transaction affect both small and large banks in the same way. Historically the adopted approach was based on international principles through a process of multilateral price setting. On this basis any additional benefits that accrue to large banks against the benefits that accrue to smaller banks, are due to economies of scale. The big banks may have a larger number of cards in issue or larger ATM

networks. On a per transaction basis, however, interchange paid or received is no different whether it is a small or large bank.

Key concern 3

*“The shop owner transmits payment instructions to its banker, normally in the form of a deposit, with the understanding that, should its banker (collecting banker) not be able to collect the payment, the shop owner’s account will be debited with such uncollected payments”* – FEASibility Report, Page 124, Section 1(d)

Considerations

The above statement holds true for cheques and debit orders. Credit and debit cards, however, function on the basis that payments at the point of purchase are guaranteed once suitably authorised, and are therefore not returned as uncollected payments. According to the Edgar Dunn & Company methodology, this contributes to the existence of the merchant service fee, payable by the retailer to the issuing bank.

**2.4 Control and Ownership**

Main Finding

*“... the current profitability of BANKSERV and the control and ownership of this essential infrastructure by the banks raise the possibility of broader representation on the Board of BANKSERV.”* FEASibility Report, Page 6, Bullet 1

Considerations

Any questions regarding the control and ownership of BANKSERV should be directed to its shareholders.

Key concern 1

*“... the current profitability of BANKSERV and the control and ownership of this essential infrastructure by the banks...”* – FEASibility Report, Page 6, Bullet 1

Considerations

It is important to note that even though the BANKSERV shareholders are also its customers, there is, according to the FEASibility Report, “little apparent link” (Page 4, Paragraph 4, Line 1) between BANKSERV’s switching cost and end user pricing as BANKSERV’s charges equate to approximately 2% of the transaction fees charged by the banks.

Key concern 2

*“... the established principle that new operators may be permitted should remain.”* – FEASibility Report, Page 31, Paragraph 1, Lines 7 – 8

Considerations

Competition to BANKSERV already exists in the form of: VISA, MasterCard and Integrated Processing System (IPS). Clear entry criteria and guidelines should

exist in order to maintain the efficiency and sustainability of the system to the ultimate benefit of the customer, especially in terms of business continuity planning (BCP) and disaster recovery planning (DRP). The entry criteria should be determined, as well as monitored, by PASA.

A further aspect that should be considered when allowing access by new operators to the payment system is that all banks (small and large) will need to connect to each operator for payment systems and interoperability to be effective. This additional requirement, and the resulting extra costs, may negatively affect banks, especially small banks, having to link with more than one operator to achieve full connectivity.

## 2.5 Market Conduct

### Main Finding

*“There is an absence of market conduct regulation throughout the Banking Industry and the NPS in particular.”* – FEASibility Report, Page 6, Bullet 2

### Considerations

In order to address the concern of banking customers not being able to compare bank fees, the Banking Association is developing a mechanism to enable customers to compare fees. The mechanism is in the process of implementation and will provide comparative bank fees for general transactional groupings in a number of market / income segments.

### Key concern 1

*“... the lack of an independent banking adjudicator to which consumer complaints can be directed has contributed to the apparent consumer resistance to high banking fees.”* – FEASibility Report, Page 29, Paragraph 4, Lines 1 – 4

### Considerations

The Banking Ombudsman is completely independent. The Ombudsman’s governance structure includes an independent chairman and the majority of its Board comprises independent members. Only two of the nine Banking Ombudsman’s board members are from the Banking Industry.

The Ombudsman deals with misconduct relating to consumer pricing complaints as one of its primary areas of focus.

### Key concern 2

*“... debit cards are a much cheaper payments instrument (than credit cards)...however, the pricing to the customer obscures the actual cost...and the perverse outcome results that the more expensive instrument (credit card) is more widely used.”* – FEASibility Report, Page 50, Paragraph 4, Lines 1-2 to Page 51, Paragraph 1, Lines 1-5

Considerations

The fact that the associated risks of a debit card are lower than that of a credit card (e.g. no interest free period, does not attract the credit risk associated with credit card) renders debit cards a relatively cheaper payment mechanism. This is however balanced by the cost incurred by issuing banks for the additional payment processing and technical work required to process a debit card transaction, e.g. online, real-time transaction processing.

**3. CONCLUSION**

We have attempted, in this section of the submission, to alert the Competition Commission Enquiry to some factual concerns regarding the content of the Report. We have also pointed out initiatives underway to address some of the concerns raised in the Report. We trust this submission will contribute to a constructive debate in this regard.

## **SECTION 4**

### **THE RATIONALE BEHIND INTERCHANGE AND THE INTERCHANGE DETERMINANT MODELS CONSIDERED TO DATE BY THE INDUSTRY**

#### **1. INTRODUCTION**

Following a request from the Competition Commission Enquiry Technical Team, this section of the submission elaborates on the rationale for interchange as well as a number of potential interchange determinant models.

#### **2. THE RATIONALE BEHIND INTERCHANGE**

Interbank pricing (interchange) is an essential component of interoperability. It is a global mechanism used in most Banking Industries and is considered to be the most effective medium to help sustain efficient exchange of interbank payments

Interchange promotes stability in a complex environment where one party performs a service on behalf of another's client. Typical examples include EFT, ATM and Card payment systems. This ensures economies of scale and allows the footprint of access to be extended beyond areas that would normally not be possible by a single participant in the payments system.

Interchange is a mechanism aimed at balancing the benefits of the payment system between all the participants thereof. By way of example, the graphic below indicates the actions and responsibilities of all the parties involved in a card payment transaction, the resulting benefits they receive, as well as the related costs.

<b>RETAIL CUSTOMER</b>	<b><u>Actions &amp; Responsibilities</u></b> <ul style="list-style-type: none"><li>➤ Give payment instruction to Merchant at the time of conducting a purchase</li><li>➤ Ensure that there are sufficient funds or credit available to enable the successful completion of the transaction</li></ul>	<b><u>Benefits from Issuer</u></b> <ul style="list-style-type: none"><li>➤ Convenience - not limited to cash</li><li>➤ Unsecured credit line</li><li>➤ Interest free / free funding period</li><li>➤ Payment guarantee</li></ul> <b><u>Benefit from Acquirer</u></b> <ul style="list-style-type: none"><li>➤ Access to card payment infrastructure, i.e. convenience</li></ul>	<b><u>Costs</u></b> <ul style="list-style-type: none"><li>➤ Annual credit card fee</li><li>➤ Financing fee if the free funding period on a credit card is exceeded</li><li>➤ Transaction fees in the case of debit cards, etc.</li></ul>
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<b>MERCHANT</b>	<p><b><u>Actions &amp; Responsibilities</u></b></p> <ul style="list-style-type: none"> <li>➤ Provide a facility whereby the retail customer can provide a payment instruction</li> <li>➤ Provide the retail customer with the product or service that was purchased</li> </ul>	<p><b><u>Benefits from Issuer</u></b></p> <ul style="list-style-type: none"> <li>➤ No cash related security risk</li> <li>➤ No credit risk as all payments are guaranteed (if properly authorised)</li> <li>➤ Potential increase in sales due to credit card customer having a free funding period</li> </ul> <p><b><u>Benefits from Acquirer</u></b></p> <ul style="list-style-type: none"> <li>➤ Provide an efficient collection method which prevents potential errors such as incorrect change on cash purchases</li> <li>➤ Access to all card Issuers</li> <li>➤ Faster account credit than in the case of cash transactions</li> <li>➤ Reconciliation, resulting in less employee fraud</li> </ul>	<p><b><u>Costs</u></b></p> <ul style="list-style-type: none"> <li>➤ Merchant fee, which includes a fee for both the Acquirer and the Issuer (Interchange fee)</li> <li>➤ Cost of Point of Sale (POS) equipment, etc.</li> </ul>
<b>ACQUIRER</b>	<p><b><u>Actions &amp; Responsibilities</u></b></p> <ul style="list-style-type: none"> <li>➤ Pass payment instructions to applicable Issuers (Connectivity)</li> <li>➤ Transfer funds to the Merchant</li> <li>➤ Conduct dispute resolution queries</li> <li>➤ Provide reconciliation services to the Merchant</li> </ul>	<p><b><u>Benefit from Merchant</u></b></p> <ul style="list-style-type: none"> <li>➤ The Acquirer receives a fee from the Merchant for the benefits that it provides to the Merchant</li> <li>➤ A component (interchange) of this fee received from the Merchant is, however, passed on to the Issuer for the benefits that it provided to the Merchant as part of the transaction</li> </ul>	<p><b><u>Costs</u></b></p> <ul style="list-style-type: none"> <li>➤ Processing costs</li> <li>➤ Network maintenance costs</li> <li>➤ Connectivity costs</li> <li>➤ Support costs, etc.</li> </ul>
<b>ISSUER</b>	<p><b><u>Actions &amp; Responsibilities</u></b></p> <ul style="list-style-type: none"> <li>➤ Manage customer's account</li> <li>➤ Processing payment instruction against customers' accounts</li> <li>➤ Transfer funds to the Acquirer</li> <li>➤ Payment guarantee, in terms of fraud, credit write offs and transaction authorisations</li> </ul>	<p><b><u>Benefit from Merchant</u></b></p> <ul style="list-style-type: none"> <li>➤ Receives a fee (Interchange) from the Merchant via the Acquirer</li> </ul> <p><b><u>Benefits from retail customer</u></b></p> <ul style="list-style-type: none"> <li>➤ Customer transaction fees in the case of debit cards</li> <li>➤ Annual card fees in the case of credit cards</li> <li>➤ Interest income if customers exceeded interest free periods on their credit cards</li> </ul>	<p><b><u>Costs</u></b></p> <ul style="list-style-type: none"> <li>➤ Account maintenance</li> <li>➤ Funding cost</li> <li>➤ Processing cost</li> <li>➤ Authorisation cost</li> <li>➤ Default risk</li> <li>➤ Fraud risk, etc.</li> </ul>

### 3. HISTORICAL INTERCHANGE PRICE SETTING PRACTICES

Historically, interchange prices were determined by means of a multilateral construct. The last time this approach was adopted was in 2003 when the Association of Bank Card Issuers and Merchant Acquirers (ABCI) commissioned an independent payments consultancy, Edgar Dunn & Company to conduct an interchange cost study. The study reviewed the following cost components relating to the card payment process:

- Free Funding Period
- Payment Guarantee Costs
  - Credit Write offs;
  - Fraud Losses;

- Authorisations and referrals;
  - Collections;
  - Other risk control costs.
- Processing Costs
- Incoming interchange processing costs;
  - Transaction settlement costs;
  - Charge-backs, re-presentment and document retrieval costs;
  - Charge-backs and disputed transaction losses.

The outcome of the study was used to revise card interchange rates, with one of the rates being set lower than the rate proposed by Edgar Dunn & Company (i.e. 0.55% for debit card transactions instead of the proposed 0.715%) whilst the proposed interchange rates for both hybrid and credit card transactions (1.09% and 1.71%) were implemented.

Since the interchange review was completed in 2003, all subsequent interchange negotiations, such as Mzansi Money Transfer (MMT) and the Early Debit Order (EDO) system have been conducted bilaterally given the competition concerns raised regarding multilateral negotiations.

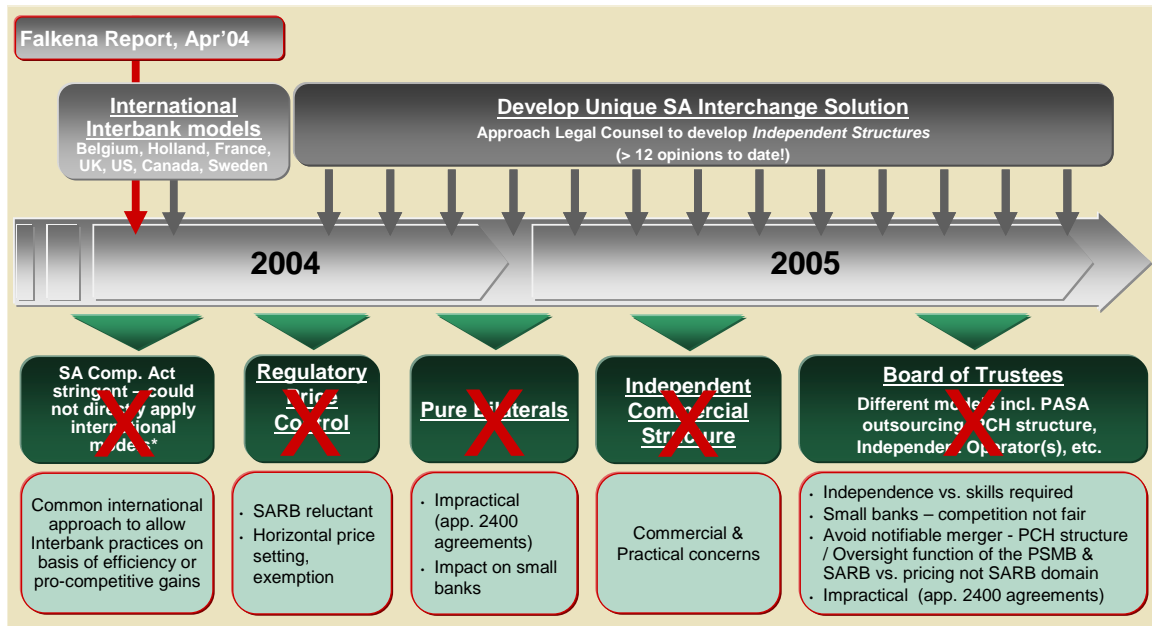
#### 4. INTERCHANGE DETERMINANT MODELS

In response to the comment made in the FEASibility Report that *“It is the understanding in the industry that the Competition Act (s4(1b)) precludes multilateral negotiations (the banks have not sought an exemption)”*<sup>6</sup> it is repeated that the Industry has, over an extended period of time (approximately two and a half years), attempted to identify a suitable as well as an acceptable interchange determinant model.

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<sup>6</sup> FEASibility Report, Page 173, Paragraph 5, Lines 3-5

Options that have been considered during the period of analysis and investigation are graphically illustrated below:



Explanations in terms of the options considered to date as well as the related issues identified are provided below.

#### 4.1 International Models

There are numerous international examples of multilateral price setting which, whilst considered to be horizontal in application, have been found to be the most efficient means to establishing interchange on the basis of efficiency or pro-competitive gains.

In reviewing potential multilateral interchange models, a number of alternative multilateral price setting mechanisms were assessed. The alternative mechanisms considered are indicated below.

##### 4.1.1 The scope of interchange models

Any interchange setting mechanism needs to take cognisance of two key steps:

- Setting the scope of the interchange fee setting process, i.e. what are the underlying principles for the fee, what is it comprised of, to what does it apply, etc.
- Setting the level of the interchange fee. Applying the principles to calculate and agree a value for the interchange fee.

##### 4.1.2 Pure Multilateral Negotiations

The Industry conducts all negotiations on a multilateral basis which involves agreements on pricing principles, cost components, quantum discussions and involves all banks participating in a payment stream in the related negotiations.

### Advantages

- Ability for industry participants to simultaneously put views forward in a single forum.
- If agreement is reached within a multilateral environment it should result in a single pricing methodology for all participants.
- Uniformity of application of principles and quantum of interchange.
- All participants pay one price.
- Since it is easier to implement, frequent reviews will take place, which should take efficiency improvements into account. This could result in lower fees.
- Less onerous, therefore lower cost implications and resource requirements.
- Supports entry by small and new banks, given that an average industry price is set which rewards large banks with economies of scale, without excessively penalizing small volume banks.
- Supports interoperability by ensuring a level playing field for all participants wishing to gain access to the payment system.
- No undue negotiation power of large volume banks.

### Disadvantages

- Potential slow progress. Difficult to reach agreement with all parties operating within the payment system as banks' views and strategies may still be in conflict with one another.
- Majority of banks can be held to ransom by a minority party.
- Restricts the freedom of banks to individually decide their own Interbank pricing policies.
- Possibly raises competition concerns.

#### 4.1.3

### Multilateral Negotiations using multiple third parties

A number of third parties, e.g. the Card Associations (Visa and MasterCard) could each conduct interchange studies on their card related products and another third party conducts an investigation on non-card related payment streams.

### Advantages

- Internationally evidence exists of Card Associations setting interchange rates for the card related payment streams.

- The fact that both the Card Associations would set interchange independently of each other is likely to be deemed to be competitive.

#### Disadvantages

- Regulatory relief may still be required to establish interchange for non-card based products.
- Three interchange studies would need to be conducted, the costs of which would in all likelihood be passed on to customers.
- Depending on the Card Associations' rules, banks may still be required to multilaterally agree on accepting the outcome of the studies and the default interchange rates.
- Competition between the two Associations may result in interchange being driven up rather than down, due to the Associations wanting to incentivise Issuing banks to issue their cards.
- VISA and MasterCard are currently under international legal scrutiny from a competition perspective. There is still a possibility that this solution raises competition concerns.
- There may be complexities around managing three pricing agents.

#### 4.1.4

#### Multilateral Negotiations using a single third party

A single independent third party is appointed to determine interchange on all payment streams.

#### Advantages

- Ensures neutrality as all participants have to abide by the interchange pricing determined by the third party who impartially considers all Industry views and applies international best practices.
- This approach has previously been successfully employed by the Industry.
- Consistent set of pricing principles is used for all payment streams.
- The banks only need to provide input to a single party conducting the study, resulting in limited Industry resources being required.
- A single interchange rate is more practical in its implementation.
- Results in all Industry participants being placed on an equal footing.

#### Disadvantages

- Suitably qualified third parties are limited.
- Possibly raises competition concerns.
- The Industry may require regulatory relief to implement this pricing determinant mechanism.

## 4.2 Regulatory Price Controls

Consideration regarding the involvement of the Regulator (SARB) was given. The concern with this approach was that:

- i) The Regulator indicated its reluctance to become involved in price regulation.

This stance has been confirmed in the SARB's Vision 2010 document which states that<sup>7</sup>:

*“Specific areas that fall outside the oversight domain are payment system competitive aspects, such as pricing and costing to the public”*

and

*“It is, however, important that fair pricing is reflected in the payment system”.*

Unfortunately, “fair pricing” is not defined, nor the practice as to how this pricing should be determined.

- ii) The fact that pricing was set via the Regulator did not remove the concerns regarding the problematic issues of horizontal price setting.

### 4.2.1 International experiences from regulatory interchange reforms

An international example of where the Regulator has conducted interchange reforms is in Australia.

According to a study by DATAMONITOR<sup>8</sup>, the outcome of the reduction in interchange on the consumer seems to have been generally negative, as can be seen from the following quotes:

*“Had the interchange reforms led to price reductions at the check out, consumers would have seen some benefit from the reforms. Price reductions aside, the impacts of the reforms on consumers have otherwise mostly been negative.”*

*“Yet, while the Reserve Bank predicted lower prices at the check out as a result of the credit card interchange reforms, as yet there is no evidence that prices have actually been lowered.”*

## 4.3 Bilateral Negotiations

From a practical and logistical perspective, local bilateral negotiations present a challenge with over 2 400 agreements required to be negotiated across all the payment streams. This could result in innovation being stifled on the one hand and the re-alignment of existing interchange fees being prevented on the other.

The number of bilateral agreements specified above has been calculated by multiplying the number of Issuers and Acquirers within each payment stream with

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<sup>7</sup> SARB: National Payment System Framework and Strategy document: Vision 2010, P.12, Section 3.4.12

<sup>8</sup> DATAMONITOR: Interchange in Australia – Global Implications, p.32, Par.5 – 7 and p.33, Par 2, Line 1-3

one another, multiplying this with the number of transactions in each payment stream and finally multiplying this with the number of device types (e.g. ATMs and mini-ATMs) in each payment stream and then adding up the number of negotiations in the different payment streams.

In addition to the logistical challenge as outlined above, the following advantages and disadvantages relating to bilateral negotiations were identified:

#### Advantages

- Satisfies the requirements of the Competition Act 4 (1)b.

#### Disadvantages

- Large number of agreements. Need to negotiate beyond fee, but also principles and cost components.
- May penalise small banks given the negotiating power of the larger banks.
- Creates a barrier to entry for new as well as low volume banks, as these players cannot merely accept a default interchange rate when joining a payment stream. They need to bilaterally negotiate interchange with each of the existing payment stream participants. In addition, low volume banks are disadvantaged by the negotiation power of large volume banks.
- Interoperability may be compromised as a result of “unlevelled playing fields”.
- May result in different pricing principles and models within one payment stream, which will require complex management systems.
- Hinders innovation (whilst the technology innovation can be achieved co-operatively, the commercial arrangements are required to be achieved bilaterally).
- Majority of banks can be held to ransom by a minority party.
- Onerous implications on costs and resource requirements due to the number of negotiations required.
- If the parties are unable to reach agreement, arbitration may be required to break the deadlock. With no standard principles in place, this task would be exhaustive.

#### 4.3.1 Recent Industry experiences from bilateral negotiations

The most recent set of bilateral negotiations was to establish interchange rates for the EDO (Early Debit Order) payment system.

EDO is an industry innovation developed due to a legislative requirement in the new National Credit Act and the Consequential Amendments to the NPS Act. The agreement to implement the solution was, however, concluded without the commercials (i.e. interchange) of the solution being resolved. The following learnings resulted from the bilateral negotiation process:

#### Lack of agreed principles

According to feedback received from participants, the Industry had widely varying views on the pricing principles required for EDO interchange. In instances where banks had similar views on the principles, there were initially large discrepancies as to the level of interchange that should apply. All involved in the process indicated that it was exceptionally frustrating, unproductive and complex, resulting in a multiplicity of interchange models and rates.

#### The challenge of multiple individual negotiations

Given the varying views as to the interchange pricing structure (principles e.g. direction of interchange flow and quantum) as well as the large number of agreements that had to be concluded (at least 144 agreements) the Industry made limited progress with the negotiations for an extended period of time.

In addition, the number of bilateral negotiations indicated above does not take into account that there are multiple transaction types in each of the payment streams for which fees needed to be negotiated, e.g. in AEDO there are three transaction types (card and PIN authentication, successful transactions and unsuccessful transactions) while in NAEDO there are two transaction types (successful and unsuccessful transactions).

#### Unresolved negotiations impacted the conclusion of end-user pricing

As interchange is one of the cost components of the EDO system, Acquiring banks needed to have agreed interchange rates with all Issuers supporting these payment streams before they could calculate and communicate EDO pricing to their customers.

Even though the majority of EDO agreements were concluded by the launch date of 18 September 2006, a number of agreements remained outstanding between the major banks. This resulted in these banks not being able to finalise and communicate EDO end-user pricing to their customers.

#### **4.4 Independent Commercial Structure**

Consideration was also given to the establishment of an independent body for the setting of interchange. This body would own the interchange rights and associated intellectual property housed in the banks and the various Interbank bodies, thus enabling it to set interchange between the acquirers and the issuers. To achieve this, an independent commercial structure would be required to “purchase” the intellectual property in order for it to establish the commercial justification to set interchange.

The need to “purchase” the intellectual property by this independent body was considered to be problematic from a commercial and practical perspective.

#### **4.5 Board of Trustees**

The establishment of an Independent Board of Trustees was investigated, utilising the existing Payment Clearing House Participant Group or PCH PG structures found within the PASA environment. The following areas of concern resulted in this being an impractical option:

- i) The structure would again fall within the domain of the Regulator.
- ii) The practical application of the solution would be a series of bilateral arrangements, which would again require a large volume of agreements to be negotiated.
- iii) Smaller banks may again be penalised given the bilateral environment.
- iv) Insufficient additional specialist resources in the country to establish this body, in addition to the resource requirements of the banks themselves.

Other Board of Trustee models which were considered and eliminated included a PCH Outsourcing model as well as an Independent Operator model.

## **5. CONCLUSION**

In an attempt to identify a suitable interchange determinant model, the Industry has over an extended period of time considered a number of potential interchange determinant models. Each of these models has different advantages and disadvantages, both from a competition as well as a practical level, leaving the Industry with the challenge of agreeing on the most suitable / preferable model and initiating the implementation thereof. The Banking Association welcomes further discussion with the Competition Commission on this topic.