

**The Standard Bank of South Africa Limited  
("Standard Bank")**

**Voluntary submission to the Competition Commission Enquiry  
into Competition in Banking**

**1. INTRODUCTION**

- 1.1 A formal enquiry into competition in banking is welcomed by Standard Bank.
  - 1.1.1 A structured and informed discussion around the issues regarding competition in banking will be helpful to all stakeholders.
  - 1.1.2 The informal debate on these issues has created misconceptions concerning the South African banking industry. The enquiry affords us the opportunity to shed light on these issues insofar as they pertain to Standard Bank.
  - 1.1.3 We believe that any enhancements to competition in our industry will be to the advantage of all Standard Bank's stakeholders.
- 1.2 We hope to demonstrate that:
  - 1.2.1 Standard Bank is concerned about the issues that have been raised in respect of competition in the banking industry.
  - 1.2.2 Many of the issues are complex, and in some instances, debate is required to understand the most pro-competitive or socially optimal solution. We present our proposals with respect to these issues in expectation of such debate.
  - 1.2.3 We are supporters of the advocacy role that the competition authorities can play, and will work with the Panel in achieving the most pro-competitive and socially beneficial outcome.
- 1.3 In this submission, we address the key areas of concern (as expressed in the Panel's terms of reference) that have been raised with regard to competition in South African banking:
  - 1.3.1 Customer charges in retail transactional banking;
  - 1.3.2 Access to the National Payment System; and
  - 1.3.3 Payment system issues.
- 1.4 Various investigations have already been conducted into competition in South African banking. In response to an invitation from the Panel we attach as Appendices 1 and 2 our commentaries on both the "Falkena Report" and the "Feasibility Study", being the two most prominent public reports on this matter.
- 1.5 A third independent report (the "Monitor Report") was commissioned by the Banking Association, and became available in its final form less than a week before the deadline for this submission. Because members of the Banking Association supplied confidential data to the Monitor Group to enable its analysis subject to such confidentiality being maintained, the Monitor Report will be made available to the Panel subject to the confidentiality protections of the Competition Act. Standard Bank regards key methodologies used and conclusions reached in the Monitor report as flawed and will provide the panel with a confidential submission in this regard.

**Glossary :**

<b>Abbreviation</b>	<b>Definition</b>
AEDO	Authenticated Early Debit Order
ATM	Automated Teller Machine
BCP	Business Continuity Planning
BSP	Beneficiary Service Provider
CCA	Consumer Credit Association
DRP	Disaster Recovery Program
EFT	Electronic Funds Transfer
FAIS	Financial Advisory and Intermediary Services
FATF	Financial Action Task Force
FICA	Financial Intelligence Centre Act
FRA	Furniture Retailers' Association
LOA	Life Officers' Association
LSM	Living Standards Measure
MFSC	Micro Finance South Africa
MMT	Mobile Money Transfer
NAEDO	Non-Authenticated Early Debit Order
NCA	The National Credit Act, no. 34 of 2005
NII	Net Interest Income
NIR	Non Interest Revenue
NPS	National Payment System
NPSD	National Payment System Department
PASA	Payments Association of South Africa
PCH	Payment Clearing House
PCH PGS	Payment Clearing House Participant Groups
POR	Point of Representation
POS	Point of Sale
PPP	Purchasing Power Parity
PSMB	Payment System Management Body
PSP	Payment Service Provider
PSSF	Payment System Stakeholders Forum
SAMOS	South African Multiple Options System
SARB	South African Reserve Bank

<b>Term</b>	<b>Definition</b>
Acquirer	The acquirer is the bank that accepts a payment transaction from the end-user for a particular payment stream. For four-party card, the acquirer is the merchant's bank, and typically owns the POS infrastructure. For ATM, the acquirer is the bank that owns the ATM that is used
Activity based costing	A system for assigning costs to products based on the activities they require
Ad valorem fee	A fee where the quantum of the fee varies according the value of the transaction, as opposed to a flat fee

AEDO	An authenticated early debit order payment instruction or AEDO payment instruction means a payment instruction issued by the cardholder which payment instruction is to be processed at a future date
Agency arrangements	An agency service arrangement means an agreement between an agent bank and a principle bank where a service is provided by the agent bank to the principal bank, under mandate and as agent of such principal bank
Bilateral	This model provides for the agreement of interbank pricing principles, cost components and fees, on a bi-lateral basis, between issuers and acquirers and thus there could be price differentiation between the participating banks
Bundled pricing option	A pricing option where a number of transactions are provided at a fixed monthly fee
Card association	The institution that defines the standards, rules, specifications and access policies of the card scheme
Cardholder fee	The once-off or recurring fee (or set of fees) paid by a cardholder for the ownership and/or use of a payment card, as well as for ancillary services.
Carriage fee	Carriage is the interbank charge levied payable from issuer to acquirer in compensation of provision of infrastructure to enable the interoperable transaction to occur
Clearing	The process of transmitting, reconciling and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possible including the netting of instructions and the establishment of final positions for settlement.
Competition Act	The Competition Act No. 89 of 1998 (as amended)
Convenience segment	Standard Bank's segment for those earning under R60 000 per annum
Debit order	A debit order or EFT debit payment instruction means an electronic payment instruction to an the issuing bank to make a payment, issued by the acquiring bank or by its customer on behalf and ostensibly under the mandate of the customer of the issuing bank
Edgar, Dunn & Co.	An independent international financial services and payments consultancy
Electronic banking infrastructure	The infrastructure for transferring funds electronically
End user prices	The price the final consumer pays
Flat fee	A fee that is charged, irrespective of the amount of the transaction
Float	Money held due to a delay in processing and not offering same day value
Four-party card system	A card payment system where the issuer and the acquirer are not necessarily the same bank, leading to four distinct parties to the transaction: the merchant, the acquirer, the issuer, and the card-holder
Full absorption costing model	A method of costing whereby all fixed and variable costs (both production and overhead costs) are allocated to products
Genesis	Genesis Analytics (Pty) Ltd

Hybrid cards	A card that is linked to a primary deposit access bank account such as a cheque account that requires signature authentication
Interchange	Interchange is the interbank charge levied within four-party payment mechanisms from the acquirer to the issuer in compensation for enabling the interoperable transaction to occur
Interoperability	A situation where common rules, standards and regulatory oversight exists within and across all payment streams, payment systems and participants within the National Payment System (NPS) so as to ensure that consumers are able to transact at multiple points and that all stakeholders have the ability to connect and participate in the NPS
Issuer	The issuer is the bank to whom the user of a particular payment stream belongs. The issuer provides it's customer with a range of payment mechanisms, these include cash, card (debit, credit and cheque), cheque, etc. For four-party card, the issuer is the bank that issued the card to the customer. For ATM, the issuer is the bank to which the ATM user belongs
LSM (Living Standards Measure)	A method of segmenting the South African consumer market
Merchant	The entity that accepts payments by means of cards
Merchant fee	The fee paid by the merchant to the acquirer in a card payment system
Mini ATM	A mini-ATM or non-ATM (NAD) device is a self-service cashless ATM device (which looks similar to a Point of Sale device) that is supported by merchant based cash floats, and performs the functions of a normal ATM (cash withdrawal and balance enquiry) by issuing a receipt / script which the merchant honours by paying cash to the customer
MMT (Mobile Money Transfer)	A money transfer product whereby customers can transfer funds locally
Money transfers	A money transfer means an instruction to a participant to transfer funds or make a payment
Multilateral	This model provides for the agreement of Interbank pricing principles, cost components and fees, on a multi-lateral basis (at an industry level), between issuers and acquirers and thus there is no price differentiation between the participating banks
Mzansi Money Transfer	A facility whereby customers are able to transfer money to their families or other individuals and neither party is required to have a bank account.
NAEDO	A non-authenticated early debit order payment instruction or NAEDO payment instruction means a payment instruction authorised by the payer to be issued on his instruction for payment on a future date or dates
National Payment System	The entire matrix of institutional and infrastructure arrangements and processes for initiating and transferring monetary claims in the form of commercial bank and central banks liabilities
Non-interest revenue (NIR)	Fee and commission income. Income earned other than from both debit and credit balances.
Overdraft	A loan made to a customer with a cheque/ current account

Payment Clearing House (PCH)	PCH means the arrangement governing the clearing of the payment instructions between the parties, which is constituted by this bilateral contractual relationship (not being a partnership) and includes all such arrangements between each party and each other participant in accordance with the terms hereof
Payments Association of South Africa (PASA)	PASA is appointed by the Reserve Bank as the Payments System Management Body as contemplated in the NPS Act 78 of 1998 as amended (Act 22 of 2004), with the object of organising, managing and regulating the participation of its members in the payment system in order to provide the South African banking community with safe and effective facilities to exchange payments, protect the integrity of the payment system, manage the clearing and settlement risks in the payment system, facilitate access of participants and prospective participants to the payment system on a fair and equitable basis, facilitate communication between participants and enable proper understanding of the system and the rules applicable to it.
Personal retail banking	Banking services for individuals
Point of Representation	The point where customers can access bank services through a branch or ATM
POS (Point of Sale)	The point where consumers can use plastic cards for payment transactions at a merchant outlet (often a payment terminal)
Price-differentiation	A situation where the merchant is permitted to charge different prices for the same good depending on the payment instrument presented by the customer. Price-differentiation is often referred to as “surcharging”.
Rebate option	The rebate option is offered on Standard Bank current accounts whereby transaction fees are rebated (i.e. not payable) if an amount of above a specific balance is held in the account.
Same day value	Where a customer earns interest on funds deposited from the date of deposit
Sort-at-source / Multiple Acquiring	Delivery of payment instructions directly to an issuing participant instead of via an acquiring participant who would then channel the transactions via the Payment Clearing House Operator
Surcharging	The term “surcharging” is typically used interchangeably with “price differentiation”. In this submission, we use the term “surcharging” when referring to a type of ATM payment system where the acquirer can charge the card-holder an discretionary fee per ATM transaction.
Switch	The ability to move from one service provide to another
Systemic risk	The risk of failure of one or more participants within a National Payment System (NPS) to meet their settlement obligations (i.e. their obligation resulting from the clearing of payment instructions) when due. Such failure may occur as a result of deterioration over a period or time and/or a sudden shock that may cause failure of a participant which would destabilise the economy

Three-party ATM system	An ATM payment system where the issuer and the acquirer are not necessarily the same bank, leading to three distinct parties to the transaction: the acquirer, the issuer and the card-holder
Unbundled pricing option	A pricing option where customers are charged on a per transaction basis

## 2. **CHAPTER 1 - THE STRUCTURE AND LEVEL OF PRICING**

### 2.1 **Introduction**

2.1.1 One purpose of the Competition Act is to provide consumers with competitive prices and product choices; and to expand opportunities for South African participation in world markets and recognise foreign competition in the Republic.<sup>1</sup> In measuring our competitiveness against the objectives of the Competition Act we conclude that our end user prices in personal retail banking are competitive in a market that is characterised by a number of both bank and non-bank participants (national and foreign) offering a wide variety of products.

2.1.2 While we believe we are neither dominant nor exercising market power as defined in the Competition Act, and while we can explain how we set our fees, we are open to discussion regarding any concerns around fees.

### 2.2 **Challenges facing Standard Bank operating in South Africa**

2.2.1 For Standard Bank, there are a range of challenges in operating in our home country while ensuring that we engage as a responsible corporate citizen and contribute to South Africa's growth. Key among these challenges is the need to extend the reach of financial services and deal appropriately with the complexities that arise in this regard including:

2.2.1.1 The need to generate income from transaction fees and other forms of non-interest income, given the low level of interest income earned from our broad base of low income customers who maintain low account balances. This profile is very different from customers in, for example, the European Union, where the generally wealthier population maintains higher account balances that contribute a greater proportion of revenue to banks through interest income.

2.2.1.2 Our geographic disparities and lack of infrastructure. For example, it is costly to provide services to the rural poor where the populations are widely dispersed, there is limited telephony and electrical infrastructure and enhanced cash handling and security is required.

2.2.1.3 The low levels of financial literacy amongst many customers can manifest in inefficient and/or wasteful banking practices.

2.2.1.4 The difficulties arising from catering to the needs of many people not having bank accounts. For example, Mzansi Money Transfer was introduced in 2005 to enable such customers to transfer money to their families or other individuals with neither party being required to have a bank account.

2.2.1.5 Endemic levels of crime result in higher operating and security costs. For example, in one month this year we had 1500 ATM's vandalized in Gauteng alone (with some of them being blown up with commercial explosives).

### 2.3 **Standard Bank's pricing is not costly by appropriate international standards**

In measuring whether South African bank charges are comparatively excessive by international standards, we use two approaches. The first is an international comparison against appropriate countries which also have developing or emerging markets similar to

<sup>1</sup> Competition Act No. 89 of 1998 (as amended), section 2.

ours; the second is the Finmark Trust benchmark which determines whether our bank charges are more than 2% of income.

### 2.3.1 *Benchmarking against appropriate countries*

2.3.1.1 When benchmarking against banking charges in other countries it is essential to first determine which are the appropriate countries against which to benchmark. Our view is that it is not appropriate to benchmark against developed countries (including Europe) as they typically have a very different banking model to that of South Africa, given that they tend to have many more affluent customers with significantly bigger average bank balances (debit and credit) and significantly higher transaction volumes, that their populations tend to be more geographically concentrated and that their proportionately higher interest revenues leave them less reliant upon transactional charges.

2.3.1.2 It should also be borne in mind that it is difficult to draw comparisons between the charges of the banks locally, let alone internationally, as has been reported in the media in recent times. The independent authors of the Finweek study of 2006 confirm this.

2.3.1.3 The fact that South Africa may be the first country in the world to give same day value, and thus not have a float to cross subsidise transactional charges, could render a comparison between us and other countries of questionable relevance.

2.3.1.4 To the extent that comparisons have been done, the Finmark Study contains useful insights.

#### 2.3.1.5 *The Finmark Study*

The Finmark Study conducted an inter-country survey of the relative costs of bank accounts (including Brazil, India, Kenya, Malaysia, Mexico, Nigeria and South Africa) on behalf of Finmark Trust. It found that:

2.3.1.5.1 Brazil and South Africa stand out as offering the best customer value, if the assumption is correct that the more developed the electronic banking infrastructure, the greater the functionality experienced by customers.

2.3.1.5.2 South Africa's transactional banking environment compares well to the other countries selected for this study.

2.3.1.5.3 Bank pricing models differ between countries. It is misleading to compare fees per transaction without a consideration of the overall economics of the applicable product including minimum balances, overdraft penalty fees or monthly fixed fees. South Africa's full activity pricing model results in a higher level of transactions fees when compared to other countries.<sup>2</sup>

2.3.1.5.4 The South African banking model has low barriers to entry compared with other countries in the survey.

2.3.1.5.5 The measures of physical access indicated that South Africa's density (in relation to geographic area and adult population) of points of representation was second only to Brazil amongst the sample countries.

### 2.3.2 *Banking fees as a percentage of income*

2.3.2.1 The Finmark Trust reliably proposes a test to determine whether banking fees are too costly as being whether banking charges are more or less than 2% of income. Applying this test to its customer base, Standard Bank is satisfied that its fees are below that measure.

2.3.2.2 Our internal research concludes that, on average, Mzansi, Eplan and Current Account customers pay less than 2% of their income towards transactional revenue to Standard Bank. The median for our Mzansi customers is

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<sup>2</sup> However, these fees are partially offset by low minimum balance requirements, a lower than average monthly fee and lower overdraft fees.

approximately 0.7% while the median is approximately 1.2% for Eplan customers.

#### 2.4 **Standard Bank is neither dominant nor has market power**

The Competition Act prohibits dominant firms from engaging in a range of behaviours, including charging excessive prices.<sup>3</sup> We are satisfied that we are not dominant and that our prices are not excessive for the following reasons:

##### 2.4.1 *We are not statutorily dominant*

We commissioned independent research by Genesis Analytics to assess our dominance and role in key retail banking markets. Genesis Analytics found that Standard Bank is not dominant as defined in the Competition Act. The Genesis Analytics research report can be separately submitted to the Panel under a claim of confidentiality. Their analysis of market shares shows that we have under 35% market share in each of the personal banking markets<sup>4</sup>.

##### 2.4.2 *We operate in a highly competitive market with low barriers to entry and exit*

We believe that we operate in a highly competitive and dynamic environment. As will be seen from the table below, there is ease of entry and exit for new competitors entering or exiting the market, and offering a range of products, including new and different products. (Note that the table below is not exhaustive, but merely illustrative of some new products and entry and exit in the market).

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<sup>3</sup> Competition Act No. 89 of 1998 (as amended), section 8.

<sup>4</sup> In the case of the credit card market three out of four data sources suggested a market share of less than 35% - with a further analysis of the competitive dynamics in the market refuting the possibility of market power on the part of Standard Bank.

**Table: Some competitor activity and market structure. (Note this is merely illustrative and excludes a number of competitors and new products, as well as new products introduced by ABSA, Standard, Nedbank & FNB)**

2000	2001	2002	2003	2004	2005	2006 <sup>5</sup>	Anticipated for the future
<ul style="list-style-type: none"> <li>• Pick 'n Pay Go Banking launched</li> <li>• Rennie's Bank granted banking licence</li> <li>• ATM Solutions enters ATM market</li> </ul>	<ul style="list-style-type: none"> <li>• icanOnline launches</li> <li>• Capitec established as microlender</li> <li>• Woolworths credit card launched</li> <li>• Spar credit card launched</li> <li>• Regal Treasury Bank collapses</li> <li>• 20twenty launched</li> </ul>	<ul style="list-style-type: none"> <li>• Saambou &amp; 20twenty placed in curatorship</li> <li>• Brait, CorpCapital, Cadiz Investment Bank &amp; African Merchant Bank return banking licences</li> <li>• FNB and Relyant form Newco (finance company)</li> </ul>	<ul style="list-style-type: none"> <li>• BlueBean sold to Barclays (repurchased 2005)</li> <li>• Standard Chartered buys 20twenty</li> <li>• MTN MobileCredit (PoS on cellphone) launched</li> </ul>	<ul style="list-style-type: none"> <li>• 20twenty re-opens</li> <li>• Teba Bank A-Card (UIF beneficiary debit card) launched</li> <li>• WesBank Islamic Finance launched</li> <li>• Discovery credit card launched</li> <li>• Mzansi launched</li> <li>• Tiger Wheels private label credit card launched</li> <li>• 20twenty home loans launched</li> <li>• Wizzit Maestro-branded debit card &amp; cellphone banking launch</li> </ul>	<ul style="list-style-type: none"> <li>• icanOnline (Nedbank) closed down</li> <li>• SA Youth Card launched</li> <li>• SHESHA taxi recharge card launched</li> <li>• JD Group &amp; Absa JV form Maravedi in-store credit &amp; financial services</li> <li>• Teba Bank 'Grow with us credit' loan launched</li> <li>• DaimlerChrysler Dream Drive (VAF Stokvel model) launched</li> <li>• ABN Amro plans to beef up SA operations</li> <li>• EasyPay brand re-launch</li> <li>• Edgars credit card launched</li> <li>• McCarthy Student Wheels financing launched</li> <li>• MTN Banking launched</li> <li>• Pick 'n Pay Go Banking MasterCard credit cards launched</li> <li>• Woolworths re-launches store card, cash card &amp; Visa credit card</li> <li>• Vodacom credit card launched.</li> <li>• MTN credit card launched</li> </ul>	<ul style="list-style-type: none"> <li>• 20twenty closed down</li> <li>• 20twenty customers transferred to Go Banking or bank of their choice'</li> <li>• Shoprite Checkers money transfers</li> <li>• Virgin Money credit card launched</li> <li>• Postbank pilots Internet banking</li> <li>• Capitec pilots Internet banking in 5 languages</li> <li>• Pep and Hollard offer insurance products</li> <li>• SAA Voyager credit card launched</li> <li>• Kulula.com credit card launched</li> </ul>	<ul style="list-style-type: none"> <li>• Mercantile credit card</li> <li>• Foschini's home loans, credit card &amp; VAF financing</li> <li>• PSG new niche bank launch</li> <li>• Virgin Money home loans</li> <li>• Sasfin home loans</li> <li>• Score &amp; Boxer supermarkets offering financial services (Nedbank)</li> <li>• Foreign bank entrants: ICICI, FirstBank of Nigeria</li> <li>• African Bank credit card</li> </ul>

Compiled from Standard Bank research, 2006

<sup>5</sup> Regarding SBSA's JV with Edcon, Edcon has been quoted in the press as saying that they had shopped around with all the banks to get the best deals for their customers

### 2.4.3 *Switching is easy and inexpensive*

2.4.3.1 The Genesis Analytics research report confirms that it is easy and inexpensive for banking customers to switch their accounts from one bank to another. Increased transparency on banking charges has further facilitated the ability of customers to switch. Typically a necessary change in debit order authorisations is one of the deterrents to switching and therefore, similarly to our competitors, we offer a service where we contact the beneficiaries of potential customers with regards to debit orders to arrange for the debit order to be switched to a new Standard Bank account. Because our competitors offer a similar service we are constantly vulnerable to losing our customers to competitors.

2.4.3.2 It should also be noted that pricing is only one element on which banks compete and customers frequently consider service, convenience, brand and reputation as important factors when choosing a bank. Banks thus not only compete on pricing but also compete with each other on service, user value, location of ATM's and branches, product innovation, branding and reputation.

### 2.4.4 *We are transparent*

The Competition Act gives the Competition Commission the responsibility to implement measures to increase market transparency. We have tried to ensure that our pricing is simple and transparent; and that we communicate, educate and advise on it appropriately. This has been pursued, for example, in:

#### 2.4.4.1 *Price structuring*

We maintain, as far as possible, a flat fee structure on convenience segment accounts. Thus, for example, Mzansi account holders pay R4.05 and Eplan account holders pay R4.90 for withdrawing cash. There is no ad valorem component to this fee, as there is with current account holders.

#### 2.4.4.2 *Aligning charges*

We have unbundled pricing options for all our products. At the low-income end of the market we only offer unbundled pricing options. Bundled (a number of transactions for a fixed monthly fee) and rebate options (fees are refunded provided a minimum monthly balance is held) are created out of customer demand for a single flat fee, better value. No customer is forced onto a bundled option.

We promote bundled pricing where appropriate and allow migration from unbundled to bundled pricing.

#### 2.4.4.3 *Annual pricing changes*

In order to minimise confusion when prices change we have a principle of adjusting our fees only once a year in January of each year. Pricing once a year gives the customer the opportunity of budgeting for the year.

We also communicate our annual price increases extensively. This includes a media and analyst briefing in advance and the placing of "awareness" advertisements in the press and on our ATM's informing customers that pricing brochures are available at our branches.

#### 2.4.4.4 *Direct communication with customers*

Because current account customers have the choice of three pricing options (Pay as you Transact: ie unbundled, Bundled or Rebate) we send a pricing letter detailing these options to customers during November of each year. In that letter we confirm the pricing option that the customer is currently using. In addition we quote the revised prices for all three options, which gives the customer the choice to change to another current account option if so desired.

Our branch and call centre staff are trained to explain fees to customers when opening an account and in response to queries. To aid staff, we conduct an annual pricing road show, prepare a pricing training video and provide pricing easy aids and information on the intranet so that staff are able to assist customers on pricing queries. (See for example Appendixes 3 and 4 in this regard)

Our bank statements generally contain details of pricing of the respective transactions.

#### 2.4.5 *Other forms of communication*

2.4.5.1 We produce and make readily available clear and concise pricing brochures containing all of our charges. Brochures also present frequently asked questions and provide customers with advice on how to minimise bank charges.

2.4.5.2 Where appropriate, for example EPlan and Society Scheme, Standard Bank publishes multiple language pricing brochures in five languages in order to allow customers to read pricing and product information in a language of their choice.

2.4.5.3 We have categorised our pricing brochures to ensure greater clarity for consumers.

2.4.5.4 In order to aid cross bank comparisons on our EPlan product, we have enhanced our brochures to show the actual fees on say R100, R200 or R500 transactions for the most commonly used transactions.

2.4.5.5 Standard Bank pricing appears on our website, which also contains a “pricing calculator”. Customers can capture transactions/details pertaining to their specific usage profile. The tool then calculates the respective monthly fee for a range of product and pricing options, enabling the customer to choose the most appropriate pricing offered.

2.4.5.6 We have run education articles and cartoon strips in major newspapers.

2.4.5.7 We actively participate in Radio Waya Waya which was a soap opera story line with a financial service education focus.

2.4.5.8 We have finance financial literacy projects to schools which have produced 2.2 million learner guides and over 14,000 schools benefited from these including workbooks, posters and training videos.

2.4.5.9 We have a dedicated pricing line in our call centre.

#### 2.4.6 *Conclusion on transparency*

Our view that our customer pricing is transparent is corroborated by Finance Week's experience of Standard Bank in an independent “ghost” study of the four major banks in August 2006. It concluded that:

“the information on the internet and at branches was easily available and the best communicated of the Big Four Banks. .... the fees relayed by the branches didn't differ from the numbers provided by pricing specialists at Standard Bank's head office”.<sup>6</sup>

#### 2.4.7 *There is a good deal of innovation at Standard Bank*

In order to keep customers and grow our customer base, we constantly endeavour to develop new products and review our pricing. While the issue of pricing is discussed in the next section, the following examples point to how Standard Bank has extended itself and innovated to meet the needs of the low income market segment and bank the un and under-banked:

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<sup>6</sup> Finweek, 17 August 2006, pg 14.

- 2.4.7.1 Standard Bank launched EBank to attract previously unbanked individuals. We later rebranded EBank as AutoBank E. Until 2004 most of Standard Bank's convenience customers - those earning R0 – R5 000 per month - were served almost exclusively by AutoBank Es and experienced a limited product and service offering. In 2004 we decided to extend our range of services to these customers.
- 2.4.7.2 Since the Introduction of the Standard Bank Mzansi Blue account in October 2004, we have acquired some 387,000<sup>7</sup> clients. The Mzansi Blue account has been developed specifically for low income clients: there are no monthly administration fees and the average fee per month for our clients is R9.28 (including VAT and penalty fees). This, for the average Mzansi Blue account holder is a good deal less than the 2% of monthly income set as the benchmark by Finmark Trust.
- 2.4.7.3 During 2005 Standard Bank commenced a number of initiatives to ensure effective physical access, and in the process improved our distribution coverage for LSM 1-5 (the low income segment) customers significantly. The areas targeted for increased representation were prioritised according to population statistics, potential growth and defined nodes.
- 2.4.7.4 From the 32 places identified as areas lacking access by the Financial Sector Charter Council, Standard Bank was first to act and deployed 28 Points of Representation (PORs) within the first 6 months of 2005. These PORs are spread across the nine provinces in areas such as Setlagole and Tlhabane in the North West, Motherwell and Dimbaza in the Eastern Cape, Seshego and Dzanani (ex Makhado) in Limpopo and Izingolweni and Madadeni in KwaZulu Natal.
- 2.4.7.5 Standard Bank developed the 'bank in a box' concept. A point of representation (POR) is built off-site and delivered fully functional within 30 days of ordering. To date 'banks in a box' have been placed in townships and deep rural areas. In this way Standard Bank has attempted to use technology in new and innovative ways to enhance access to banking services, specifically for the poor.
- 2.4.7.6 We have launched a cell phone banking initiative in partnership with MTN. This has increased access for customers who possess a mobile phone.
- 2.4.7.7 Our joint venture with Edcon provides new opportunities for LSMs 1-5 with store cards to migrate to banking products.
- 2.4.7.8 We developed and launched PureSave - a low cost savings vehicle for the low income markets. Essentially, fees are structured in such a manner as to attract deposits (including cash deposits, into the account) and encourage savings. Average monthly fees for PureSave are less than R10 and reasonable interest rates are paid.
- 2.4.7.9 Mobile Money transfer (MMT) and MoneyGram are money transfer products where consumers can transfer funds locally and across borders without having to have a bank account. For example, a customer can go to a Standard Bank branch and deposit cash (even though he does not have an account there) and a beneficiary can collect the funds at another branch of Standard Bank even if he/ she does not have an account there. All that is required is an Identification Document and a reference number to collect the funds. AEDOS and NAEDOS will further facilitate fair collection in the micro lending space.
- 2.4.7.10 The financial needs of our customers are diverse, and in response we deliver a wide array of products, services and functionality to different customer segments. This invariably leads to a complex set of price structures.

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<sup>7</sup> August 2006

## 2.5 **Standard Bank prices**

### 2.5.1 *Background to pricing*

A number of features determine how Standard Bank sets prices. These include :

#### 2.5.1.1 *Reliance on fee income largely due to low-balance accounts*

2.5.1.1.1 The majority of our customers - well over 4 million - are low income earners. (See diagram below. Note that our convenience banking serves low income clients<sup>8</sup>, our affinity banking caters for middle income clients<sup>9</sup> and private banking serves upper income clients). The products currently serving the LSM 1 – 5 market are Mzansi Blue, EPlan, and Mzansi Money Transfer.<sup>10</sup>

#### 2.5.1.1.2

**CONFIDENTIAL GRAPH DELETED**

In a perfectly competitive market, where firms only seek to maximise profit, we would not naturally pursue the convenience segment.

**CONFIDENTIAL TABLE AND  
PARAGRAPH DELETED**

As shown in the table above, Standard Bank's business model is to derive income from multiple sources – which includes both interest revenue and

<sup>8</sup> Convenience segment customers earn less than R60 000 per annum.

<sup>9</sup> Affinity segment customers earn between R60 000 and R504 000 per annum.

<sup>10</sup> The **Mzansi BlueAccount** is a simple, affordable, standardised banking account, catering for individuals with low incomes, as well as irregular and seasonal incomes, and even the unemployed.

The benefit of **MMT** is that it offers a safe, simple and easy way of moving money to individuals with or without bank accounts. It will give the bank an opportunity to sell the Mzansi Blue / E Plan Account to customers who do not hold bank accounts and who want to transact regularly.

**E Plan** is a transaction and savings product for customers who require a basic bank account, with extended self-service and funds transfer capabilities.

fees. To this extent, we differ in our business model from banks in Europe, the UK and the US which all rely to a much greater extent on generating income from interest. There are numerous reasons for this:

- 2.5.1.1.3 Many international banks have longer clearing periods and therefore earn interest on the “float” as opposed to South African banks that provide same day value – in other words, we pay interest on a positive balance, even if the deposit has not yet been cleared.
- 2.5.1.2 The Usury Act limits the rate of interest that South African banks can charge to lending customers which thereby limits the banks’ ability to optimise interest income on lending balances.
- 2.5.1.3 Penalty fees are usually far higher in the developed world. For example, an unpaid item in the UK could cost the customer up to 30 pounds or R430 as compared to the R31,50 to R99,00 (depending upon the applicable service or product) charged by Standard Bank) than in South Africa.
- 2.5.1.4 *Recovering the costs of all services rendered by charging for only a few*
- 2.5.1.4.1 Standard Bank does not charge directly for all the costs we incur in opening, running and closing an account. For example, we do not charge for opening an account. If we did so we would severely restrict access to the banking system for low income earners. We also do not charge for dealing with enquiries and closing the account. These typically require human intervention and therefore are, in many cases, the heaviest costs that we incur relative to an account, and these costs are covered by fees in respect of other services and transactions provided to the account holder.
- 2.5.1.4.2 The importance of being able to open and close accounts with ease is essential in South Africa, given our high levels of unemployment, and temporary and contract work.
- 2.5.1.5 *No determination of the cost of individual transactions*

Even though we engage in limited activity based costing, we do not apportion all costs across each and every product (of which there are over 1000), each and every transaction type (over 40) and each and every channel utilised (around 10). Therefore we do not record costs down to an individual transaction level. To do so would be an investment decision for which the business case in terms of value to our customers and to our shareholders is not sufficient. It would be misleading to place undue reliance on costing information for pricing decisions. Furthermore, the vast majority of our costs (our capital, our computer systems, our branches and ATM networks, our staff in the distribution network and our head-office expenses) are fixed.
- 2.5.1.6 *Bundling and comparative prices*

Standard Bank offers both bundled and unbundled offerings. One way our customers can determine whether the bundled or unbundled option offers better value is by using the pricing calculator on our website. The pricing calculator identifies what a customer would pay if he takes the bundled option or the unbundled option. Most of our customers in the current account space have chosen bundled options as these are easy to budget for, transparent, easy to operate, and offer good value. The high take up of bundled options by our customers makes us significantly different to our competitor banks which predominantly provide unbundled options.
- 2.5.2 *Principles and factors informing pricing*
- 2.5.2.1 Standard Bank’s pricing is informed by a number of high level/ key principles including that pricing should:

- 2.5.2.1.1 Be simple and transparent, aligned between similar products and services.
- 2.5.2.1.2 Match customer value.
- 2.5.2.1.3 Be competitive relative to other banks.
- 2.5.2.1.4 Support the business objectives to provide an appropriately balanced value to all stakeholders, including customers and shareholders.
- 2.5.2.2 We initiate a detailed and comprehensive annual process when setting prices. The mandate of the pricing executive committee is to provide a holistic perspective and ensure sustainable implementation of Standard Bank's retail pricing strategy. A range of elements are considered including competitive positioning, customer and product strategies, compliance, legislation and revenue impact. At the end of the process the pricing proposal is taken to executive level for justification, consideration and approval.
- 2.5.2.3 *Prices are determined taking a range of factors into account including:*
- 2.5.2.3.1 Our clients' needs. Pricing experts liaise with segment experts on customers changing requirements. For example, Mzansi Blue was developed after determining what low income clients needed in terms of price vs functionality. Another example is that of My Updates: the sms notification service that arose from our customers' need to be informed of activity in their accounts via their cell phones and the value customers placed on this convenience. A final example is that of Standard Bank/MTN foreseeing a need to do banking via cell phones and developed this to meet customer need together with an appropriate pricing structure.
- 2.5.2.3.2 The need to meet shareholder expectations. Our shareholders have provided the capital required to enable us to conduct the business of a bank and they are entitled to an appropriate return on their investment. The sustainability of banks, as for any commercial entity, is dependent on continued investment and re-investment.
- 2.5.2.3.3 Competitor activity in new product design. For example, if one bank introduces an sms update, the other banks may need to develop it in order to offer their own customers similar value.
- 2.5.2.3.4 Pricing of existing products and service and the impact this has on client behaviour.
- 2.5.2.3.5 Competitor market share. Market share is tracked on a monthly basis, and comparisons of fees and new products are analysed on a regular basis.
- 2.5.2.3.6 The economic and social environment. This includes inflation, potential regulatory changes, and economic challenges faced by our customers. For example, Standard Bank took the competitive lead and reduced penalty fees for Eplan customers a number of years ago. These were reduced from R90 to R31.50 per rejected transaction and then later capped at a maximum of 2 charges per month. We are reviewing our penalty fees on the Mzansi account with a view to further reductions.
- 2.5.2.3.7 The regulatory framework. A classic example is the recently introduced National Credit Act that changes the lending environment by disallowing certain fees and regulating credit extension. Another would be the National Payment System Act which disallows preferential collection of payment and contributed to the introduction of AEDO and NAEDO.
- 2.5.2.3.8 Our social and Financial Sector Charter drivers. The imperative to bank the unbanked has driven the development of new lower priced products to cater to these customers' needs.

- 2.5.2.3.9 Cost recovery. We aim to ensure our fees at a broad level cover operating costs - both direct (for the transaction) and indirect (for example maintaining the infrastructure and capacity for use). However, the method of costing applied is not appropriate to make pricing decisions at a transaction level.
- 2.5.2.3.10 Cost recovery method per customer. The need to cover costs from opening to closing an account, without charging for each activity. For example, there is no charge for opening or closing an account, yet the bank incurs costs in this regard.
- 2.5.2.3.11 The convenience provided to the customer. For example, internet banking gives access 24 hours a day and can be undertaken at the customer's convenience so the value to the customer is greater than that of attending a counter at a branch.
- 2.5.2.3.12 The life stage of the customer. For example, students are charged lower rates given their means and future earning potential than more established customers.
- 2.5.2.3.13 The channels used. For example, the cost of withdrawal or deposit from or at a branch vs that at an ATM.

2.5.3 *Standard Bank offers competitive pricing*

2.5.3.1 We have asserted that Standard Bank is highly competitive in a competitive environment. Sets of data and research demonstrate this.

2.5.3.2 Standard Bank's price setting process takes competitor pricing into account. Our research shows that, at the entry level where we do not have a bundled offering, we are competitive compared to other banks.

2.5.3.3 **Table: Comparison of pricing for Mzansi account worked out by Standard Bank using publicly available competitor information and our own customer profile, as at 1 September 2006<sup>11</sup>**

Standard Bank	Competitor A	Competitor B	Competitor C	Competitor D	Competitor E
R9.28	R7.23	R10.10	R10.06	R9.17	R11.66

*Source: Standard Bank data, September 2006*

2.5.3.4 **Table: Comparison of pricing for low income customers (excluding Mzansi) worked out by Standard Bank using publicly available competitor information and our own customer profile, as at 1 September 2006<sup>12</sup>**

Standard Eplan	Competitor A	Competitor B	Competitor C
R35.09	R40.27	R39.28	R28.71

*Source: Standard Bank data, Sept 2006*

2.5.3.5 At all other levels, where we do have a bundled offering, we are consistently low-priced compared to other banks, as is corroborated by the Finweek Trust study which shows that Standard Bank's bundled offering to Finweek's fictitious customer<sup>13</sup> was significantly cheaper than the other banks' cheapest offerings. According to our own analysis our typical customer taking the bundled offer experiences savings of 35 – 50% as compared to the unbundled or "pay as you go" offer.

2.5.3.6 **Table: Comparison of cheapest offering using Finweek study data**

	Absa	FNB	Nedbank	Standard

<sup>11</sup> Prices include VAT and penalty fees

<sup>12</sup> Prices include VAT and penalty fees

<sup>13</sup> This fictitious family had an income of R500,000 per annum.

Cheapest offering	R338.86	R404.45	R449.71	R206.40
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Source: *Finweek*, August 2006

- 2.5.4 *Standard Bank has aimed to ensure price affordability – specifically for low income customers.*<sup>14</sup> For example on Mzansi:
- 2.5.4.1 There are no monthly management fees;
  - 2.5.4.2 All cheque deposits and electronic deposits are free;
  - 2.5.4.3 Customers are provided with one free cash deposit a month;
  - 2.5.4.4 We make use of a low flat fee and uniform pricing structure;
  - 2.5.4.5 Unlike the other banks we provide unlimited free airtime top-ups; and
  - 2.5.4.6 Customers are able to make use of any ATM (of approximately 16 000) without incurring inter-bank charges.

We believe that Mzansi is competitively priced and offers banking to low income customers for less than R10 per month (for the average customer). This compares well to a range of other expenses such as a return trip in a taxi from Johannesburg to Diepkloof of R13.00. A typical Mzansi customer performs approximately three transactions a month. Our high transacting Mzansi account holders perform an average of seven transactions per month at a cost of less than R20.

### 3. **CHAPTER 2 - ACCESS TO THE NATIONAL PAYMENT SYSTEM**

#### 3.1 **Defining the National Payments System**

- 3.1.1 The National Payment System (NPS ) is, according to the South African Reserve Bank (SARB or the Reserve Bank), “a broad concept, encompassing the total payment process (including settlement in the books of the Reserve Bank and/or Continuous Linked Settlement (CLS) Bank) including all the tools, systems, mechanisms, institutions, agreements, procedures, rules, laws, etc. that are used in the process for a person to make payment in money or to initiate an instruction to a drawee institution to make a payment to, or to transfer funds to, another person (the payee) or the agent of such payee”.<sup>15</sup>
- 3.1.2 According to the SARB’s Blue Book the NPS:
  - “is therefore a core component of the broader financial system. It should be viewed as the infrastructure that provides the economy with the highways for processing the payments resulting from various economic activities. The NPS supports the full spectrum of financial activity, from South African businesses transacting in the global market to servicing the individual payment requirements of South Africa’s population”.
- 3.1.3 In Standard Bank’s view the NPS is critical infrastructure for the functioning of the National Payments System and its stability in South Africa. The NPS is the only mechanism that enables both the mechanisms for financial institutions to interact with one another and the SARB to monitor this interaction and the risks associated therewith.

#### <sup>14</sup> **MMT**

- Relative to the cost of traditional mechanisms of transferring funds to unbanked recipients, coupled with the potential security issues that may be experienced, the MMT product provides a cheaper, convenient and more reliable alternative.
- Pricing is simple.
- R 13 per R 100 transferred and then R 2 extra for every R 100 thereafter is charged. The most prevalent informal alternative (using taxis to relay cash) is on average R50-R60 per trip.
- The recipient pays nothing and receives the full value of funds intact
- These transactions are also not limited, from an access point of view, to any particular bank. Any of the big four banks may be used for origination or receipt of funds transferred. Any Post Office can also be used to access the funds.

<sup>15</sup> SARB’s Blue Book provides this definition.

Should this infrastructure not be managed in an efficient manner, as required in the NPS Act and exercised by the SARB's NPS Department, the consequences for the SA economy could be significant.

- 3.1.4 Furthermore the NPS is a complex system which requires co-operation in setting up common and individual infrastructure, while at the same time balancing this co-operation with competition and consumers' interests. This requirement for balance is well recognised and articulated by the SARB in its Blue Book:

"The NPS requires a delicate balance between market-driven competition, co-operation and public-good considerations. Banks and other customer payment-service providers compete for payments business and customers, whilst the efficiencies of sharing infrastructure necessitate that the participants also co-operate in setting up non-competitive infrastructures. In the national interest, it is imperative for economies to be created to allow as many participants as possible to offer their services to the public."

- 3.1.5 Integrity and functionality of the NPS cannot in anyway be compromised. Disruptions to the operation or sustainability of the payment system would have national implications. These implications must be balanced with the continued need for competition in the banking industry.

- 3.1.6 We make ourselves available to meet with the Technical Team or the Panel to discuss how the NPS works and issues of concern. We also refer the Panel to previous inputs we have made on the NPS. (See Appendix 2).

## 3.2 **Defining access and the National Payments System structure**

- 3.2.1 At present numerous players enjoy access to the NPS. These include banks and non banks such as the cell phone companies, retailers, service providers (such as EasyPay), system operators (such as TSS), and card companies such as American Express, Diners and Koopkrag. The current presence of so many non bank players in the NPS (including Pick 'n Pay Go Banking, Shoprite Money Transfers and EasyPay) is testimony to the fact that access to the NPS is not impeded or closed. However, discussion on access needs to be more specific – in particular, it is critical to specify which kind of access to the NPS is being referred to. The FEASibility Report identifies various kinds of access to the NPS:

- 3.2.1.1 "For some, access means access to the clearing and settlement system, an area that has traditionally been the preserve of banks.

- 3.2.1.2 Access for the NPSD is access to the real-time high-value SAMOS system that it owns and operates, and the department points out that there are no barriers to entry – except of course that to operate in SAMOS one must be a registered bank.

- 3.2.1.3 For some of the non-bank players, access means being allowed to enable clients to make payment against deposits.

- 3.2.1.4 For yet others it means having access to bank accounts via their own system operator - rather than Bankserv, a NPS Operator - which is an operator that is wholly owned by the banks and overseen by PASA.

- 3.2.1.5 And then of course, for would-be bankers, access is concerned with the problem of gaining entry to a restricted area."

- 3.2.2 This submission explores the various kinds of access when examining the players in the NPS and how they are governed / regulated. We also make recommendations on how to both improve access and/or governance and regulation of the NPS and ensure the stability, integrity and sustainability of the system while promoting competition within the industry.

- 3.2.3 The fundamental principle of a safe and secure NPS is the quality and reach of the regulatory overseer. As stated in the FEASibility Report, the current NPS regulatory oversight does not adequately provide for the management of the participation of non-banks, system operators and service providers within the NPS. To remedy this, the

SARB has issued its Vision 2010 document, wherein its stated aim is to increase access with the appropriate regulation and oversight of the NPS based on sound risk based entry criteria. The fundamental principles relating to increased access to the NPS is that “liquidity, operational, credit, settlement, legal, systemic and reputation risks determine the entry criteria for participants into the payment system.” In addition to the objective of increased access comes the tightening of the regulatory oversight framework of the NPS so as to ensure that all payment activities are adequately regulated.

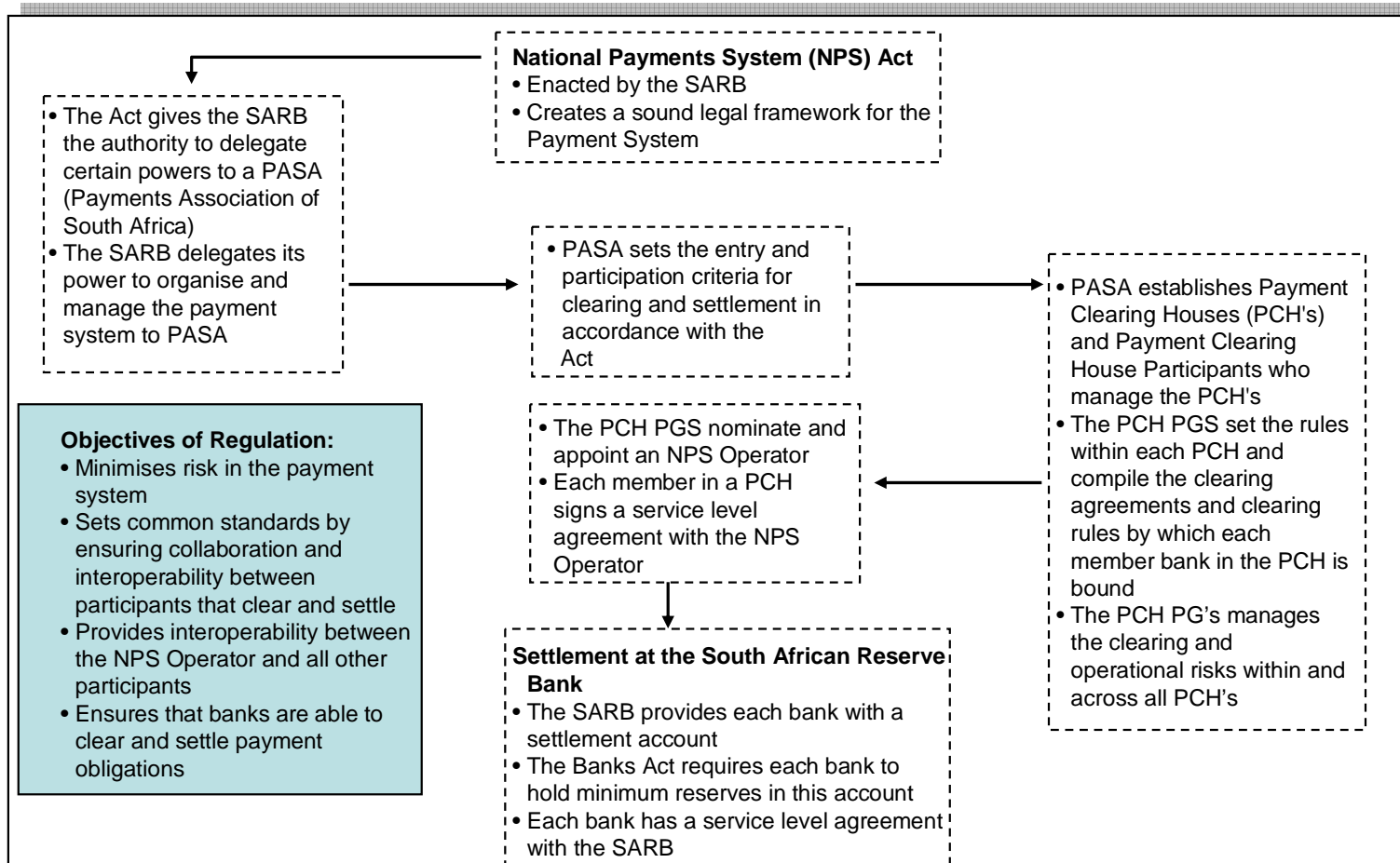
- 3.2.4 To this end the SARB has expanded its definition of what constitutes regulatory oversight within the NPS that all payment activities from payer to beneficiary are included. In this expanded view banks, payment service providers, system operators, PCH system operators and agents of payers and/or beneficiaries are included.
- 3.2.5 The diagram below illustrates the current regulatory oversight framework within the National Payments System; it can be seen that the SARB and PASA are at the core of the NPS and hence carry the responsibility for ensuring that the proper risk management processes and procedures are in place. However, the banks (direct clearing, mentored clearing and sponsored banks) are the only entities that fall under the direct regulatory oversight of the SARB and PASA.
- 3.2.6 The diagram also represents the significant amount of work by SARB, Standard Bank and the other banks, which has taken place over the last 10 years to strengthen oversight of the NPS. Initially, work had focused on setting up a framework and strategy and culminated in the SARB’s Blue Book. According to the SARB (in Vision 2010) “all the major milestones and major risk reduction objectives described in the Blue Book have since been achieved”. These include setting up the South African Multiple Option Settlement (SAMOS) system in 1998, and promulgating the National Payment System (NPS) Act in 1998. The latter enhanced the regulatory and supervisory powers of the SARB to manage and control payment system risks.
- 3.2.7 Further work on enhancing regulation and oversight of the core took place with the introduction of risk-reduction measures. These included introducing Payment Clearing House (PCH) agreements, intra-day monitoring of liquidity usage, the setting of item limits and the introduction of same-day settlement. The NPS Act was also amended in 2004 in order to enhance SARB’s regulatory and supervisory power, and to address the inclusion of the rand as an international settlement currency.<sup>16</sup>
- 3.2.8 Given the significant work that has been undertaken to strengthen the regulation of the Inner Core of the NPS, while still allowing for access by Outer Core members, it is now appropriate to address how to maintain the principle of allowing access to non banks, while ensuring stability and appropriate risk management. The SARB envisages a Blue Book Two that will address many of the aspects relating to the Outer Cores from an access, regulation and oversight function view.

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<sup>16</sup> The Rand was accepted as a Continuous Linked Settlement (CLS) currency in 2004. The objective of CLS is to reduce foreign exchange risk.

## GOVERNANCE / REGULATION

Regulation is necessary to create sound legal framework in the payments system. Regulation around all role-players is interlinked to ensure that a sound legal framework is created.



### 3.3 **The Cores of the NPS**

In principle, the National payment system may be divided into the Inner Cores and their various participants and the Outer Cores and its participants. This section examines each of the various cores (Inner and outer) in South Africa, identifying who participates, how they are governed and challenges faced within them.

### 3.4 **The Inner Cores**

3.4.1 This section outlines the structure, governance and regulatory oversight of the Inner Cores of the NPS in South Africa. As shown in the diagram below, the following have access to or constitute the Inner Core of the NPS:

3.4.1.1 The SARB;

3.4.1.2 PASA (Payment Association of South Africa);

3.4.1.3 Settlement banks;

3.4.1.4 Clearing banks;

3.4.1.5 Mentored and sponsored (technical and/ or settlement) banks;

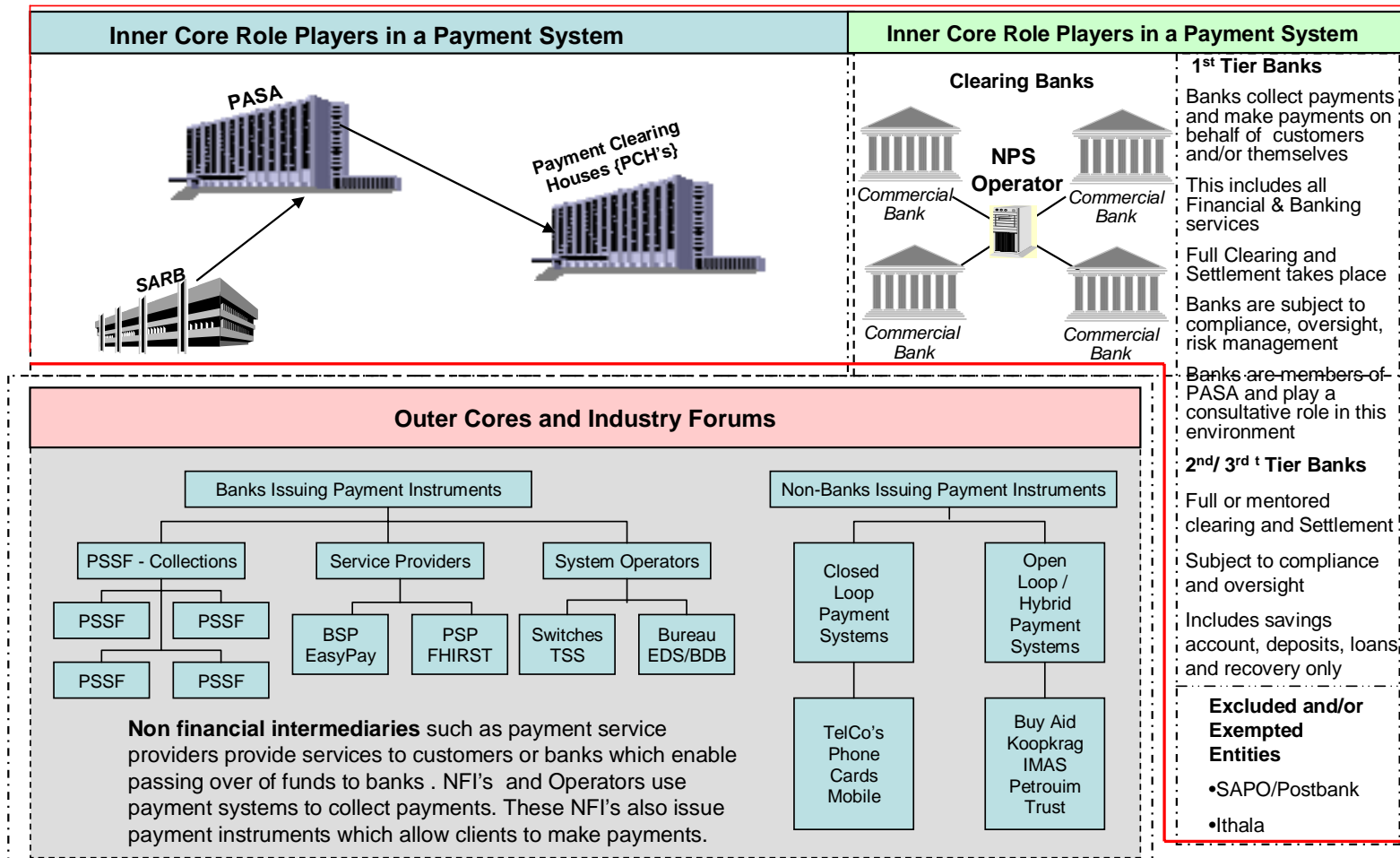
3.4.1.6 Exempted/excluded banks (which access the NPS directly for clearing purposes where they so choose, but access the SARB (SAMOS) through a settlement bank); and

3.4.1.7 NPS operators – including Bankserv, STRATE (for equities trade settlement and regulator), SBV (cash clearing and distribution), Visa (for offshore clearing and settlement and domestic ATM and POS switching) and MasterCard (for International and domestic clearing and settlement).

3.4.2 The above are overseen by PASA, which is the Payment System Management Body (PSMB) appointed by the SARB under the NPS Act. STRATE is also a regulator, but for the securities part of equity and bond trades.

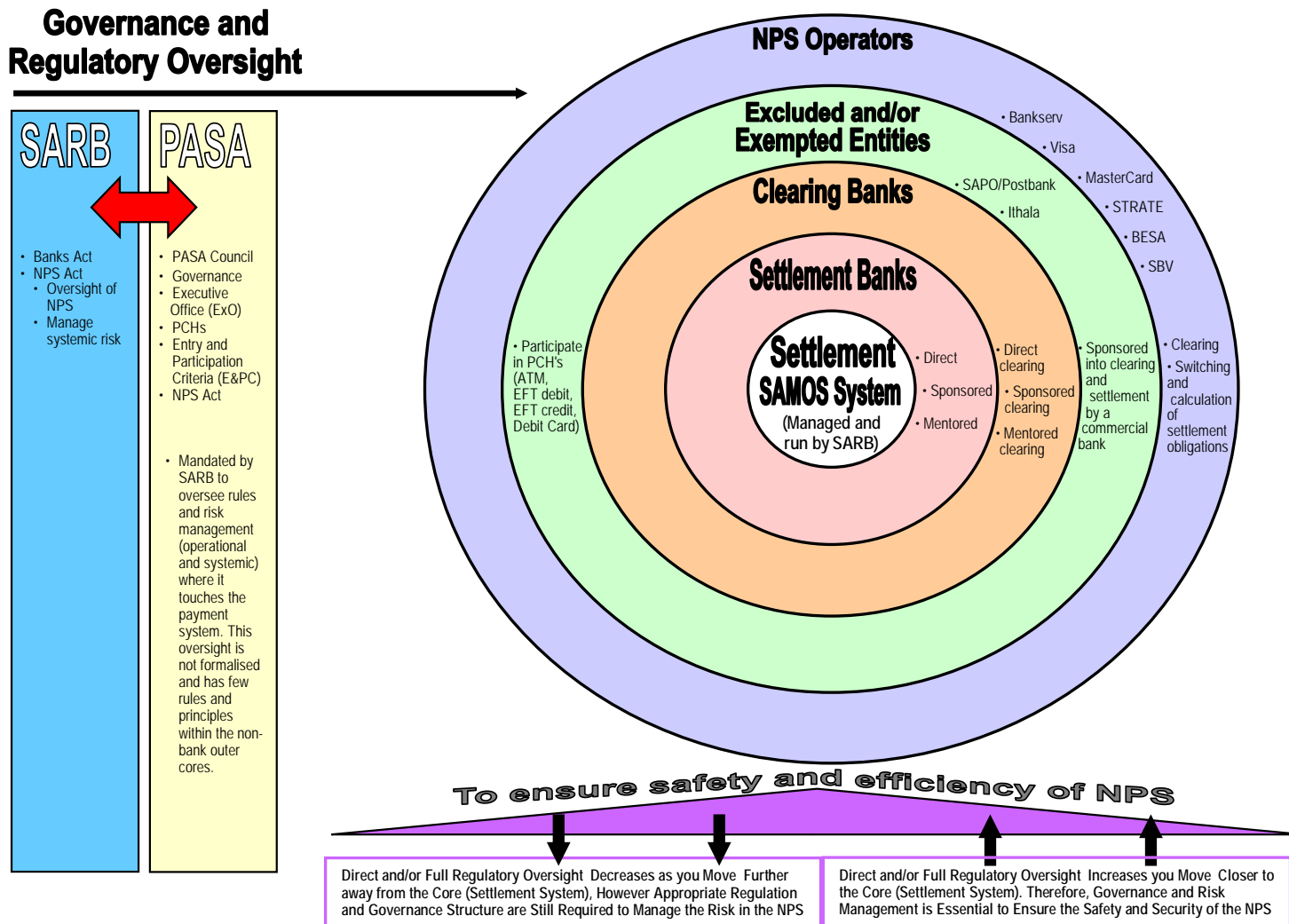
## THE ROLE-PLAYERS IN NATIONAL PAYMENT SYSTEM

A payment system may be divided into inner core role-players and outer-core role-players. The core role-players are responsible for the governance and regulation of the payment system and outer core role-players are those that use the payment system to transfer payments; perform clearing functions; holding of float; etc.



## INNER CORES of the NPS

The diagram below reflects the functions of clearing and settlement within the NPS and includes the participants and their responsibilities



### 3.4.3 *Settlement – SAMOS System*

3.4.3.1 The Reserve Bank provides an inter-bank settlement service via the real-time electronic settlement system, the South African Multiple Option Settlement (SAMOS) system which was implemented in March 1998. Besides single settlements between banks, SAMOS is also used for the settlement of obligations arising out of retail payment clearing and the equity and bond markets.

3.4.3.2 The SAMOS settlement system is at the epi-centre of the financial economy of the country, and as such has the highest risks and requires the most stringent regulatory and governance structure. The SARB manages and runs the SAMOS system and each settlement bank is required to hold a SAMOS settlement account at the SARB. All settlements in SAMOS are pre-funded by secure liquid assets such as treasury bills or government stock, to ensure that all settlements are final and irrevocable.

### 3.4.4 *Settlement Banks*

Settlement banks have the highest regulatory requirements in the Inner Cores of the NPS as they are responsible for ensuring the final and irrevocable settlement of all payment transactions issued by clients. Given that the corner stone in maintaining stability of our economy is the stability of the settlement system, it is critical to have stringent laws and regulatory oversight so as to avoid settlement failure within the NPS. As such these banks are required to have a SAMOS settlement account and to lodge the requisite liquid assets for use in settlement. Settlement banks are also required to be full/direct clearing banks and as such provide payment instruments to their clients and have direct access to the NPS Operators.

### 3.4.5 *Clearing Banks*

Clearing banks are also subjected to high regulatory requirements as they participate directly in the clearing of payment instructions, issued by clients, and have direct access to the NPS Operators. Clearing banks may issue payment instruments to their clients and have the option to be mentored or sponsored (technical) clearers in the NPS. Therefore, the stability within the clearing system is required as this is the primary arena where transactions are inputted into the NPS Operators who then clear on behalf of the banks and calculate payment obligations which result in settlement finality via SAMOS.

### 3.4.6 *Excluded/Exempted Entities*

These are entities which are excluded/exempted from the Banks Act and its regulations but nevertheless are permitted to participate in the PCH's under the sponsorship of a commercial bank. This is presently a significant risk in the payment system as it results in non-banks holding deposits and participating as if they were a bank in the payments issuing and clearing environment under the governance and oversight of a commercial bank.

### 3.4.7 *NPS Operators*

NPS Operators are the cornerstone of the clearing and switching in the NPS and as such are a critical part of the Inner Cores of the NPS. The NPS Operators perform these core functions – clearing, switching and settlement – on behalf of banks. Therefore, should the requisite governance structures, regulatory oversight and controls not be in place the risk to the NPS and the economy would be significant.

### 3.4.8 *The SARB*

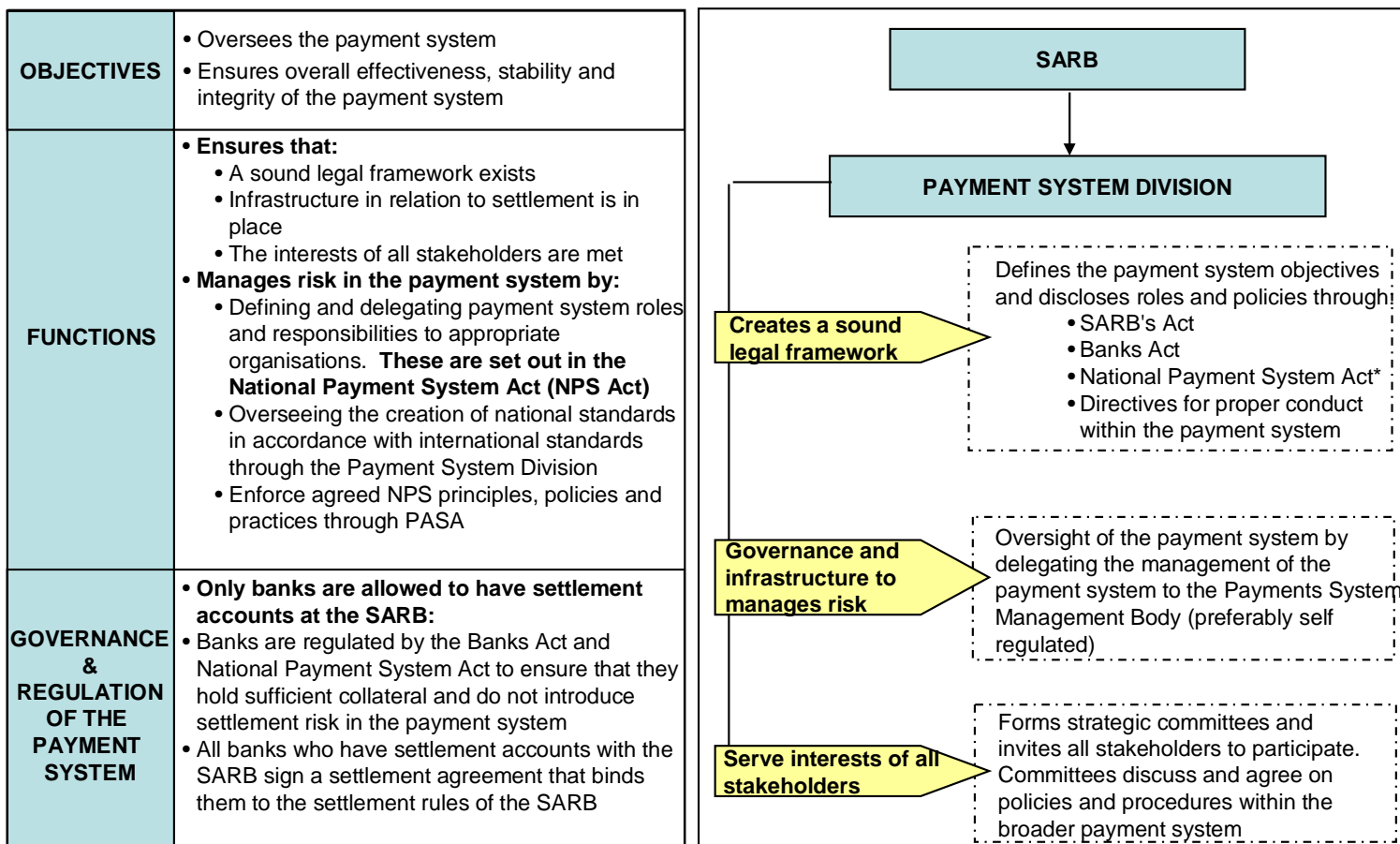
The SARB is the core role-player in the NPS. Through its National Payment System Department (NPSD) it:

3.4.8.1 Creates a sound legal framework;

- 3.4.8.2 Exercises oversight of the National Payment System;
- 3.4.8.3 Ensures efficiency, risk management and soundness of the NPS; and
- 3.4.8.4 Serves the interests of all stakeholders, taking into account the relevant risks, etc.

## INNER CORE ROLE-PLAYER: SOUTH AFRICAN RESERVE BANK

The South African Reserve Bank (SARB) achieves its objectives by creating a payment system division which is responsible for carrying out the functions of the SARB as follows:



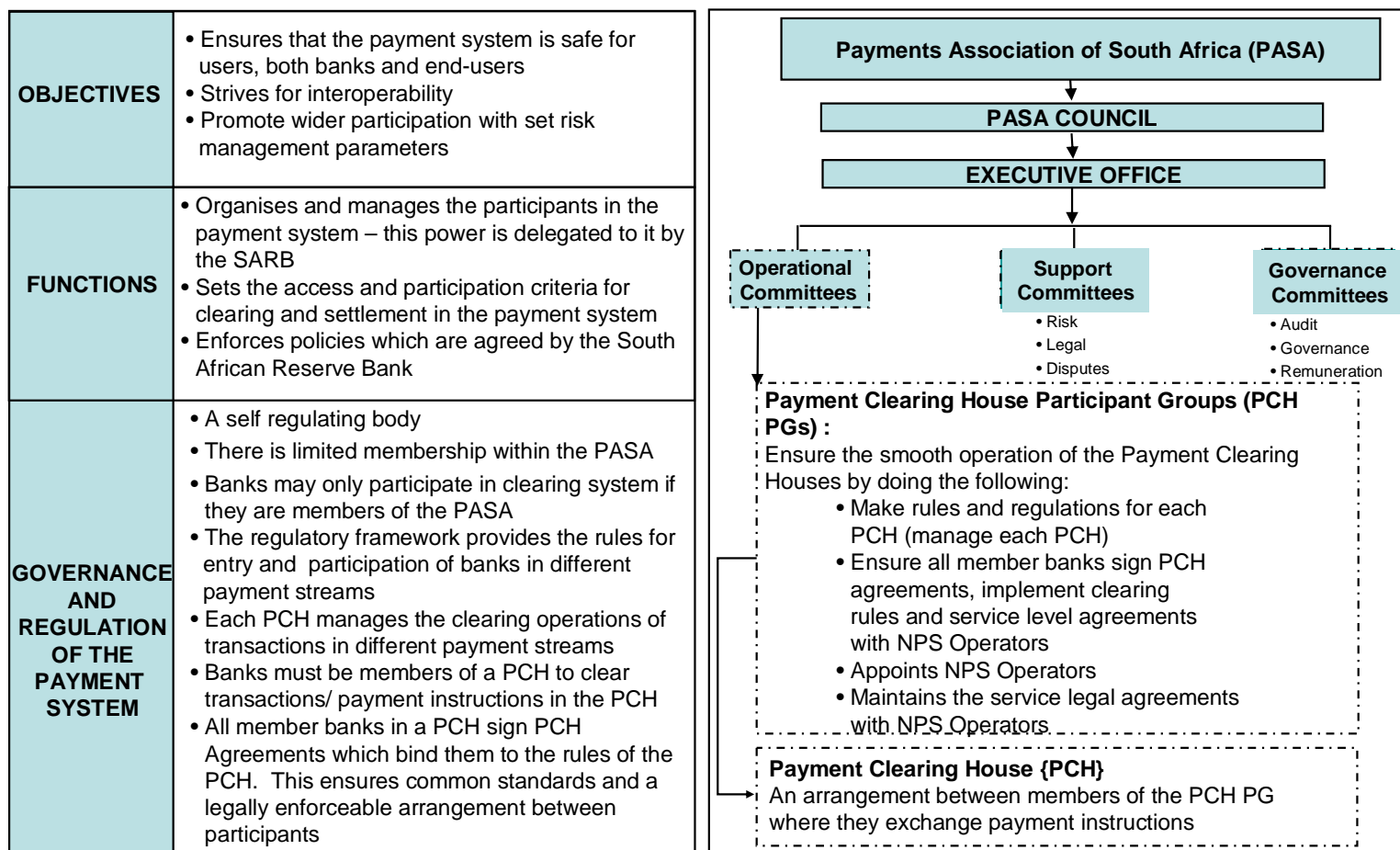
Note\*: The legislation that governs the system that enables payments to be effected or facilitates the circulation of money and includes any instruments and procedures that relate to the system

### 3.5 PASA

- 3.5.1 In broad terms, the Payment System Management Body (PSMB) has to ensure that the payment system is safe for users, both banks and end-users (such as individual customers), promote interoperability and promote wide participation with set risk management procedures. The functions of the PSMB are thus to:
- 3.5.1.1 Organise and manage the participants in the payment system;
  - 3.5.1.2 Set the access and participation criteria for clearing and settlement in the payment system; and
  - 3.5.1.3 Enforce policies which are agreed by the central bank.
- 3.5.2 In South Africa, the National Payments System Department (NPSD) of the SARB has the mandate, entrenched in law, to perform such functions, implement such rules and procedures and in general take the necessary steps to establish, conduct, monitor, regulate and supervise payment clearing and settlement within the NPS.
- 3.5.3 Under this authority the SARB has appointed the Payments Association of South Africa (PASA) as the Payment System Management Body to carry out its mandate in the daily management and oversight of the operational and risk issues within the NPS. While PASA's mandate is derived from the NPS Act, PASA is a self regulatory body and the governance structure is managed by PASA Council. The SARB is a member of PASA Council and the PASA Governance Committee to ensure the mandate given under the NPS Act is carried out. As such PASA is mandated to develop such rules, criteria and governance structures as may be required to carry out this function.
- 3.5.4 The function of PASA within the NPS is to provide a safe and sound payment system to the South African banking industry on a fair and equitable basis for the benefit of the South African community. In order to achieve this, the primary objectives of PASA are to:
- 3.5.4.1 provide the South African community with safe and efficient facilities to exchange payments,
  - 3.5.4.2 protect the integrity of the National Payment System,
  - 3.5.4.3 manage the clearing and settlement risks in the National Payment System, facilitate access of participants and prospective participants to the National Payment System on a fair and equitable basis,
  - 3.5.4.4 facilitate the communication between participants, and
  - 3.5.4.5 enable proper understanding of the system and the rules applicable to it.
- 3.5.5 This is an acceptable model in many countries since it manages the Inner Core and is critical to ensuring systemic and other risks are well contained.
- 3.5.6 International research has shown that regulators are exploring the possibilities of having the Payment System Management Body (PSMB) have regulatory oversight over non-banks, Beneficiary Service Providers (BSP's), Payment Service Providers (PSP's) and Operators. However, in Australia they have found that given that the Central Bank is not the primary regulator this oversight model is not effective. The SARB shares this view and is pursuing alternative regulatory models. We support the SARB's view that opening the Inner Core regulatory body to Outer Core role players could lead to other dynamics driving the NPS. Inner core members have the safety, soundness and efficiency of the NPS as their first priority, whilst Outer Core members would predominantly be driven by other priorities, many of which may be in conflict with the national good.

## INNER CORE ROLE-PLAYER: PAYMENTS ASSOCIATION OF SOUTH AFRICA

The Payments Association of South Africa (PASA) achieves its objectives by creating a regulatory framework as well as structures within itself to manage the way in which participants clear and settle transactions in the payment system



### 3.5.7 *Banks*

3.5.7.1 Banks registered in terms of the Banks Act may participate in the NPS. They issue payment instruments, receive and send payment instructions, provide clearing of payment transactions and settlement of payment obligations between banks and end users. As such banks are the gateway to payment clearing and settlement facilities. However, even in this space, not all banks are settlement banks.

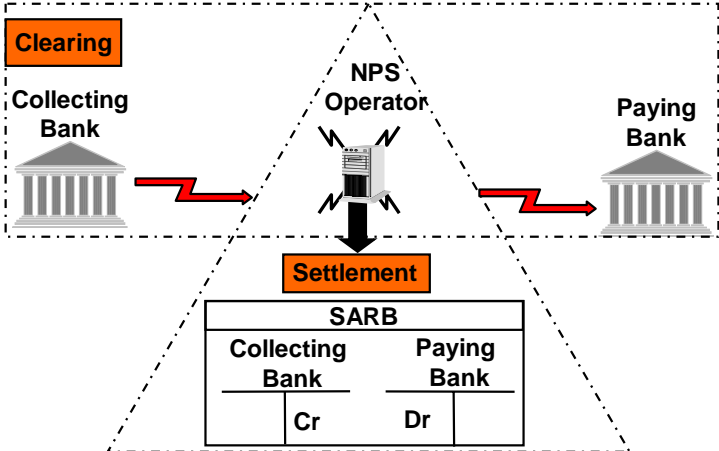
3.5.7.2 The structure of the NPS allows banks to choose whether or not they want to become settlement members – either direct or sponsored settlement banks. Banks can also choose to become clearing banks, for which they must first enter as a mentored bank (this is a requirement if the bank issues payment instruments to their customers). However the option is available to banks to continue to be a corporate customer of settlement member banks (if the bank does not issue payment instruments to their customers).

3.5.7.3 Banks are highly regulated when participating in the NPS and are subject to requirements under the Banks Act the NPS Act PASA rules, standards and compliance requirements. Clear conditions of governance - rules and agreements that regulate access, membership and participation in the NPS - exist for banks, under a dedicated regulator namely SARB with a delegation of certain powers to PASA.. All banks are eligible to become members of PASA and participate in the payments clearing, switching and settlement systems.

3.5.7.4 PASA member banks participating in the NPS are subject to rules, criteria, legally binding agreements and fees. Fees include joining and participation fees for PASA and PCH System Operators. We do not believe that these fees are a barrier to entry.

## INNER CORE ROLE-PLAYERS : 1<sup>st</sup> TIER BANKS

**Banks are the gateway to payment clearing and settlement facilities. They issue payment instrument instructions, provide clearing of payment transactions and settlement of payment obligations between end users**

<b>OBJECTIVES</b>	<ul style="list-style-type: none"> <li>• Provide transactional services to end-users (customers)</li> </ul>	<p><b>What is clearing?</b></p> <ul style="list-style-type: none"> <li>• The exchange of payment instructions between parties</li> <li>• Involves banks setting up electronic and/ or other links and agreements through a Payments Association of South Africa with all other banks and financial institutions in the country in order to exchange payments</li> <li>• Clearing is the domain of banks only</li> </ul> <p><b>What is settlement?</b></p> <ul style="list-style-type: none"> <li>• “Settlement” means the final and irrevocable discharge of a settlement obligation, owed by one clearing and settlement participant to another pursuant to a settlement instruction, which has been effected in money or by means of entries passed in the settlement accounts of the relevant participants, through their respective accounts in the books of the SARB</li> </ul> 
<b>FUNCTIONS</b>	<ul style="list-style-type: none"> <li>• Provide clearing of payments between end-users to satisfy payment obligations</li> <li>• Only clearing banks can: <ul style="list-style-type: none"> <li>• Have a settlement account at the SARB</li> <li>• Participate in Interbank clearing and settlement</li> <li>• Act as a principal or intermediary in the payment system</li> </ul> </li> <li>• Provide a link to payment service providers to participate in the payment system</li> </ul>	
<b>GOVERNANCE</b>	<ul style="list-style-type: none"> <li>• PASA Regulatory Framework</li> <li>• National Payment System Act</li> <li>• Banks Act</li> <li>• Compliance Regulation (FICA; FAIS; BASEL II; FATF)</li> </ul>	
<b>RISKS AND REGULATION</b>	<ul style="list-style-type: none"> <li>• <b>Clearing:</b></li> <li>• May create open credit exposures during clearing if they do not clear according to a set of standards</li> <li>• The PCH Agreements ensure that acceptable standards for clearing are maintained</li> <li>• <b>Settlement:</b></li> <li>• May create settlement risk if sufficient collateral is not held.</li> <li>• The Banks Act ensures that sufficient collateral is held by banks (Monetary Policy)</li> <li>• The NPSD ensures banks have sufficient collateral/ payment capacity to meet settlement obligations</li> </ul>	

### 3.5.8 *Exempted / Excluded Entities*

3.5.8.1 Certain non-banks, which may also be government departments, are not precluded from participating in the NPS because they are not governed under the Banks Act. There are currently two exempted/excluded entities (by virtue of the Banks Act) operating within the NPS as 'quasi' banks, namely SAPO/Postbank and Ithala. These entities are not subject to capital adequacy requirements as banks are and are not required to lodge capital with the SARB. These entities participate in the banking and payments system outside of the formal regulatory oversight of the SARB's Banking Supervision Department and the NPS Department of the SARB and PASA.

3.5.8.2 The one entity (SAPO/ Postbank) is regulated only by the Minister of Postal and Communications and its associated Act, but are not directly regulated by the SARB, albeit they are essentially becoming the 5<sup>th</sup> largest bank in South Africa, Postbank. It is effectively being regulated in the banking and payments system by Standard Bank which sponsored it into the NPS. The result is that the function of regulatory oversight is placed in the wrong place i.e. on the sponsoring bank instead of the exempted entity. For this reason PASA is in discussions with both the Reserve Bank (NPS Department & Banking Supervision) to explore ways in which the South African Post Office / Postbank (and other exempted entities, entities who are not subject to the same compliance and regulatory requirements as banks under the Banks Act) could be regulated under the NPS Regulatory Oversight Framework with the purpose of managing their participation in the NPS.

### 3.5.9 *NPS Operators*

3.5.9.1 *A number of National Payment System Operators exist, namely:*

3.5.9.1.1 South African Multiple Options System (SAMOS) – which enables real time settlement by banks through their settlement accounts at the Reserve Bank;

3.5.9.1.2 Bankserv (which is by far the predominant NPS operator in the batch related to the clearing of payment instructions);

3.5.9.1.3 STRATE/BESA – which does clearing and settling for equity and bond transactions between participating banks;

3.5.9.1.4 MasterCard International;

3.5.9.1.5 Visa; and

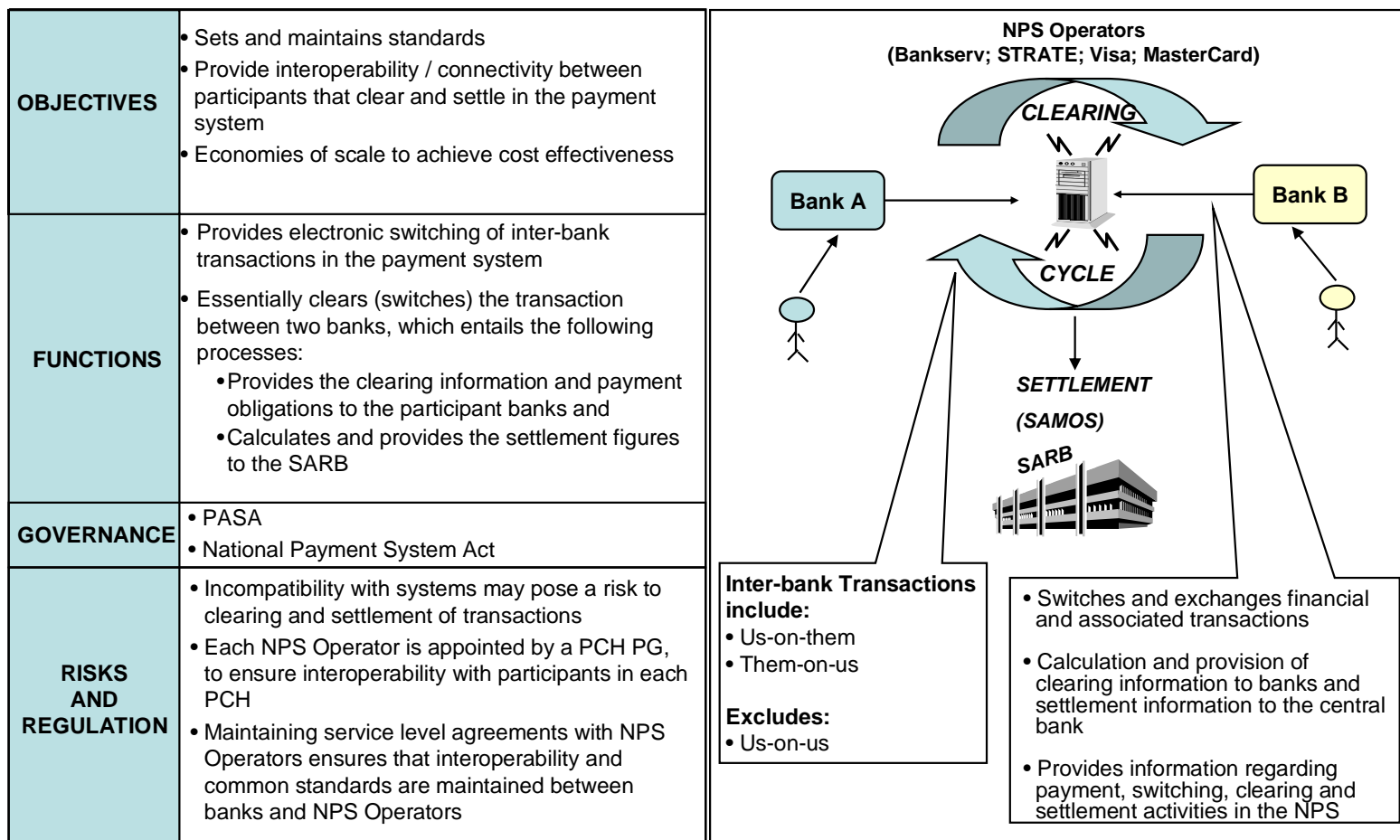
3.5.9.1.6 SBV.

3.5.9.2 Given the critical function which Bankserv and the other NPS Operators perform, as an integral part of the Inner Core of the NPS, we are of the view that these entities are national utilities and need to be managed in this manner, self funding not for profit. This is due to these utilities performing clearing on behalf of banks and calculating settlement obligations on behalf of the nation. There is a strong need to ensure the correct governance and regulatory oversight continues as part of the risk management function of the NPS operators and that they at all times remain focused on their core responsibility of clearing and determining settlement obligations. Deviation from this will lead to adverse unintended consequences and may lead the NPS operators into anti-competitive behaviour. There is typically only sufficient volume of transactions to render one operator viable and, for so long as that endures, its operations should be conducted as a utility to prevent anti competitive behaviour.

3.5.9.3 A more detailed submission on this issue is contained in section two of this chapter.

## INNER CORE ROLE-PLAYER : NPS OPERATORS

**NPS Operators provide the infrastructure and technology to enable banks to clear payment transactions between themselves and settle payment transactions with each other in their settlement accounts at the SARB**



Source: Strategic Framework for Payment Principles Pack

### 3.6 **Issues regarding Inner Core participation**

As had been shown above access to the Inner Core is dependent on being registered as a bank under the Banks Act, or being exempted/excluded from the Banks Act (such as the Postbank and Ithala) or being appointed as a National Payment System Operator to effect clearing and determine settlement obligations on behalf of two or more banks. Furthermore Inner Core participants are subject to oversight, regulation and governance.

### 3.7 **Standard Bank does not believe that the current entry requirements create unnecessary barriers to entry, and will address each issue mentioned below.**

3.7.1 The NPS Act provides that clearing and settlement is the domain of **registered banks** and the NPS is set up to adhere to this. This is fundamental for a sound NPS, as counterparty risk is then contained to acceptable levels.

3.7.2 Since SARB is the 'banker to the banks' and responsible for the settlement of all cleared transactions, all banks that wish to operate and settle in their own right in the NPS are required to have a **settlement account** at the SARB. However, for banks that do not want to clear in their own name, they can still participate in the Inner Core of the NPS by entering into a sponsorship arrangement with a direct clearing and settlement member. This enables new entrants to come in at a lower cost and only once they reach a certain size, could they be required to become settlement banks.

3.7.3 The payments clearing and settlement environment is a complex and specialised environment requiring specific knowledge, expertise and skills. At present, there is a skills and expertise shortage in this regard. For this reason (amongst other) a new bank entering the NPS must be **mentored or sponsored** by an existing member. Sponsorship involves an existing bank processing (technical sponsorship) or settling (settlement sponsorship) on behalf of the new bank. Mentorship involves assisting with day to day processing operations and staff training. These functions are generally provided at cost. This enables new entrants to have access to industry expertise to become a "solid" clearing bank and enables the risk of a new participant to be managed.

3.7.4 Technology, specifically technology supporting clearing and settling, has developed significantly in recent years. Banks need to keep pace with the new technology as an essential part of providing payment services. A new bank entering the NPS also has to adhere to **technical entry criteria and national standards**. Interoperability and standards across the industry are in place, not to prevent entry, but to eliminate costly processing within each bank, at the operator and across the industry as a whole. This results in efficiencies and cost reduction to the benefit of all participants, including customers.

3.7.5 **Operator certification and interbank testing** is vital as the operational risk that could be introduced to the industry will originate at this point. The processes put in place for testing with the operator and the other banks, including the three months required for live data testing and modifications to existing systems to accept transactions from new participants, are essential to ensure the, reliable operation of the NPS and the reduction of systemic and operational risks within the NPS. Failure to adhere to a well constructed testing and certification process of new members would compromise the ability of the affected NPS Operator to perform the clearing function and calculate the settlement obligations between settlement banks. A case in point would be the importance of the Business Continuity Plan (BCP) and Disaster Recovery Plan (DRP) facilities in the financial systems in New York following the 9/11 disaster. It was at this time that the major international banks and the New York Federal Reserve gained a clear insight as to the importance of the financial infrastructure. The SARB, through the Financial Stability Committee, embarked on a similar review to ensure that the financial system in South

Africa is robust and has the necessary DRP and BCP processes and procedures in each area affecting the financial system. The NPS Operators form the heart of the clearing, switching and settlement within the financial system for efficiencies and interoperability to be maintained and should be managed as such.

3.7.6 Banks have to pay **membership fees** to PASA, Bankserv, PCH entry fees, and SAMOS.<sup>17</sup> The costs associated with these functions are not considered prohibitive and/or punitive to create barriers to entry; they are a recovery of the costs of setting up, running and maintaining of the current NPS and payment infrastructure within South Africa. Without these fees being paid by members the services would not be available to customers wishing to transact.

3.7.7 Moreover, the fees are related to size and usage, so the bigger banks pay considerably more than the smaller banks (see table below). The fees cannot therefore be regarded as exclusionary.

**Examples of the approximate annual fees paid by SBSA and a smaller volume bank**

	<b>SBSA</b>	<b>Smaller Volume Bank</b>
SAMOS	214 000	40 000
PASA	900 000	180 000
Bankserv	46 000 000	800 000
SWIFT	16 000 000	250 000
STRATE / BESA	33 000 000	Don't participate

*Source: calculated by Standard Bank*

3.7.8 In order to gain access to a PCH, the existing members of the PCH have to **approve membership**. Each applicant is required to obtain a letter from each existing participant stating its willingness to trade and/or accept the additional risk into the existing PCH. Given that existing banks in the PCH have a multiparty obligation in the event of a settlement failure, the approval process is a mechanism for existing banks to evaluate

<sup>17</sup> PASA – All banks who currently participate in the NPS have paid fees according to their participation in the NPS (volume and value). These fees ensure the industry has the correct structures, staff and systems to ensure the minimising of systemic and other risks within the NPS.

Bankserv – Is essentially a self funding organisation (not for profit), to ensure all costs are covered members are required to pay for all costs associated with their connectivity to the operator (testing, processing costs for each stream, etc)

PCH Entry Fees – PASA ExO is a self regulatory association funded 100% by its existing members. The costs associated with the administration and staff time to assist new entrants in completing the relevant applications for membership to one or more PCH are fully recovered from the applicant bank. Given that fees are based on the number of PCHs, a niche bank belonging to fewer PCHs would pay a lower amount.

SAMOS – As with all other memberships to the NPS the SAMOS system is run and managed by the SARB, all SAMOS costs are fully recovered from the participating banks.

their risk/exposure and not a barrier to entry. Approval of membership can only be withheld for risk reasons; however, existing banks don't really have the power to refuse an application even though there may be valid risk reasons. This mechanism is not applied to exempted entities and they are automatically given the right to participate under the sponsorship of an existing bank. This imbalance should be addressed through the introduction of 2<sup>nd</sup> and 3<sup>rd</sup> tier banks that are required to seek the approval of the existing members of the PCH. In addition the structure and access of the PCH's should be addressed to enable banks, based on risk/exposure reasons, to withhold access of new/ existing participants should their risk profile be unacceptable. The sponsorship and mentorship mechanisms could be used to assist new members to "grow" into clearing banks within the existing structures. This process was introduced in order to broaden the access to PCH's in a way that did not bring any additional and/or un-monitored risk into the NPS.

### 3.8 **Making changes to the Inner Core can have serious unintended consequences**

The sections above point to the structure, governance, regulation and complexity of the Inner Core of the National Payments System. They further provide justifications for the rules and standards that exist. We are however interested in debate around change that will improve the NPS and the potential positive and negative consequences of such changes.

### 3.9 **Recommendations regarding the Inner Core**

3.9.1 South Africa has an internationally acclaimed and recognised sound NPS, which accords with and in many instances, sets the trend, for international best practices. These include our provision of same day clearing and settlement, and same day value. Standard Bank believes that the main strengths of the NPS are found in the governance of the Inner Core, including compliance with the Bank for International Settlement recommendations and principles for systemically important payment systems. There are strong risk mitigating controls, many of which are world firsts, to reduce overnight settlement values, risk and the impact of bank settlement failure. Such risk containment is paramount in protecting consumers' money. The Inner Core is also characterised by a high degree of co-operation and commitment from participants in the interests of establishing and maintaining a system of the highest standard in terms of security, risk containment and service levels. There is also appropriate bank and PASA co-operation with the SARB's NPS Department.

3.9.2 The current SARB position paper on 'bank models in the NPS' allows for banks wishing to enter the payments clearing and settlement domain to be mentored or sponsored into the relevant PCH's. This practice should continue, and be enhanced where required, in order to ensure the continued support for new entrants into the NPS.

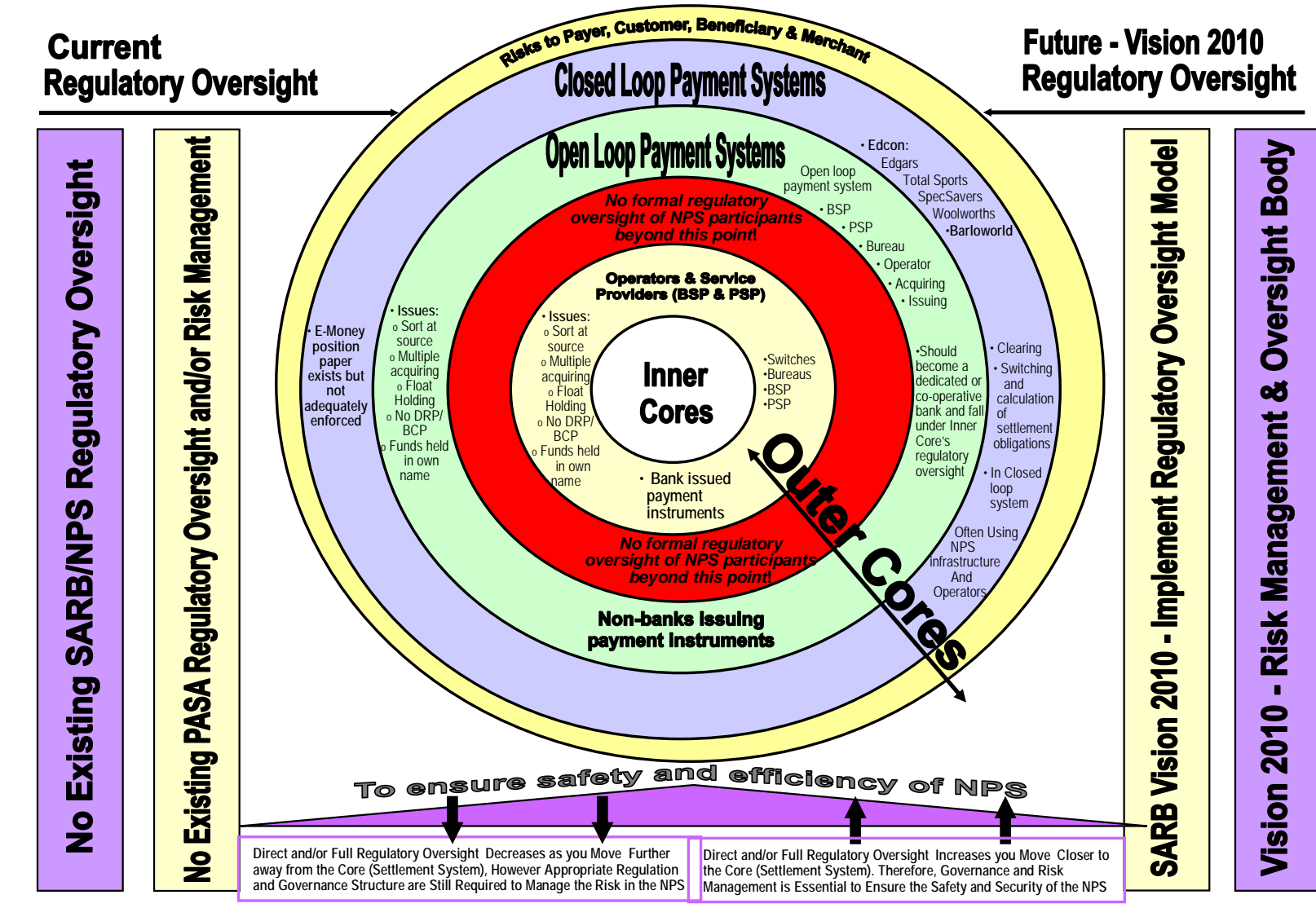
3.9.3 The key change we would suggest in the Inner Core, is that exempted entities be brought into the formal regulatory and oversight structures of the SARB. Therefore, these entities – presently SAPO/Postbank and Ithala - should be converted to either Dedicated Banks or Cooperative Banks. In order to achieve this both the Dedicated Banks Act and/or the Co-operative Banks Act, either as stand alone Acts or incorporated into the current Banks Act, should be promulgated as a matter of urgency in order to ensure the NPS is protected by the appropriate regulatory model.

### 3.10 **The Outer Core**

3.10.1 As shown in the diagram below both banks and non banks have access to the Outer Core of the NPS. The number of non bank players in this space is high - in fact there are too many to place in the diagram so they have been listed on Appendix 5. We also believe that the introduction and participation of non banks presents a risk in the NPS since they do not fall under the direct regulatory oversight of the SARB and as such are not regulated. This is in stark opposition to Inner Core participants that are highly regulated, as outlined in the previous section.

- 3.10.2 Given that the Dedicated Banks Act and the Cooperative Banks Act or other forms of regulation have not yet been finalised and/or promulgated, there is no mechanism currently for non-banks, payment service providers, beneficiary service providers or system operators to formally be brought into the NPS regulatory framework.
- 3.10.3 It is envisaged that the SARB, as part of the execution of their Vision 2010 strategy, will procure amendment of the current legislation and/or regulation to bring all participants and service providers into the NPS regulatory oversight. Such amendments may include the redefining of the payments arena to more fully understand and develop regulatory oversight models to include all participants and activities performed on behalf of payers and beneficiaries thereby further reducing systemic, liquidity and counterparty risk exposures. We support this position.

OUTER CORES of the NPS

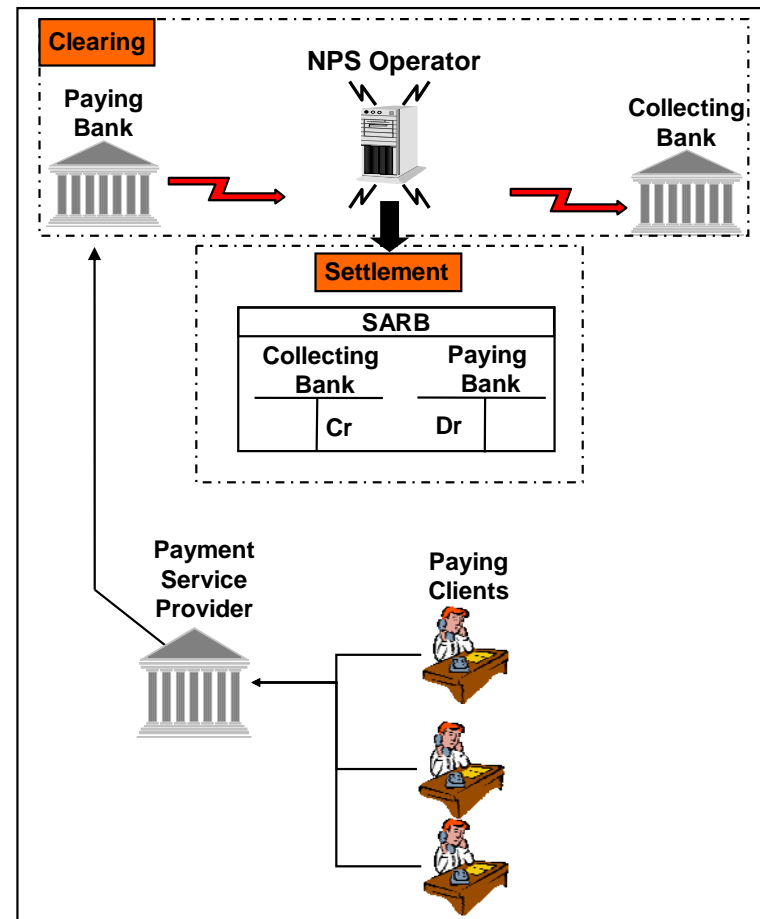


- 3.10.4 The diagram above gives a graphical representation of the layers, participants and/or nature of payment services provided in the Outer Core of the NPS. These are:
- 3.10.4.1 The 1<sup>st</sup> layer looks at participants intermediated into the bank issued payment space. The participants and issue around their participation will be more fully described in the sections below, including some recommendations on how to correct the situation;
- 3.10.4.2 The next layer represents the open-loop payment systems utilising non-bank issued payment instruments and its participants. These will be more fully contained in the sections below, including recommendations on how to correct the situation; and
- 3.10.4.3 The final applicable layer is the closed-loop payment system which utilise non-bank issued payments instruments. These participants and the issues surrounding their participation are more fully described below, including recommendations on how to manage their participation to ensure the risks are contained.

## OUTER CORE ROLE-PLAYERS : PAYMENT SERVICE PROVIDERS

**Payment service providers collect or make payment on behalf of customers to banks for the purposes of clearing and settlement**

<b>OBJECTIVES</b>	<ul style="list-style-type: none"> <li>• Are end-users in the payment system</li> <li>• Channel payment instructions to and from banks to customers</li> </ul>
<b>FUNCTIONS</b>	Provide following services to customers: <ul style="list-style-type: none"> <li>• Collection of payment instructions</li> <li>• Pre-processing of payments in a variety of value added processes before entering the payment system</li> <li>• Receipt of confirmation of payment finality from banks and communication of completion of transactions to customers</li> <li>• Act as agents for banks</li> <li>• Hold bank accounts with clearing banks for clearing and settlement of payments</li> </ul>
<b>GOVERNANCE</b>	<ul style="list-style-type: none"> <li>• PASA</li> <li>• National Payment System Act</li> </ul>
<b>RISKS AND REGULATION</b>	<ul style="list-style-type: none"> <li>• Payment service providers are not required to comply with onerous regulation around clearing and settlement. Hence they cannot be allowed to intrude to far into the value chain</li> <li>• In order to ensure that they do not introduce clearing and settlement risk into the payment system, collection and payment services are provided to it's customers</li> <li>• Banks provide the clearing and settlement services to payment service providers</li> <li>• This is stipulated by the National Payment System Act and rules of the PASAB</li> </ul>



### 3.10.5.1 *Service Providers*

#### 3.10.5.1.1 Beneficiary Service Providers (BSP)

3.10.5.1.1.1 Beneficiary Service Providers (BSP's) act as agents on behalf of the beneficiary, by collecting payments due to the beneficiary e.g. Telkom and then paying such payments collected over to them. Members of the public make use of and rely on the BSP to accept their payment in the discharging of their payment obligation to the beneficiary and to pay over such funds to the beneficiary. Should a BSP disappear the customer has no legal recourse to their bank or the regulators as the BSP's are currently not regulated within the NPS. The banking industry may however face reputational risks if, for example, the BSP did not make it clear that they are an agent of the beneficiary and not of the bank.

3.10.5.1.1.2 Participation in the NPS by un-regulated BSP's has the following consequences : At present there are unregulated non-bank players operating in the NPS. The key challenge is how to accommodate them in the NPS in a manner that does not jeopardise the safety, soundness and integrity of the NPS. In order to do this, it is necessary to understand the risks associated with unregulated BSP's operating in the NPS.

3.10.5.1.1.3 Example of risk associated with unregulated BSP's operating in the NPS.

3.10.5.1.1.4 The participation of unregulated BSP's in the system can pose risk to customers as well as the system as a whole. A simple example is used to illustrate the point.

3.10.5.1.1.5 A consumer of electricity makes payment at a retailer of monies due to the local authority. The consumer believes she has discharged her debt not realising that the retailer may be declared insolvent before the payment is paid over to the local authority or that the retailer may build up a float of such payments for up to a month in order to earn the interest thereon without the knowledge of either the consumer or the local authority

#### 3.10.5.1.2 Payment Service Providers (PSP)

3.10.5.1.2.1 Payment service providers channel payment instructions to and from corporate customers to retail customers. However, there is no formal regulatory oversight of how these PSP's participate in the NPS. The PSP's may hold the funds of the payment in transit (float holding), The payroll service providers are appointed as service providers by employers to calculate the net amount due to their employees. These PSP's receive the data (employee salaries, amounts to be deducted for tax, medical aid deductions, micro loans, etc), they then aggregate the deductions and pay these over to the beneficiaries (using direct access to the NPS Operator). The net amounts due to the employees are then submitted to the NPS Operator for clearing and settlement to clients of all banks. The PSP also receives the funds from the employer and holds those funds in their own name until such time as the settlement occurs through the bank (via the NPS Operator).

3.10.5.1.2.2 Should a PSP fail and/or disappear at any time during this process (which could be up to 20 days) there will be a knock-on impact on the bank and the NPS, therefore these participants must be brought into the regulatory oversight of the SARB and their conduct in the market

and risks associated with their participation in the NPS should be managed by an industry body who forms part of that PSP's legal oversight. It is not recommended that this function fall under the regulatory and risk management of PASA as these PSP's are not banks and are not regulated by the SARB. In addition to this the Service Providers also participate in practices which go against the structures and processes put in place by banks in order to ensure the safety and effectiveness of the NPS, these practices are multiple acquiring and sort-at-source, which are more fully explained below:

### 3.11 **Multiple acquiring and sort-at-source**

#### 3.11.1 *Introduction*

3.11.1.1 The issue of multiple acquiring and sort-at-source applies specifically to card (multiple acquiring) and EFT (sort-as-source) payment systems, but whilst they have different names, they are in essence the same thing, but arose for different reasons. For clarity, we discuss the issue in terms of card payments only, but this applies equally to operators and bureaus in the EFT space. Multiple-acquiring applies to the four-party card payment system whereby merchants seek to be acquired by several or all acquiring banks, generally through a non NPS operator, who effectively sorts the transactions per bank and bypassing the NPS operator, submits each banks transactions to that bank. Sort-at-source applies typically to the EFT payment stream whereby service providers (which would typically be multiply acquired) sort merchant/corporate transactions independently of the PCH switch.

3.11.1.2 Merchants were restricted to a single acquiring bank to process all their transactions of the same payment stream. "On us" transactions are those by card holders of the same bank as the merchant's acquiring bank, "on them" transactions are those by card holders not belonging to the same bank as the merchant's acquiring bank. "On them" transactions are switched to the relevant other bank through an operator (Bankserv or a card association), whereas "on us" transactions are processed directly by the acquiring bank (as it is also the issuer) and are not switched via an NPS operator. Some merchants appear to believe that "on us" transactions attract neither operator fees (which is true) nor interchange fees (which is false) and therefore if all the transactions in their stores were "on us", all switching fees and interchange fees are avoided, resulting in reduced merchant fees to the merchant. In order to convert all their transactions to "on us", merchants seek to be acquired by all banks, sort their transactions themselves or do so via an unlicensed operator (i.e. by-pass the operator, and do the switching themselves), and send each bank directly the transactions generated by that bank's card holders. The NPS Supervision Department placed a moratorium on multiple-acquiring/sort-at-source in December 2004, but subsequently lifted it in January 2006, but have stated that they are not in favour of sort-at-source and multiple acquiring and are still investigating this.

#### 3.11.2 *The benefits of a single-acquirer model*

We believe that there are a number of significant social benefits inherent in the single-acquirer model that would be forfeited if this practice were scrapped.

3.11.2.1 The single-acquirer model promotes common standards, which leads to a more efficient payment system,

3.11.2.2 Maximising traffic through the regulated common switch ensures that the payment system is also underpinned by a formal and regulated disaster recovery plan,

3.11.2.3 Compliance with the various governing policies (e.g. FATF) is facilitated in the single-acquirer model,

3.11.2.4 Routing the majority of payment instructions through the regulated switch enhances

the ability of the SARB to monitor systemic and other risks, and

3.11.2.5

The scale in switching inherent in the single-acquirer model implies that the total cost of payment transaction processing is minimised, making single-acquiring the most efficient model from a system point-of-view.

3.12

### **Standard Bank's view on multiple acquiring and sort-at-source**

3.12.1

We do not believe that prohibitions on multiple acquiring and sort-at-source reduce competition. Nevertheless, we point out a few adverse unintended consequences that need to be taken into account if the status quo is not changed and sort-as-source and multiple acquiring prohibited.

3.12.2

#### *Curtailment of the payment system*

If large merchants move to multiple-acquired and sort-at-source arrangements, the transaction volume of the PCH switch will necessarily decline, leading to increased per transaction costs for the switch. This rise in costs will be carried by the smaller retailers who cannot afford the investment required to implement the multiple-acquired model. On the margin, small retailers would then be priced out of the payment system as costs rise beyond their means. Payment infrastructure would disappear from poorer areas and smaller retailers, to the disadvantage of the low-end of the market and contrary to government and banking industry objectives to extend financial services. A parallel argument holds true for smaller banks – retailers will not install direct connections to smaller banks, and these smaller banks will be obliged to continue using the switch (Bankserv or card association). The higher per transaction costs of the switch (due to loss of economies of scale) will increase the cost base of the smaller banks, and negatively impact their ability to compete. The customer would also pick up the fee.

3.12.3

#### *Flawed reasoning*

The key motivation on the part of the merchant appears to be the assumption that “on us” transactions do not attract interchange, and that merchants can eliminate unnecessary costs in the payment system through multiple acquiring and sorting-at-source. This is not true. Although an “on us” transaction by-passes the switch (Bankserv or card association), and thereby obviates the (small) operator fee, it does not avoid interchange. The cost base of the issuing business in the bank is unaffected, and interchange is still payable from the acquiring business to the issuing business of the (acquiring and issuing) bank, and is un-related to the fact that the transaction is not switched. Interchange and switching are not connected in the way that retailers appear to assume, and interchange does not cover switching costs. So whereas the merchant will in theory be able to negotiate a slightly lower merchant fee on the basis that operator fees are not payable by the acquiring and issuing businesses of the bank, the large component of the merchant fee (interchange) is still payable by the acquiring bank, and the merchant will not be able to negotiate a significant reduction in the merchant fee. In fact, the bank's cost base is likely to rise as reporting standards are imposed on banks to enable the regulator to monitor transactions that no longer route through the central switch. On this reasoning, multiple acquiring and sort-at-source do not, in our view, represent the pro-competitive outcome claimed by those who advocate it.

3.12.4

#### *Reduced ability to monitor systemic risk*

The fact that currently, the bulk of all inter-bank clearing and settlement instructions are routed through the PCH operator allows the authorities to monitor systemic risk on a real-time basis. For example, the liquidity problems of Saambou were apparent in the payment system well in advance of signals in any statutory returns<sup>18</sup>. The transfer of credit exposure and clearing and settlement instructions away from the regulated domain reduces the ability of the authorities to efficiently monitor systemic risk.

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<sup>18</sup> The Hawkins Report, pg 46

### 3.12.5 *Increased payment system risk*

Multiple acquiring and sort-at-source will lead to the disintermediation of regulated PCHs in the payment system, and a consequent shifting of credit exposures from the regulated banking arena into the wholly un-regulated world of the merchants. The systems and procedures that regulated PCHs are subject to have been carefully worked out to maintain credibility and stability in clearing and settlement. The disintermediation of the PCH would therefore represent an unwelcome introduction of un-monitored and unregulated risk into the payment system. Given that sorting at source arrangements facilitate the proliferation of non-regulated, non-bank participants (retailers, bureaux, operators / switches etc.) into the NPS, these participants will operate outside of the regulatory, governance and risk mitigation framework, which is the cornerstone of the NPS's stability leading to no regulatory oversight of their activities. The NPS operator undergoes rigorous approval criteria through PASA, amongst other, with particular emphasis on their BCP / DRP and this rigour extends to the fact that the PCH System Operator (i.e. Bankserv) has dual processing sites to ensure that the stability is maintained within the NPS and the appropriate risks associated with payments clearing and settlement are mitigated. With non regulated operators performing clearing with no regulatory oversight and little or no extensive DRP / BCP rigour (as compared to PCH System Operator's dual processing capabilities) the stability of payments clearing is at risk. Sorting at source arrangements will lead banks, including small volume banks to incur additional costs as they will need to increase their oversight role of their sorting at source participants, operators and bureaux to include acceptable DRP / BCP processes and will necessitate the registering of these arrangements with PASA. The increased risk and costs that banks will have to incur will invariably hamper key initiatives to fulfil government's mandate within the banking arena and will hamper innovativeness within this space.

### 3.13 **Recommendations for Regulation of Service Providers**

3.13.1 There is a need for an oversight body, driven by the SARB in consultation with the DTI (Department of Trade and Industry), to be established in order to manage the overall market conduct (risks, systems, market practices, etc) of the Service Providers. This oversight function cannot be performed by PASA, as PASA has the responsibility to manage the affairs of banks under the delegated mandate from the SARB. PASA will provide a link between the PSP, the banks, the NPS Operators and the SARB but will not assume direct responsibility for managing the affairs of Service Providers as they are responsible for the safety and security of the Inner Core together with the SARB.

3.13.2 As part of the operational and risk management of the Inner Core PASA has the obligation to ensure that the Service Providers do not transgress the rules, regulations and legal arrangements established within the Inner Core, for example:

3.13.2.1 Sorting-at-Source – should be prohibited given the above;

3.13.2.2 Multiple Acquiring – this should be prohibited given the above;

3.13.2.3 Float Holding – management of the exposures outside of the formal banking industry, in order to avert the risk of failure of one or more Service Providers causing a systemic knock-on in the National Payments System;

3.13.2.4 Preferential payments processing through the payroll; and

3.13.2.5 Management of the exposures.

### 3.14 **System Operators**

3.14.1 *Switches*

3.14.1.1 Switches, other than NPS Operators, currently operate in the NPS in an un-regulated way and provide services to banks and bank customers (large corporates, retailers, SME's and individuals). These switches are currently not

bound by the same standards, rules and regulatory oversight which the NPS Operators and as such don't necessarily take the same steps in order to provide a safe, efficient and cost effective interoperable service within the NPS. By not regulating these switches in the same way the NPS is at risk should one of these switches fail. The regulatory oversight of these switches (non NPS Operators) does not necessarily need to be on the same level as that of NPS Operators. However, the oversight should be in line with their role and size in the payment value chain, thereby ensuring that the potential risk they introduce is contained. A further step could be limiting what type of clearing functions they can perform relative to their size, and restricting their clearing function (still a function of regulated NPS Operators as contained in the NPS Act).

3.14.1.2 *Example of risk associated with an un-regulated switch providing services in the National Payments System*

3.14.1.2.1 One independent switch that provides debit and credit card switching for some of the larger retailers, currently switches transactions (authorisation requests and authorisations received) to the value of some R80 billion per month. As part of this service, it does the clearing between banks (on a sort-at-source basis for debit cards) and calculates the settlement obligations. These settlement obligations are then forwarded directly to each bank for settlement (between banks).

3.14.1.2.2 Should this Operator fail at any time and/or be out of service for a day or two, the systemic knock-on in the NPS would bring clearing, settlement and reputational risks resulting in destabilisation of the NPS as a whole.

3.14.2 *Bureaus*

3.14.2.1 Bureaus, other than NPS Operators, currently operate in the NPS in an un-regulated manner and provide services to banks, and bank customers (large corporates, retailers, SME's, and individuals). These bureaus are currently not bound by the same standards, rules and regulatory oversight that the NPS Operators are bound to, and as such may not take all the necessary steps in order to provide a safe, efficient and cost effective interoperable service within the NPS.

3.14.2.2 By not regulating these bureaus, in the same way as the NPS Operators, the NPS is at risk should one of these bureaus fail. The regulatory oversight of these bureaus (non NPS Operators) does not necessarily need to be on the same level as that of NPS Operators. However, the oversight should be in line with their role and size in the payment value chain, thereby ensuring that the potential risk they introduce is contained. A further step could be limiting what type of clearing functions they can perform relative to their size, and restricting their clearing function.

3.14.2.3 *Example of risk associated with an un-regulated Bureau providing services in the National Payments System*

3.14.2.3.1 Bureaus in essence have the potential to create a significantly larger risk (systemic, regulatory, fraud, etc.) in the NPS than do switches. A bureau acts on behalf of more than one corporate client whereby these corporate customers appoint the bureau to collect payments from bank customers on their behalf. The bureau assumes no responsibility for the authenticity of the debits sent to them for collection (e.g. no fraud checks; not insuring the corporate holds a valid mandate from the payer), but merely do the clearing and/or collation and submit these transactions directly to the NPS Operator for settlement.

3.14.2.3.2 Given the fact that the bureau has direct access to the NPS Operator and is not required to submit all transactions for collection to its bank, there is no

confirmation regarding the validity of the debits inputted. Should a fraudulent transaction be processed against a payer's account the payer's bank would be required to assist the client in retrieving the funds fraudulently debited. This situation could be further aggravated by the fact that the beneficiary (fraudulent company) may have disappeared leaving the collecting bank to assume the risk in order to refund the paying customer.

3.14.2.3.3 Conversely this could also happen where salary credits are submitted to a bureau, with the accompanying credit, for clearing to the NPS Operator and the bureau disappears. An example of this is a bureau that holds approximately R400 million for between 7 and 20 days before the settlement occurs and the funds are transferred to the individual clients' accounts.

3.14.2.3.4 Should this bureau fail at any time and/or be out of service for a day or two, the systemic knock-on in the NPS would bring a clearing, settlement and reputational risks and the result would be a destabilisation of the NPS as a whole.

### 3.15 **Non-Banks Issuing Payment Instruments – (open-loop payment system)**

3.15.1 An open-loop payment system as provided by non-banks is a many to many payment system where the issuer and acquirer is the same person, but the mechanism can be utilised at a host of different retailers, beneficiaries, etc for payment. The "funds" as shown below can be used for the purchase of goods/services, etc, beyond the business of the issuer. For example, an in-store card can now be used at all shops in a shopping centre, or across multiple shopping centres. This system would not have the same level of interoperability as a "public payment system" as provided by the banks under the current NPS regulatory oversight structure.

3.15.2 This open-loop payment system is underpinned by many "account types". These are:

3.15.2.1 Accounts regulated as deposit accounts in terms of the Banks Act, and/or

3.15.2.2 Pre-funded/Pre-paid accounts; and/or

3.15.2.3 Accounts funded through discounts; and/or

3.15.2.4 Accounts with a line of credit; and/or

3.15.2.5 Overpayment of account normally intended to have a line of credit available.

3.15.3 There are a number of concerns relating to payments made from 'quasi' deposits (those mentioned above) as these are not directly covered in the definition of Deposit and/or Deposit Taking in the Banks Act. This gives these instruments a life of their own and gives rise to a number of risks in the NPS, some of which are:

3.15.3.1 Subsidiary money supply (i.e. creating money – M3);

3.15.3.2 Credit risk;

3.15.3.3 Replaces cash;

3.15.3.4 Reputational risk to NPS and banks; and

3.15.3.5 Preferred informal payment product, with no regulatory oversight.

3.15.4 This regulatory gap creates a potential for arbitrage (regulatory and other) opportunities within the current regulatory environment of deposit taking in relation to making payments. In these instances payments are made from monies held by exempted and/or non-bank entities using 'quasi' deposits.

3.15.5 In these open-loop payment system there are a number of participants who issue payment instruments, as mentioned above, in an un-regulated manner. Some of these entities and their actions are described below:

- 3.15.5.1 Retailers – are expanding the use of their extensive foot-print. They are issuing payment instruments, on the premise that these instruments are issued on the basis of “credit granting”, however the customer often uses these instruments as savings and/or pre-funded payment mechanisms. This in effect equates to the retailer taking deposits; however, this is outside of the scope of the current definition of “deposit taking” in the Banks Act.
- 3.15.5.2 Mobile Companies – given the explosion of mobile technology, the mobile companies are fast becoming “banks” in their own right by creating various mechanisms for customers to transact, in real time, using their handset and their mobile account. Customers transfer money into their mobile account, i.e. overpay their account, this then gives them a mechanism to transact in real-time by-passing the formal banking sector. This effectively creates a pseudo-currency and gives the mobile company the ability to hold deposits, outside of the regulatory environment.
- 3.15.5.3 Buy-Aids – essentially these entities negotiate with merchants and suppliers to obtain trade discounts for their customers. In return the merchants and suppliers increase their sales by having additional customers in their store. The Buy-Aid then signs up customers, provides credit to them, issues a card in the customers name, provides the customer with various repayment options and gives the customer a list of merchants and retailers at which they can shop using the POS infrastructure created by banks. A closed-loop system migrates into the open-loop system and a non-bank then performs all the functions of a bank with little or no regulatory oversight.

### 3.16 **Recommendation relating to Open-Loop Payment Systems**

- 3.16.1 In order to more effectively manage the risks which these non-banks bring into the NPS, the SARB together with the DTI, should define the criteria to manage the market conduct and the payments system participation of these entities. In this both regulatory bodies should clearly demarcate their respective areas of responsibility and together ensure that the participation of these entities do not negatively impact the economy. To this end these two government departments should join forces in order to finalise and promulgate the Dedicated Banks Act (creating 2<sup>nd</sup> tier Banks), either as a stand-alone piece of legislation or incorporated into the existing Banks Act.
- 3.16.2 Once the necessary regulation has been put in place, the participants in open-loop payment system who issue transactional accounts should be assessed against a set of entry and participation criteria (determined by SARB and PASA in conjunction with the DTI) in order to establish the participation category they fall into and the appropriate way in which to regulate them.
- 3.16.3 *Some specific recommendations are:*
- 3.16.3.1 Non-banks issuing payment instruments which effectively act as a deposit taking mechanism (pre-paid/pre-funded credit instruments) should be required to become 2<sup>nd</sup> tier banks. As second tier banks they would be able to become members of PASA, participate in some of the PCH’s as sponsored and/or mentored clearers with a view of growing into full direct clearers, submit transactions directly to the NPS Operator and settle in the SAMOS system in their own name. These 2<sup>nd</sup> tier banks would have a lower statutory requirement (liquid assets and Capital Adequacy Requirement) and would be limited in the types of transactions and/or banking activities they would engage in (i.e. deposit taking, savings accounts, loans and recovery of loans).
- 3.16.3.2 These 2<sup>nd</sup> tier banks would be subject to the compliance requirements of PASA for participation in the NPS and would participate in all the self-regulatory functions of the PASA and PCH structures, including direct access to the NPS Operator in accordance with the relevant service level agreements.

3.16.3.3 In addition to this the SARB would be given oversight, through the Banking Supervision Department and the NPS Department, over the current exempted entities (SAPO/Postbank and Ithala). This would remove the current situation of a Government entity, exempted from the Banks Act, being 'regulated' in the payments system by a commercial bank.

### 3.17 **Non-Banks issuing Payment Instruments – (Closed-loop Payment Systems)**

3.17.1 A closed-loop payments system, as provided by non-banks, is a payment system where the issuer is the only person that accepts payments from the payment system provided by itself. The funds accepted and/or received into this system are purely used, by the consumer, to pay for goods and/or services provided by the issuer of the payment instrument (i.e. a Telkom pre-paid phone card). This system would not have the same level of interoperability as a "public payment system" as provided by the banks under the current NPS regulatory oversight structure.

3.17.2 This closed-loop payment system is underpinned by many "account types", these are:

3.17.2.1 Accounts regulated as deposit accounts in terms of the Banks Act, and/or

3.17.2.2 Pre-funded/Pre-paid accounts, and/or

3.17.2.3 Accounts funded through discounts, and/or

3.17.2.4 Accounts with a line of credit, and/or

3.17.2.5 Overpayment of account normally intended to have a line of credit available.

3.17.3 By limiting the extent to which these closed-loop payment instruments are used within the NPS and enhancing the regulatory oversight of the payments activity the market conduct potential contagion from these non-regulated payment instruments/systems into the NPS would be minimised.

### 3.18 **Recommendation relating to Closed-Loop Payment Systems**

3.18.1 The fundamental departure point in discussing the regulatory oversight and management of the market conduct of participants in the closed-loop payment system is that the activities of these participants must be restricted to the defined closed-loop space and not creep into the open-loop or banking space. In this, it is important to ensure that closed-loop participants don't use their holding company structure to allow for payments across all of their subsidiaries outside of the formal regulatory oversight of the NPS. The importance of managing this very closely is that through the holding company / subsidiary structure the payment activities have the potential to expand exponentially and create a new payments market outside of the formally regulated one. The risk and contagion effect this will have in the NPS will destabilise the economy as this market creates payment transactions and lending products predominantly, but not exclusively, to the lower-end of the market.

3.18.2 In order to achieve this, there is a requirement for the SARB, together with the Department of Trade and Industry to implement appropriate oversight including an efficient "Assisting Body" to address the current high risk areas and subsequent deterioration across the NPS and the entire payments value chain within the closed-loop payment system.

### 3.19 **Summation and Overall Recommendations in relation to Access for Outer Core Participants**

3.19.1 Given the motivations outlined in the sections above, Standard Bank has a number of recommendations on how to strengthen regulatory oversight of non bank players in the NPS.

3.19.2 An overall legal and regulatory structure within the NPS should continue to be created with the cooperation of all the relevant stakeholders. This would include a legal and

regulatory oversight framework that holds all persons participating in the NPS (open-loop, closed-loop and bank issued payment systems responsible to protect the NPS as a whole and/or its components).

3.19.3 The responsible persons would include the SARB (oversight of the NPS as a whole, which includes all the different payment systems provided by banks and non-banks) and the individual NPS Providers (for individual payment systems including the protection of the users of those systems).

3.19.4 In addition to this, the promulgation of the Dedicated and Cooperative Banks Acts will allow the open-loop systems of the existing cooperatives (which are hybrid or open loop) wishing to assist their members by providing basic banking mechanisms in a closed environment. This would go a long way to capture more of the un-banked customers and fulfil the requirements of the Financial Sector Charter. This too will further reduce the potential for systemic risk, destabilisation of the NPS and the impacts on the economy.

**Table: Proposed new regulatory oversight**

Entity	Proposal for strengthening regulatory oversight
Banks	Continued oversight by SARB through PASA
Exempted/excluded banks	Convert to banks - bring in the Dedicated/Co-operatives Banks Act  Oversight by SARB through PASA
Non banks playing in bank issued payments space – Open loop	Provide clear regulation and oversight for Payment Service Providers, bureau's, Beneficiary Payment Providers, operators, payroll providers, etc. This should include regulation and oversight for managing float holding, sort-as-source, multiple acquiring, etc and creating a new body to assist the SARB to oversee these participants.
Non banks playing in bank issued payments space – closed loop	<ul style="list-style-type: none"> <li>• Clearly define the extent and definition of closed loop, to prevent reach creep.</li> <li>• Principles set by SARB in conjunction with PASA, overseen by separate body. (They cannot be allowed into PASA as that is the core and the non banks have significantly different drivers and risk profiles to banks. The Central Bank of Australia has substantiated that the notion of allowing non banks into a core PSMB such as PASA is not a good idea).</li> <li>• The non banks should oversee there own body, reporting to SARB.</li> </ul>

3.19.5 In order to provide the Reserve Bank with greater regulatory oversight, of all the players in the NPS provider, to ensure sustainable access to the NPS and control of risk, a number of changes would have to be made to the NPS Act. These changes include:

3.19.5.1 Broadening the definition of risk to include both risk leading to sudden shocks as

well as risks leading to a deterioration of the NPS over time. This will allow SARB to monitor all players in the NPS and intervene timeously where needed.

- 3.19.5.2 Ensuring that the scope of the duties of the Reserve Bank is clearly defined to ensure that the Reserve Bank has oversight of all participants and activities of the NPS.
- 3.19.5.3 Categorising all forms of payment systems open or closed loop payment systems and ensuring the Reserve Bank sets up appropriate structures and processes to oversee both systems.
- 3.19.5.4 Amending the definition of clearing to reflect clearing by both banks and other parties.
- 3.19.5.5 Limiting the amount of time a payment service provider and/ or NPS provider may hold payment to that of the relevant settlement cycle, and that payment is final when the payer has moved the claim to another payment system provider (or the same as the case may be).
- 3.19.5.6 Granting the Reserve Bank the power to ensure implementation of the NPS Act and institute remedial action through both criminal action (which it can now do) and directives.
- 3.19.5.7 Further details on what legislative changes could be made to improve access and competition, can be provided on request.

## 3.20 **Section 2: Bankserv and other NPS related operators**

### 3.20.1 *Background*

3.20.1.1 Numerous bank owned NPS operators have been created over time by the banking industry, in order to ensure efficient clearing and determination of settlement obligations. These have consisted of Saswitch (ATM switching), Multinet (ATM switching), Bankscan (credit card voucher clearing), ACB (cheque clearing), STRATE (for settlement of equity trades), BESA (Bond Exchange of South Africa), SBV (cash clearing and distribution), to name a few, by the banking industry.

3.20.1.2 Bankserv is the current predominant Payment Clearing House System Operator<sup>[1]</sup> in relation to low value, high volume transaction clearing. Bankserv arose out of the merging of many of the above mentioned NPS clearing houses (Multinet, Saswitch, ACB, Bankscan). This is in line with international trends, where the convergence of NPS System operator's in smaller volume countries i.e. outside the USA, will always occur, to strive for greater efficiency, economies of scale and cost reduction. This also enables easier access to the NPS, due to one connection being required (not one per participant). Bankserv primarily provides electronic switching and clearing of inter-bank transactions in the NPS. It essentially clears the transaction by switching the payment instruction between two banks and providing the clearing information and payment obligations to the participant banks<sup>[2]</sup>, and calculating and providing the gross settlement figures to the central bank. (See diagram below). As such, Bankserv, STRATE/BESA and SBV, are an integral part of the banking infrastructure of the NPS and should be national utilities. Most countries have one NPS Operator per payment stream and many have only one for all. This is in a desire to achieve national efficiencies, especially in larger volume countries e.g. the United Kingdom.

<sup>[1]</sup> Bankserv was appointed as a "Payment Clearing House System Operator" by PASA in terms of the National Payment System Act of 1998

<sup>[2]</sup> Bankserv's core services are ATM switching including debit card transactions processed through an ATM, Saswitch Credit Card Authorisation service, Cheques - CLC (code line clearing) switching, and Electronic Funds Transfer Switching – both same-day service value and dated transactions (1 day and 2 day). It also offers non core services – a cheque verification system, fraud management, operator processing and switching services into Africa, web based Management Information Services, research and development, and consulting services.

- 3.20.1.3 The entry and participation criteria of the relevant NPS operators are set by PASA in terms of the NPS Act and monitored by SARB. Therefore, the NPS operators are appointed under the auspices of the SARB and managed by PASA through the PCH structure.
- 3.20.1.4 The NPS Act stipulates that only banks can be members of PASA and only banks can clear and settle payment obligations for the following reasons:
- 3.20.1.4.1 protection of the economy from systemic and reputational risk,
- 3.20.1.4.2 protection of banks from liquidity risk by reducing open counterparty exposures during the clearing process, which ultimately protects consumers.
- 3.20.1.5 *If the criteria were not applied by PASA under the NPS Act, banks would be exposed to higher levels of liquidity risk and there would be an increase in systemic and other risks. This could lead to instability in the banking industry and could result in reputational damage to the economy.*
- 3.20.2 Ownership and control
- 3.20.2.1 Bankserv, STRATE and SBV primarily form the non-competitive operations of banks in the National Payment System as a shared infrastructure and are wholly or partly owned by a number of banks that operate in South Africa. Bankserv's owners are divided into majority shareholders and minority shareholders :
- 3.20.2.1.1 Majority Shareholders (referred to as "A" Shareholders):
- 3.20.2.1.1.1 ABSA Bank Ltd
- 3.20.2.1.1.2 FirstRand Bank Ltd
- 3.20.2.1.1.3 Standard Bank Ltd
- 3.20.2.1.1.4 Nedbank Ltd
- 3.20.2.1.1.5 Dandysheff (representing Citibank, Bank of Athens, Capitec Bank, Mercantile Bank, Investec Bank and Teba Bank)
- 3.20.2.1.2 Minority Shareholders (referred to as "B" Shareholders):
- 3.20.2.1.2.1 Eighty One Main Street
- 3.20.2.1.2.2 ABSA Nominees
- 3.20.2.1.2.3 Standard Nominees
- 3.20.3 Shareholders
- 3.20.3.1 The Shareholders, when they established Bankserv as a utility, agreed to limit the return on their capital contribution. This ensures that the infrastructure for interoperability and efficient processing of banking transactions is maintained and no undue risks are taken. The setting of a low return on investment has led to lower fees, which leads to NPS operator fees being a very low percentage of overall customer fees.
- 3.20.3.2 The Shareholders to date have managed Bankserv as a low cost self-funding national utility dedicated to providing the core switching, clearing and settlement systems of the NPS thereby ensuring the highest possible standards of safety, efficiency and reliability within the NPS.
- 3.20.3.3 Bankserv's shareholders (contrary to Standard Bank's view) recently agreed to Bankserv providing services outside of the "utility" domain by commercialising its services and operations. In Standard Bank's view a number of potential unintended consequences could result:
- 3.20.3.3.1 Since Bankserv is considered an integral part of the NPS, operating outside

of this could jeopardise the stability of the NPS and the economy.

- 3.20.3.3.2 If Bankserv proceeds to act outside of its intended utility function it could be accused of anti-competitive behaviour.
- 3.20.3.3.3 Commercialising Bankserv could lead to the destruction of industry value and could lead to potential abuse of customers from a cost absorption perspective. There would potentially be an increase of costs to smaller players resulting in them not being able to participate on a competitive basis.
- 3.20.3.3.4 If Bankserv moved beyond its interbank switching, and its clearing and settlement function, and in additional facilitated non-bank direct participation in the clearing of transactions, it would give non-banks direct access to the bank infrastructure. This, in our view, would be an abuse of the interoperability created in the NPS, giving un-regulated participants access which could lead to instability in the NPS as a whole.
- 3.20.3.3.5 If Bankserv ceases to be a utility likelihood of its major customers withdrawing their business is greater, thereby leading to direct clearing between such customers with the following impacts:
  - 3.20.3.3.5.1 Elimination of economies of scale
  - 3.20.3.3.5.2 Reduction in transactional processing efficiency
  - 3.20.3.3.5.3 Reduction in inter-operability within the National Payments System
  - 3.20.3.3.5.4 Increased cost of participation for smaller banks
  - 3.20.3.3.5.5 Increased charges to the end-customer.
- 3.20.3.3.6 If Bankserv were to commercialise its services, smaller banks would be disadvantaged since under the current operation Bankserv has consistently lowered prices for small banks at the behest of SARB.
- 3.20.3.3.7 If pursuit of profit in other industries causes Bankserv to divert resources away from its core business with consequential system failures it is Bankserv's shareholders that undoubtedly would be expected to intervene in the national interest.

### 3.21 **Concerns around access**

- 3.21.1 We are aware of the concern about the structure and role of Bankserv, and the impact that might have on access. But, as in the case of the UK Office of Fair Trading enquiry into the UK national payment system, we think that it will be found that there is little to criticise the operators for.
- 3.21.2 In fact Bankserv has no say in who should or should not have access to the national payment system or to the Bankserv switch. That is all determined by PASA and the relevant Payment Clearing Houses.
- 3.21.3 Moreover, although the Bankserv Board of Directors determines the switch fee, that is minimal in the overall context (i.e less than 2% of overall customer fees).

### 3.22 **Recent developments**

- 3.22.1 As a shareholder we have recently been party to a review of the control and role of Bankserv. The other 'A' shareholders and management have come to the conclusion that the company ought to diversify and "commercialise". If it does not do so, they believe it will be very difficult to maintain the high standards of management expertise that are required, and that the company has the ability to perform services in addition to those related to the core clearing services of the banking industry.-
- 3.22.2 Standard Bank fully subscribes to the desirability of "cleaning up" the governance of

Bankserv, We have therefore proposed that the shareholders' agreement should be scrapped in its entirety, that some independent directors (and most particularly the regulator) should be elected onto the board, and that the user agreements with the banks should be amended to ensure that the banks are able to take the action necessary to ensure that the service standards are maintained, and to ensure stability of operation for Bankserv provided those standards are maintained.

- 3.22.3 In doing so we have refused to sign an interim agreement (which has been signed by all the other shareholders) which selectively deletes some of the existing provisions of the shareholders' agreement, but not all of them, and which fails to put anything else in its place to ensure the maintenance of service levels, or stability of the operating environment for Bankserv.

#### 4. **CHAPTER 3 – PAYMENT SYSTEM ISSUES**

##### 4.1 **Introduction**

- 4.1.1 Chapter 2 dealt in detail with the various issues under access to the National Payment System. There are a number of additional issues related to the National Payment System that are not directly related to access, and which are addressed in this chapter.

- 4.1.2 In Chapter 2 we quoted the SARB's view, as contained in its Blue Book, that co-operation between banks is unavoidable in the conduct of the NPS. This co-operation manifests itself in, amongst other things, the reasonable and necessary practice whereby the banks recover from one another the costs incurred in the use of one another's systems and facilities. These interbank interchange/carriage recoveries will be of interest to the Panel, as will prohibitions on price-differentiation (on the part of the merchant) by the card associations, and multiple-acquiring/sort-at-source. The existence of garage cards has also been raised as an area of concern by the Technical Team, although we have not found any serious competitive issues with respect to garage cards, and present a summary of our reasoning.

- 4.1.3 A number of our proposals in this chapter refer to mechanisms aimed at ensuring a cost-based or component-based price in relation to interbank interchange/carriage fees. As discussed in Chapter 1, Standard Bank does not calculate its fully absorbed transaction costs on a per transaction basis across its businesses, nor do we calculate the marginal costs or marginal profitability on a per transaction basis. In the case of interbank payment system fees, we will discuss a system for setting interbank payment system default fees that potentially involves the calculation of *partial* per transaction average costs for interbank interchange/carriage fees. This is not inconsistent with our statements in Chapter 1. Firstly, the interbank interchange/carriage cost calculation discussed in this chapter will be carried out by independent expert 3rd parties based on their proprietary methodologies. Standard Bank has provided cost data as inputs to such calculations, but has not itself performed such per transaction calculations. Secondly, the per transaction cost calculations contemplated in this section are not done on a fully absorbed basis i.e. only part of the issuer or acquirer's cost base is considered, and bank overheads are not allocated. The difficulty of a proper overhead allocation has been a key reason why Standard Bank has not been able to calculate a fully absorbed per transaction cost across its transactions. On this basis, the partial per transaction costing suggested in this section should be seen for what it is, a fair way to set the default rate in a multilateral setting. It does not solve the problems of performing a fully absorbed per transaction costing across our business.

##### 4.2 **Interbank interchange/carriage fees**

- 4.2.1 Four-party card interchange, three-party interbank carriage charges, and interbank fees in other payment streams (e.g. EFT, AEDO/NAEDO, money transfers and agency arrangements) are often mistakenly treated as areas exhibiting distinct issues. To understand, and thereby resolve, the complex competition issues in this regard, it is

important to recognise that interbank charges across all payment systems exhibit a common set of underlying issues, and therefore require a holistic solution. We believe that the key issues are the following:

- 4.2.1.1 What is the justification for interbank interchange/carriage fee recovery?
- 4.2.1.2 Why is a system of multilaterally implemented interbank interchange/carriage fees the only workable approach?
- 4.2.1.3 What is the optimal practical and pro-competitive system for determining interbank charges across payment systems (in the case of a unique industry that is obliged to co-operate for the national good and contain risk to appropriate levels)?

4.2.2 The case that we will propose with respect to each of these issues is consistent across payment streams. However, the issues are at the forefront of the debate in the case of four-party card interchange and interbank carriage, and we will focus most of our attention on these systems.

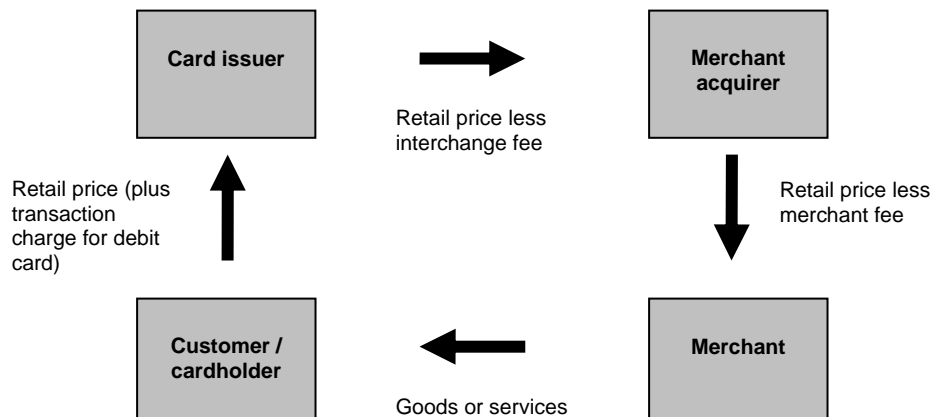
4.2.3 A point worth noting at the outset is that certain payment streams in South Africa (e.g. EFT) exhibit interbank interchange/carriage fee, whereas internationally the same payment streams typically do not have interbank interchange/carriage fees. This is predominantly due to the existence of float in these international systems through which banks earn float interest in lieu of interbank interchange/carriage fees. As the international payment systems migrate to the more advanced South African model of same day clearing and settlement and hence same day value, this float income will disappear. Payment streams that currently do not exhibit interbank interchange/carriage in international systems will likely reflect the South African system over time out of necessity to ensure the continuance of interoperability in an economically feasible manner.

4.2.4 *Introduction to interbank interchange/carriage fees*

Interchange and carriage fees are interbank charges levied across the various payment streams (credit card, debit card, hybrid cards, EFT, AEDO/NAEDO, ATM, money transfers and agency arrangements) by the acquirer or issuer (depending on the payment stream) for work done on behalf of the other party, which enables some economic compensation for enabling interbank interoperability.

4.2.4.1 *Introduction to card interchange*

**Figure: flow of fees in a four party model**



4.2.4.2 Card interchange is the fee paid by acquirers to issuers in a card purchase transaction within a four-party payment system. There is a distinction between the issues associated with interchange on the one hand, and the merchant fee on the

other. The merchant fee is the fee that the acquirer charges the merchant for acquirer services, for which the merchant receives many benefits. A component of the merchant fee is the interchange that the acquirer passes on to the issuer. In our view, the acquirer market is highly competitive as evidenced by the thin margins in this market, particularly in respect of large merchants. We will propose a number of pro-competitive measures related to interchange; the debate should not be distracted by the dynamics of the acquirer market and the merchant fee.

4.2.4.3 Interchange is simply a price set in the market for issuer services. The issuer markets to the general public, assesses the credit risk and makes the credit decision, issues and re-issues the cards, services and maintains the card-holder base, funds the credit, bears the full cost of that funding for the interest-free credit period (credit cards), processes the incoming transactions against the card-holders' accounts, bears the risk of payment fraud, and bears the credit risk of non-payment of the balance on the account. In the credit card environment, the issuer receives no transaction fee from the client.

4.2.4.4 The market for issuer services is more complex than normal markets because, unlike typical markets, the demand for issuer services arises from the interaction between issuers and three other distinct parties, namely: merchants, acquirers and card-holders.

4.2.4.5 Merchant demand for issuer services arises from the benefits that accrue to merchants from the issuer's client base, including:

4.2.4.5.1 incremental sales arising from the utility of a credit card;

4.2.4.5.2 incremental sales arising from the card-holder's access to credit provided by the issuer;

4.2.4.5.3 guaranteed payment and an underwriting of payment fraud by the issuer; and

4.2.4.5.4 easier reconciliation of purchases (due to electronic records), easier banking compared to other payment mechanisms, and reduction in expensive and less desirable (from a safety aspect) cash and fraudulent cheques (for which the merchant pays no "deposit type/merchant fee", yet chooses to not accept.)

4.2.4.6 Acquirer demand for issuer services arises from the fact that the acquirer's business depends on the existence of the issuer's card-holder base. Without the issuer's client base out in the market there would not be any demand from the merchants for the services of an acquirer.

4.2.4.7 Card-holder demand for issuer services arises from the utility of having a credit card, including the convenience that it affords, the benefit of being able to buy on credit, and the benefits of interoperability in that the card-holder can use the card almost anywhere.

4.2.4.8 *Introduction to the interbank carriage fee*

Interbank carriage fees are interbank fees paid by the card issuer (issuing bank) to the acquiring bank (ATM infrastructure provider) when a customer of the issuing bank uses the acquiring bank's ATM network.

4.2.5 *The justification for interbank interchange/carriage fee*

The first issue outlined in the introduction to this section is "what is the justification for interbank interchange/carriage?". We will make the case explicitly for four-party card interchange and three-party interbank carriage fees, but it should be clear that the arguments made in the case of these payment systems apply across payment systems in general.

- 4.2.5.1 *Justification for four-party card interchange*
- 4.2.5.2 Interchange is the most effective method of dealing with the complex relationships involved in four-party card systems.
- 4.2.5.3 It would be possible, in theory anyway, to leave the acquirer and the merchant to sort out their relationship, and the issuer and card-holder to sort out theirs. The merchant would probably pass that fee on to the card-holder. The issuer would likewise charge the card-holder the full cost plus profit for receiving the debit, granting the credit, and performing all the other functions described above. Interchange is the foundation of interoperability in the four-party card system, and its removal will cause the true drivers of interoperability to fail.
- 4.2.5.4 The intention of allowing free market forces to prevail theoretically should make the process transparent and drive fees lower thereby promoting competition, however the unintended consequences of this would be that the overall cost to the consumer and smaller merchants would increase with cross subsidisation of larger merchants' margins (due to their strong negotiating power), thereby decreasing competition within the industry.
- 4.2.5.4.1 A legitimate price in a normal market
- From the description of interchange above, there are three clear sources of demand for issuer services, and clear costs that issuers incur in providing these services. Interchange is the legitimate price paid in the market for issuer services by the acquiring bank. The corollary is that regulatory endeavours to do away with interchange would undermine the market for issuer services, with significant adverse implications for the card payment system as a whole.
- 4.2.5.4.2 Card interchange is internationally accepted
- Interchange is a standard feature of card systems around the world, and is internationally recognised as a legitimate fee. The European Commission's 2006 investigation<sup>19</sup> found no credit card payment system that did not exhibit interchange. Interchange is internationally a standard feature of card payment systems and a line of inquiry into the removal of interchange should proceed with caution.
- 4.2.5.4.3 Adverse consequences of removing card interchange
- 4.2.5.4.3.1 **Increased cost cost to card holders:** if interchange is removed or reduced, issuers will need to find compensating sources of revenue, or reduce benefits provided to card holders. Australia provides a good example of how a large reduction in interchange led directly to reductions in the benefits of card reward programs<sup>20</sup>. Importantly, although the retailers almost immediately enjoyed the benefits of reduced merchant fees, it is disputed in the Australian market whether this cost reduction to retailers was passed on to end-consumers through reduced retail prices. We are not aware of any convincing evidence that reduced or eliminated interchange leads to a net benefit to end-consumers, and in fact may increase the burden on card-holders through the increase in costs and reduction in benefits discussed above.
- 4.2.5.4.3.2 **Undermining of the acquiring model:** The single acquiring model is undermined as there is no economic incentive for acquirers to remain

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<sup>19</sup> The European Commission Sector Inquiry – Interim Report 1: payment cards, pg 20

<sup>20</sup> Fumiko Hayashi and Stuart E. Weiner, "Interbank Fees in Australia, the UK, and the United States: Matching Theory and Practice", Economic Review – Third Quarter 2006

in the market, further intensifying the proliferation of sorting at source and multiple acquiring.

4.2.5.4.3.3

**Threats to interoperability:** interoperability is a key feature of the South African banking industry. Bank customers may not enjoy the benefit of this interoperability in an unfettered competitive market, where banks may either charge high prices for interoperability, or motivate to not accept other banks' customers altogether (which is not currently feasible in the banking industry where the principles of interoperability oblige banks to accept each others' transactions for the national good).

4.2.5.4.3.4

**Inefficient payments system:** the emergence of an inefficient payments system would result through the duplication of banking infrastructure, the reduced ability to extend the banking footprint for issuing customers and inconveniences caused through the reduced service levels and functionality to customers.

4.2.5.4.3.5

**Proprietary networks:** we believe that if the system were structured in such a way that there was no interchange, the acquiring networks would become proprietary (in the sense that the acquirers would not acquire transactions on all credit cards), the card-holders would be charged on both sides of the transaction and there would be a great deal of uncertainty. This would be of particular disadvantage to the smaller retailers

4.2.5.5

Card interchange is appropriate by normal economic principles (albeit in a not-so-simple market), is internationally recognised as legitimate, and its removal has been shown to have potentially severe adverse consequences. It is the most efficient means of issuers covering their cost base for providing interoperability. The key issue with respect to interchange is not its existence, but the mechanics of arriving at its quantum, as well as the principles that underlie the calculation and the mechanism for performing the calculation. These issues are addressed in the final part of this section.

4.2.5.6

*Justification for interbank carriage fees*

ATM networks are expensive to install, maintain and operate. While banks may provide ATM services to their own customers at a reduced cost as part of the overall banking service, banks are justified in charging customers of other banks a market-related price for the use of their ATM network. The ATM network is not like a normal consumer market where e.g. retailer A is under no obligation to stock the branded goods of retailer B, or if a price cannot be agreed upon, they do not have to accept the goods. In the payments industry, banks are obliged to provide service to the customers of other banks in the name of interoperability. The interbank carriage fee is then simply a network charge or charge for infrastructure usage paid by the issuing bank to the acquiring bank for its provision of the service (provision of infrastructure) to the issuing bank's customer.

4.2.5.6.1

Cashback at POS

4.2.5.6.1.1

Cashback at POS relates directly to the carriage fee issue for ATM (given that cashback at POS is a substitute for ATM), and exhibits the identical problems related to surcharging discussed in the next subsection.

4.2.5.6.1.2

The banking industry has been proactive in developing suitable alternatives/substitutes to ATM cash in the form of cashback at POS. Cashback at POS is not only a convenient alternative for customers but it is also a relatively cheaper mechanism for customers. However,

the proliferation and adoption of cashback at POS at retailer stores has been slow due to:

- 4.2.5.6.1.2.1 the generally slow adoption rate of debit card transactions by customers, particularly relating to the migration path whereby customers firstly adapt to making pure purchases using their debit cards, thereafter to purchase with cashback transactions, and finally to pure cashback at POS;
  - 4.2.5.6.1.2.2 the agreement of common standards and general *modus operandi* relating to these transaction types within the broader market place, as experience mounted within the pure purchases environment (i.e. implications on retailer queues for normal purchases, float requirements etc.);
  - 4.2.5.6.1.2.3 the current prohibition of the card associations' international operating rules to enabling pure cashback only transactions (although this view has changed since inception, given the uniqueness of South Africa in enabling access to cash and banking in deep rural areas in accordance with Financial Sector Charter requirements); and
  - 4.2.5.6.1.2.4 the need to institute the correct rules and standards to protect customers from other forms of cashback not placed within the correct PCH frameworks.
- 4.2.5.6.2 The proactive proliferation of pure cashback transactions at retailer stores benefits all participants (banks, retailers, associations and customers) within the broader market in the following way:
- 4.2.5.6.2.1 it enables access to cash and general banking especially in deeper rural areas where mechanisms such as ATMs do not make economic sense;
  - 4.2.5.6.2.2 retailers, especially deeper rural merchants, are incentivised to provide the capability through their POS devices thereby attracting customers into their stores, recycling their cash holdings and inherently reducing security risks and bank costs; and
  - 4.2.5.6.2.3 customers have frequent access to mechanisms that provide cash and over time can start migrating their transaction behaviour from cash to suitable electronic mechanisms such as debit card purchases.
- 4.2.5.6.3 Problems with the surcharge model as an alternative to the interbank carriage fee.
- This section makes the argument against surcharging in the case of ATM and cashback at POS.
- 4.2.5.7 *Summary of the unintended consequences of surcharging in four-party card systems.*
- 4.2.5.7.1 The following arguments apply to cashback at the merchant, via POS or mini-ATM, which fall into the category of four-party card systems.
  - 4.2.5.7.2 Retailers could potentially pass on their banking charges to customers, resulting in the overall cost to the consumer becoming higher, with retailers blaming banks for the cost. Hence retailers would not carry their portion of costs, and the "man in the street" will bear the full burden. This will be particularly problematic in under-serviced areas where nodes of dominance would likely develop and merchants with cashback at POS facilities would be in a position to charge excessively for cash withdrawals. The concerns here

are substantially the same as those raised in the case of ATM surcharging below.

4.2.5.8 Complicated logistics and associated cost would be incurred (which would be passed on to end-consumers) due to the implementation of surcharging, including:

4.2.5.8.1 Should the acquiring bank surcharge the issuing bank customer directly?;

4.2.5.8.2 Should the acquiring bank surcharge via the issuing bank who in turn will charge its customer? (funding implications; is there liability for government duty? etc); and

4.2.5.8.3 Big acquirers would be able to individually determine surcharge pricing for issuing bank customers. The consequent differentiated surcharge pricing between acquirers would put pressure on pure issuers to either absorb costs (wholly or in part) or find cheaper alternatives to extend their acquiring footprint.

4.2.5.9 *The adverse consequences of ATM surcharging*

4.2.5.9.1 For ATM, “surcharging” is an alternative system of recovering network costs whereby the bank that owns the ATM (acquirer) surcharges the other bank’s (the issuing bank) customer directly on use of the ATM, with no interbank fees paid. Surcharging allows the acquirer to charge a discretionary fee to the issuer’s customers for using that ATM. The fee may vary according to the bank to which the ATM user belongs, and by ATM location.

4.2.5.9.2 The ATM surcharging model has been adopted in a number of countries. Although it is difficult to predict what the impact of the surcharge model would be on Standard Bank’s ATM business, it is likely that, given the scale and reach of our ATM network, a surcharging model might even be in our interests from a financial point of view. That notwithstanding, we do not believe that a surcharge model would have any pro-competitive effect and would, in fact, have a negative social impact on the market for ATM services in South Africa

4.2.5.9.3 Nodes of dominance in under-serviced areas

In the surcharge model, banks would be able to charge other banks’ customers individual prices per ATM (this is also a significant issue for cashback at POS, as discussed above). Many towns in South Africa are serviced by a single ATM, and the banks that own such ATM’s would be able to charge higher prices in respect of ATM services in those towns. These “nodes of dominance” would lead to a natural upward bias to the prices charged for ATM services in under-serviced areas, to the direct disadvantage of people living in or visiting those areas.

4.2.5.9.4 Disadvantage of dominance in under-serviced areas

In the surcharge model, banks would be able to charge other banks’ customers individual prices per ATM (this is also a significant issue for cashback at POS, as discussed above). Many towns in South Africa are serviced by a single ATM, and the banks that own such ATM’s would be able to charge higher prices in respect of ATM services in those towns. These “nodes of dominance” would lead to a natural upward bias to the prices charged for ATM services in under-serviced areas, to the direct disadvantage of people living in or visiting those areas.

4.2.5.9.5 Disadvantage to small players and discouragement of new entrants

An ATM surcharge model runs the risk of discouraging new entrants and/or small players, for at least two reasons. Firstly, there is the possibility that

banks with large ATM networks would legitimately invoke volume discount principles to charge higher prices to banks with relatively low transaction volumes which could discourage new banks from entering the market. Secondly, the complexity and large number of required negotiations would pose a significant barrier to entry into the market for ATM services. In a single interbank ATM charge model, small volume players effectively enjoy the benefits of the negotiating power of the larger players, and new entrants can enter the market without having to engage in a wide range of costly and time-consuming negotiations

#### 4.2.6 *Why a multilateral approach is required*

##### 4.2.6.1 *Introduction to the issue*

4.2.6.1.1 The above arguments establish the legitimacy of interbank interchange/carriage fee. In this section we turn to the second key issue raised in the introduction which is: why is a multilateral implementation of the interbank interchange/carriage fee (per transaction type) the only workable approach?

4.2.6.1.2 Our consistent view across payment systems is that a component-based multilaterally determined single inter-bank fee (independently verified, if appropriate) is the most pro-competitive outcome available. Ideally, uniformity in setting the principles and quantum should be aimed for across payment instruments in order to prevent a differential treatment of payment instruments (specifically with respect to principles; cost components will likely be different per payment stream), or arbitrage due to misinterpretation of principles etc., resulting in unfair discrimination between streams. A regime of this nature provides a competitive outcome in that the price is component-based, and has economic utility advantages over alternative systems in that price confusion, threats to interoperability, network curtailment and unnecessary infrastructure costs are all avoided. We expand on these views below, again with a focus on interbank card interchange and interbank carriage fee, but with the explicit view that the arguments relevant for these two payment systems are applicable across the full universe of payment systems (EFT, AEDO/NAEDO, money transfers and agency arrangements, etc.).

4.2.6.1.3 It is worth noting that the necessity of a level of co-operation in the National Payment System is explicitly recognised by the SARB. Chapter 1 of the SARB Blue Book states that "...the NPS requires a delicate balance between market-driven competition, co-operation and public-good considerations. Banks and other customer payment-service providers compete for payments business and customers, whilst the efficiencies of sharing infrastructure necessitate that the participants also co-operate in setting up non-competitive infrastructures. In the national interest, it is imperative for economies of scale to be achieved and for a national payment-service infrastructure to be created to allow as many participants as possible to offer their services to the public." We expand on this necessary co-operation below. Our position is that the primary motivation for the multilateral approach is to implement and preserve the interoperability and functionality of the National Payment System. The setting of a single interbank fee is a necessary step in the process, but not the process's primary function.

##### 4.2.6.2 *The current card interbank interchange fee regime*

Current card interchange levels are based on an independent interchange component study by Edgar, Dunn & Co. conducted in 2002. The banks set credit card and hybrid card interchange at the rate determined in the study, and set debit

card interchange below the level recommended in the study (in order to encourage take-up in the relatively new debit card market). Given technological advances and scale efficiencies that have accrued since 2002, we would expect that a revised calculation would recommend a further downwards revision of card interchange. Banks however face the dilemma that the co-ordinated effort required to conduct a revised study may be viewed as a contravention of the Competition Act, and so the industry has been reluctant to do the study on a joint basis, even though it may lead to a reduction in card interchange.

#### 4.2.6.3

##### *The current interbank carriage fee regime*

#### 4.2.6.3.1

“Interbank carriage” fee is the incumbent system whereby banks charge each other a per transaction interbank fee for the use of their ATM network by the other bank’s customers.

#### 4.2.6.3.2

Similar interbank interchange/carriage fee arrangements exist for other payment streams e.g. EFT. As discussed in the introduction to this section, the South African payment system exhibits interbank interchange/carriage fees for payment streams that internationally typically do not exhibit such fees. This is predominantly due to the existence of float in these international systems through which banks earn float interest in lieu of interbank interchange/carriage. As the international payments migrate to the (more advanced) South African model, this float will disappear, and payment streams that currently do not exhibit interbank interchange/carriage in international systems will likely reflect the South African system over time.

#### 4.2.6.4

##### *The benefits of a multilateral approach*

Multilateral fee implementation provides for agreement of interbank pricing principles and cost components on a multilateral basis by the industry, the SARB, the competition authorities and an independent expert, leading to no price differentiation between banks. We believe this is the most pro-competitive option. Multilateral implementation of an agreed regime presents the following opportunities from a competition perspective:

#### 4.2.6.4.1

They create uniformity and standardisation in the application of principles, fee flows, cost components and quantum of fees;

#### 4.2.6.4.2

It is a “small volume” and “new bank” friendly model in that an average industry price is set which incentivises players with economies of scale without excessively penalising small volume banks, thereby maintaining interoperability and promoting competition;

#### 4.2.6.4.3

It represents a practical model to implement a pro-competitive system with few onerous implications on costs and resources of all participants in the industry;

#### 4.2.6.4.4

With frequent reviews and/or oversight on fees, efficiency improvements will be taken into account which could result in lower fees over time and will lead to transparency of the process; and

#### 4.2.6.4.5

The system restricts the undue negotiating power of the large volume players, minimises price confusion given that one price is paid by all, and promotes competition.

#### 4.2.6.5

##### *The adverse consequences of a non-multilateral approach*

The unintended consequences of a bi-lateral approach would lead to:

#### 4.2.6.5.1

Price confusion as a result of different prices per bank and potentially per merchant chain;

#### 4.2.6.5.2

Lower volume banks will challenge larger volume banks on the basis that

their negotiating power is limited to the size of their transaction volumes thereby promoting unfair competition and creating barriers to entry;

4.2.6.5.3

As a result of this smaller volume banks may exit the payments arena due to uneconomical business cases, reducing competition, affecting shareholder value and leading to loss of employment opportunities; and

4.2.6.5.4

As a result of the negotiating power of large volume banks interoperability is threatened leading to a reduction in interbank clearing and an increase in clearing costs as a result of an inefficient clearing model.

4.2.6.5.5

These issues are discussed in more detail below.

4.2.6.5.6

Un-manageable complexity and threats to interoperability

4.2.6.5.6.1

In the case of all interbank interchange/carriage fees, the extent and complexity of the bilateral interactions that need to be concluded in order to set interchange in accordance with normal market practice have been shown to be un-manageable, and would fundamentally threaten the integrity and interoperability of the payment system.

4.2.6.5.6.2

A bilaterally determined price implies the possibility of individual prices for every issuer-acquirer combination in each payment stream in the system. For a system of 8 issuers and 8 acquirers, this could imply 64 separately negotiated interchange prices per payment stream. When we consider that this number would then be multiplied by the number of payment streams, and multiplied again by the number of transaction sub-types per payment stream, it becomes clear that the total number of negotiated prices becomes un-manageable.

4.2.6.5.6.3

To make matters worse, it is not only the price that needs to be negotiated, but the principles upon which the price should be based. Normal market interactions would run the risk of failure by some, if not many, participants in the system to reach bilaterally agreed arrangements. Such failure would introduce unacceptable risk to the interoperability of the system, as a failure to reach agreement between any participants will undermine confidence in the system as whole. A case in point is the recent AEDO/NAEDO negotiations which were conducted on a bilateral basis. Even given the high political profile of this payment stream, the negotiations ended with two sets of banks being unable to reach a bilateral arrangement. If this were to be the result in the bigger and more important payment streams over extended periods, significant risks would be posed to the interoperability of the payment system. In our view, the social cost of any threat to the interoperability and functioning of the payment system weighs heavily against any benefits of attempting to force the market to reach a price on a bilateral basis.

4.2.6.5.6.4

For both interchange and interbank carriage (and all other relevant payment streams), attempting to negotiate and implement interbank interchange/carriage fees on a bilateral basis would fundamentally compromise the comprehensive interoperability of the South African payment network. It is highly likely that given the complexity of bilateral negotiations, many pairs of banks would not reach agreement on interbank interchange/carriage for each other's customers. Consumers would potentially find themselves unable to use other banks' payment infrastructure (e.g. ATM or POS network), leading to significant losses in utility and convenience for the consumer. Such inconvenience and lack of interoperability is a typical feature of e.g. the United States ATM surcharge system where a large portion of the total ATM network

is not available to certain card holders, because not all banks have successfully concluded bilateral arrangements with each other. The functionality of the South African payment network is admired internationally on the basis that the entire network is available to all South African bank customers. The convenience and coverage enjoyed by South African bank customers would be undermined in a bilateral model.

4.2.6.5.6.5

Threats to interoperability have adverse consequences other than those to consumers described above. The interoperability of the systems in the NPS is an element in the criteria used by rating agencies in assessing South Africa's country risk, and hence its attractiveness as a destination for foreign capital. A reduction in interoperability could be detrimental to foreign direct investment

4.2.6.5.7

Disadvantage to small players and discouragement of new entrants

In the case of card inter-change, a bilaterally determined interchange level runs the risk of discouraging new entrants and/or small players, for at least two reasons. Firstly, there is the likelihood that the differences in volumes will result in small banks having to pay higher interchange than the larger banks and discourage new issuers from entering the market. Secondly, the complexity and large number of negotiations required would pose a significant barrier to entry into the card market. In a single interchange model, small players effectively enjoy the benefits of the negotiating power of the larger players, and new entrants can enter the market without having to engage in a wide range of costly and time-consuming bilateral negotiations. This argument applies identically to ATM and other payment systems.

4.2.6.5.8

Price confusion

4.2.6.5.8.1

A system of bilaterally negotiated interchange, even if successfully implemented, would likely lead to significant price confusion. Differential interchange may lead acquirers to want to charge differential merchant fees depending on the issuer of the card presented in-store. This in turn may lead to merchants seeking to surcharge card-holders of certain issuers, or even decline their cards. The confusion caused in this way will significantly undermine the utility of the payment system to bank customers.

4.2.6.5.8.2

A bilateral system of setting ATM charges would lead to price confusion in banking products. Bank customers would at best face differential ATM charges depending on ATM network, and at worst face differential ATM charges depending on ATM location. This confusion and uncertainty would significantly detract from the utility of South Africa's extensive ATM network to bank customers

4.2.6.5.9

Increased cost and risk

4.2.6.5.9.1

A system of bilaterally determined prices will require an up-grade of the underlying payment system technology. The upgrades and modifications necessary to implement a system with the required level of flexibility will have at least two adverse effects from a competition point of view: firstly, the cost of upgrading the payment system infrastructure will ultimately have to be carried by consumers, as banks will need to recover these costs through higher prices. The cost to consumers due to system upgrade might well exceed any benefits achieved through a market-determined price, particularly relative to the pro-competitive solution we propose below. Secondly, the required

upgrade may impose risks to the payment system, in particular the risk of system failure as the upgrades are phased in. The inherent costs of running these risks may outweigh the benefits of a market determined (bilateral) price relative to the cost-based regime proposed below.

4.2.6.5.9.2

As in the case of four-party system interchange, a bilateral model for ATM network costs would imply costly upgrades to the underlying technology and infrastructure. Although this does not represent technical barriers to implementing a bilateral scheme, these costs would ultimately be borne by the end-consumer in the form of higher bank fees. The costs that consumers would incur weigh against any benefits of bilateral price setting model.

4.2.6.5.10

#### Network coverage

This issue applies predominantly to ATM. A non-multilateral model may be detrimental to the extensive coverage of the current ATM network, and would inhibit access to financial services via ATMs. The multilateral system of agreeing interbank ATM charges is a significant factor in the extension of the ATM network into under-serviced areas. In a surcharge or bilateral model, bank's would have to consider ATM-specific economics far more closely, and it is likely that ATMs in rural and sparsely populated areas would be sub-economic on a per-ATM evaluation. This would lead to a curtailing and withdrawal of the ATM network from the under-serviced areas of the country, which is contrary to our goal and obligation to spread banking services to poorer areas.

4.2.6.6

#### *Conclusions on the multilateral vs. bilateral approach*

4.2.6.6.1

We are therefore convinced that an “unfettered market” or bilateral approach to interchange will lead to economically sub-optimum outcomes across payment systems. It is worth noting that (in the case of card interchange) there is not a single working example world-wide of a fully bilateral interchange system (Sweden is the only country that approximates a bilateral system, and there the central bank actually sets a default ceiling, below which banks may negotiate bilaterally). Our considered view, consistent across all payment systems (card, EFT, AEDO/NAEDO, money transfers, agency arrangements and ATM), is that the competitive advantages of a multilateral inter-bank fee adopted by all banks outweigh any potential incremental competitive benefits of a bilateral outcome.

4.2.6.6.2

The central question in respect of interbank interchange/carriage is then how to achieve a pro-competitive set of principles, and hence level, for interchange while simultaneously preserving the interoperability and functionality of the payment system as a whole. In the following section, we present our view of the most pro-competitive solution to the setting of interchange.

4.2.7

#### *Practical pro-competitive multilateral mechanisms for agreeing the principles and quantum of interbank interchange/carriage*

4.2.7.1

We have now covered in detail the first two of the three issues introduced at the beginning of this section on interbank interchange/carriage (being the justification of interbank interchange/carriage, and the importance of a multilateral approach). We now turn to the third and final issue, which is: what precisely is the optimal mechanism for determining the principles and level of interbank interchange/carriage across payment systems?

4.2.7.2

Given the problems with bilateral interbank interchange/carriage described above, we believe that the optimal outcome for bank customers and the financial system

as a whole, is for a single interbank interchange/carriage fee per transaction type to be multilaterally determined on a component-related basis, based on multilaterally agreed principles and cost components. This is our consistent approach across payment systems, and would permit the banking industry to implement a pro-competitive component-based pricing regime based on international best practice. We are highly aware of the danger that in this proposed system, the interbank interchange/carriage fee may not be guaranteed to be cost-based, or may need be deemed to be fair. We are open to engagement on disciplining devices to ensure a fair fee. In this section, we discuss two possible mechanisms (in order of priority) that could be implemented under a multilateral regime. The two key issues are, firstly, how should the principles and cost components upon which the interbank interchange/carriage fee should be based be determined; and secondly, how is the actual quantum of the fee then determined? Both proposals below are premised on the multilateral approach motivated for above.

- 4.2.7.3 In adopting a multilateral approach for all payment mechanisms, firstly the guiding principles for the industry need to be set and agreed upon. Secondly, the cost components per payment mechanism would need to be agreed. Finally, an actual level of interbank interchange/carriage would need to be implemented by the banks (with independent refereeing, as appropriate).
- 4.2.7.4 The overarching principles that need to be maintained and adopted in any solution to address interbank interchange/carriage fee setting are:
- 4.2.7.4.1 Interoperability must be maintained;
  - 4.2.7.4.2 All fees to customer and merchant must be transparent;
  - 4.2.7.4.3 Risks introduced by a bank (acquirer or issuer) must remain with the introducing bank;
  - 4.2.7.4.4 In order to ensure interoperability and access to bank payment services interchange is required;
  - 4.2.7.4.5 Charging of customer / merchant for banking services provided by a bank, must remain within that bank in order to protect consumer / merchant against abusive pricing and risky payment transactions;
  - 4.2.7.4.6 Any proposed solution must have internal checks and balances to ensure its integrity and should not require external policing or rely on the goodwill of the parties involved (arbitrage opportunities); and
  - 4.2.7.4.7 Ensure the protection of the consumer and the broader National Payments System environment.
- 4.2.7.5 Of the two mechanisms proposed below, the first is, in our view, the optimal option from the point-of-view of competition. We discuss the second option as an alternative to the first approach, should the first approach fail, or be deemed unacceptable by the competition authorities, but believe that the impact of implementing this second approach may be unintended consequences that may adversely affect the market and competition.
- 4.2.7.6 *Option 1: Independent expert sets default ceiling interbank interchange/carriage fee*
- 4.2.7.6.1 In our view, this is the optimal choice from the point-of-view of the competitiveness of the system as a whole. The banks, the SARB, the competition authorities and an independent expert referee negotiate an overarching set of principles common across payment systems; the same parties also negotiate the cost components appropriate to each payment stream (absent any sharing of non-public information). The independent expert then determines a single default ceiling price per payment stream based on the principles and cost components agreed to above. Individual banks would still

have the option to bilaterally negotiate an independent rate between themselves.

#### 4.2.7.6.2

The SARB would vet the independent referee that would set the default interbank interchange/carriage fee ceilings per payment stream. Ideally, the SARB would appoint a single referee, with international experience, across all payment streams (i.e. a payment system specialist like Edgar, Dunn & Co.). This would ensure that the approach adopted per payment stream is consistent with a single set of over-arching principles adopted across payment streams. This avoids the introduction of artificial discrimination between payment streams, and inter-payment stream arbitrage. If for some reason a single referee system were not possible, then there should be some procedure to ensure that the various referees per payment stream are adopting approaches based on the same principles. It might even be appropriate to have a formal review process for redress in the case of patent error, on the part of the expert referee. Importantly, there should be only one referee per payment stream, to prevent referee-arbitrage on the part of the participants.

#### 4.2.7.7

##### *Option 2: Different approaches and principles per payment stream*

#### 4.2.7.7.1

We believe it is critical to view all payment systems as an integrated whole, to recognise that the issues raised are common across all payment systems, and to adopt solutions that can be applied consistently across payment systems. If, however, the above proposal proves to be unworkable or unacceptable from a competition point-of-view, then the only remaining multilateral approach would be a system characterised by unique approaches and principles per payment stream. Although this system is multilateral in the sense that banks, the SARB, the competition authorities and an independent expert referee agree principles and cost components per payment stream, and the independent expert sets the default ceiling fees, we believe that this approach suffers from the same essential problems as a bilateral approach in that the severe complexity involved would introduce the danger of failure to reach agreement. Payment systems include the POS systems (credit card, hybrid card and debit card), ATM, cash back at POS (with purchase), cash back at POS (without purchase), EFT, AEDO/NAEDO, money transfers and agency arrangements. A system in which banks, the SARB, the competition authorities and (potentially multiple) independent experts were required to agree approaches, principles and cost components for each of these systems would clearly introduce the risk of multiple instances of failure to reach agreement, and thereby introduce unacceptable threats to interoperability into the payment system as a whole.

#### 4.2.7.7.2

Although we motivate strongly against this second multilateral option, we include below summary proposals for how card interchange and ATM surcharge might be determined in this approach. We would still be faced with the predicament of how to handle the various other payment streams.

#### 4.2.7.7.3

Card interchange:

#### 4.2.7.7.3.1

At the outset, it is important to note a concern with using card associations. Interchange levels set by the card associations could potentially result in differentiated rates for the different associations which would have the consequence of driving destructive competitive behaviour at the POS as well as leading to complexities for merchants and customers alike. This situation could be further exacerbated as more card associations enter the South African Market such as the Japanese Card Bureau (JCB) and EuroPay.

#### 4.2.7.7.3.2

Nevertheless, the card associations (MasterCard and Visa) do have well-established and internationally endorsed approaches to calculating a component-based default interchange rate, using information supplied by issuers, and based on independent expert methodology. In addition, the card associations have the advantage of being un-biased with respect to interchange, yet having an interest in its rigorous calculation. In this proposal, the rate calculated independently by the card associations based on their principles and cost components sets the default ceiling for interchange, and is implemented multilaterally by the banks. Individual banks would have the option to bilaterally negotiate separate interchange arrangements independent of the default rate (in practice, banks simply adopt the default rate). The calculation would be reviewed regularly to ensure appropriate component-based interchange levels, with the period between reviews being limited to a maximum of three years.

#### 4.2.7.7.3.3

For several reasons, this would lead to a pro-competitive outcome: there is an independently set default ceiling price (i.e. there is no danger of excessive pricing), the interoperability, integrity and ubiquity of the payment system is preserved, and no system upgrade costs are passed on to end-consumers. Regulatory oversight would include vetting of an association as the independent referee and enforcement of regular interbank interchange reviews. But to repeat the point, we are still faced with the fundamental problem of the complexity of determining and implementing similar unique solutions for every payment stream in the system.

#### 4.2.7.7.4

##### ATM carriage:

#### 4.2.7.7.4.1

The ATM system does not have the benefit of the equivalent of the card associations to fulfil the independent expert role. Instead, it might be appropriate to involve an expert payment consultant like Edgar, Dunn & Co. to play the role of independent expert. The banks, the SARB, the independent expert and the competition authorities would agree principles and cost components appropriate to ATM. The banks would confidentially supply the appropriate cost information to allow the independent expert to calculate a default fee ceiling. This would lead to a pro-competitive solution, whereby the ATM carriage fee is based on accepted components, full interoperability is maintained, no unnecessary IT costs filter into customer prices, and the extensive coverage of the South African ATM network in rural and under-served areas is maintained and enhanced.

#### 4.2.7.7.4.2

Although the above proposals sketch workable regimes for four-party card and ATM carriage, as we have tried to make clear, we believe that it would be completely unworkable to attempt to devise unique mechanisms and principles for every payment stream in the payment system, and strongly motivate for the first option based on a single set of over-arching principles for the entire payment system, preferably with a single independent expert referee.

#### 4.2.8

##### *Conclusion*

Interbank interchange/carriage charges, across payment streams, are justified fees. A multilaterally agreed fee and approach to setting the principles and quantum of interbank interchange/carriage, with appropriate independent refereeing, is the only workable mechanism that preserves the interoperability and functionality of the National Payment System.

#### 4.2.8.1 *The need for regulatory relief*

The implementation of a single price could be a necessary adjunct of the mechanisms proposed in this section, but is not the primary purpose of those mechanisms; nevertheless, all of our multilateral mechanisms proposed above are potentially problematic under competition rules, and might require condoning by the competition authorities.

### 4.3 **Price differentiation amongst payment options**

#### 4.3.1 *Introduction*

The “no price differentiation” rule is a rule of the card associations, enforced by acquirers through their contracts with merchants. The rule prohibits merchants from charging separate prices for goods depending on the payment instrument chosen by the customer. That is, a customer who chooses to pay with cash cannot be charged a different price for his purchase than a customer who chooses to pay by card for the same purchase. Questions have been raised as to whether this prohibition may be anti-competitive. Given that we have no market power in the acquiring space, and that this is specifically a card association rule, we do not believe that this rule has significant bearing on us from a competition point of view. We are nevertheless happy to share our views, as this is an issue that the competition authorities have specifically highlighted as an area of concern in respect of competition in the banking industry.

#### 4.3.2 *Standard Bank’s view on price differentiation*

We do not believe that the card associations’ prohibition on price differentiation represents a threat to competition, and we would discourage the scrapping of the rule for the following reasons.

##### 4.3.2.1 *Support for the lower end of the market*

###### 4.3.2.1.1

This point is often incorrectly turned on its head, with the claim that cash payers subsidise card payers. Such arguments focus on the notion that the merchant fee is built into the retailer cost base and recovered through increased prices on all goods, and that therefore all consumers, including cash payers, indirectly pay for the merchant fee. While it is true that the merchant fee is probably built into the retail price of all goods, so too are the (higher) costs to the retailer of taking payment in cash.

###### 4.3.2.1.2

Although the actual costs per payment stream are not accurately known on a fully absorbed basis, our view, which is corroborated by international studies<sup>21</sup>, is that cash is a more expensive payment instrument than card. Setting all payment instruments at the same price implies that users of the cheaper payment instrument are subsidising the users of the more expensive payment instrument. Therefore, users of cards are subsidising users of cash, or alternatively, the higher income end of the consumer market is subsidising the lower income end of the consumer market, which directly reduces the burden on the lower income end of banking customers, which is in line with national and banking industry goals. Removing the price differentiation prohibition would frustrate this benefit to poorer consumers.

##### 4.3.2.2 *Price confusion*

Differential pricing of goods and services in-store according to payment instrument would add significant complexity to the use of payment instruments by customers. Our commitment is to reduce complexity and price confusion on the part of our customers, and for this reason would prefer the status quo with respect to this rule.

##### 4.3.2.3 *No competitive effect*

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<sup>21</sup> The European Commission Sector Inquiry – Interim Report 1: payment cards, pg 10

4.3.2.3.1 In its decision of 7 August 2001, the European Commission gave Visa “negative clearance” to the Visa price differentiation prohibition on the grounds of lack of appreciable competitive effects. The European Commission concluded that even when permitted to do so, few merchants make use of the ability to charge differentially according to payment instrument. The European Commission’s 2006 investigation corroborates this view<sup>22</sup>, as do findings in the Australian and UK markets<sup>23</sup>. This is consistent with our view of merchant behaviour. The case of cheques supports this conclusion – cheques are very cheap from the merchant’s point-of-view, yet merchants typically reject cheques. It is therefore not clear that merchant preference for payment instrument is driven by cost to the merchant of that payment instrument. If the cost of the payment instrument is not important to the merchant, we would not expect merchants to price differentiate. This is consistent with international findings.

4.3.2.3.2 If a rule has no significant impact on competition or market conduct, it is not clear what reason we would have to oppose it from a competition point of view.

4.3.2.4 In summary, we have no specific reasons for opposing this card association rule, and in fact see some merit in supporting it, if it does reduce the burden on the lower end of the market and reduce price confusion. We are not however wedded to this position, and will engage the competition authorities, or any other party that held a contrary view.

#### 4.4 **Multiple acquiring and sort-at-source**

##### 4.4.1 *Introduction*

4.4.1.1 The issue of multiple acquiring and sort-at-source applies specifically to the card (multiple acquiring) and EFT (sort-at-source) payment systems, but whilst they have different names, they are in essence the same thing, but arose for different reasons. For clarity, we discuss the issue in terms of card payments only, but the issue applies equally to operators and bureaus in the EFT space. Multiple-acquiring applies to the four-party card payment system whereby merchants seek to be acquired by several or all acquiring banks, generally through a non-NPS operator, which effectively sorts the transactions per bank, bypasses the NPS operator, and submits each bank’s transactions to that bank. Sort-at-source applies typically to the EFT payment stream whereby service providers (which would typically be multiply acquired) sort merchant/corporate transactions independently of the PCH switch.

4.4.1.2 Merchants were restricted to a single acquiring bank to process all their transactions of the same payment stream. “On us” transactions are those by card holders of the same bank as the merchant’s acquiring bank; “on them” transactions are those by card holders not belonging to the same bank as the merchant’s acquiring bank. “On them” transactions are switched to the relevant other bank through an operator (Bankserv or a card association), whereas “on us” transactions are processed directly by the acquiring bank (as it is also the issuer) and are not switched via an NPS operator. Some merchants appear to believe that “on us” transactions attract neither operator fees (which is true) nor interchange fees (which is false) and therefore if all the transactions in their stores were “on us”, all switching fees and interchange fees are avoided, resulting in reduced merchant fees to the merchant. In order to convert all their transactions to “on us”, merchants seek to be acquired by all banks, sort their transactions themselves or do so via an

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<sup>22</sup> The European Commission Sector Inquiry – Interim Report 1: payment cards, pg 124

<sup>23</sup> Fumiko Hayashi and Stuart E. Weiner, “Interbank Fees in Australia, the UK, and the United States: Matching Theory and Practice”, Economic Review – Third Quarter 2006

unlicensed operator (i.e. by-pass the operator, and do the switching themselves), and send each bank directly the transactions generated by that bank's card holders. The NPS Supervision Department placed a moratorium on multiple-acquiring/sort-at-source in December 2004, but subsequently lifted it in January 2006, but have stated that they are not in favour of sort-at-source and multiple acquiring and are still investigating this.

#### 4.4.2 *The benefits of a single-acquirer model*

4.4.2.1 We believe that there are a number of social benefits inherent in the single-acquirer model that would be forfeited if this practice were scrapped.

4.4.2.2 The single-acquirer model promotes common standards, which leads to a more efficient payment system;

4.4.2.3 Maximising traffic through the regulated common switch ensures that the payment system is also underpinned by a formal and regulated disaster recovery plan;

4.4.2.4 Compliance with the various governing policies (e.g. FATF) is facilitated in the single-acquirer model;

4.4.2.5 Routing the majority of payment instructions through the regulated switch enhances the ability of the SARB to monitor systemic and other risks; and

4.4.2.6 The scale in switching inherent in the single-acquirer model implies that the total cost of payment transaction processing is minimised, making single-acquiring the most efficient model from a system point-of-view.

#### 4.4.3 *Standard Bank's view on multiple acquiring and sort-at-source.*

We do not believe that prohibitions on multiple acquiring and sort-at-source reduce competition. In addition, we point out a few adverse unintended consequences that need to be taken in account if the status quo is not changed (i.e. if sort-at-source and multiple acquiring are not prohibited).

##### 4.4.3.1 *Curtailment of the payment system*

If large merchants move to multiple-acquired and sort-at-source arrangements, the transaction volume of the PCH switch will necessarily decline, leading to increased per transaction costs for the switch. This rise in costs will be carried by the smaller retailers who cannot afford the investment required to implement the multiple-acquired model. On the margin, small retailers would then be priced out of the payment system as costs rise beyond their means. Payment infrastructure will disappear from poorer areas and smaller retailers, to the disadvantage of the low-end of the market and contrary to government and banking industry objectives to extend financial services. A parallel argument holds true for smaller banks – retailers will not install direct connections to smaller banks, and these smaller banks will be obliged to continue using the switch (Bankserv or card association). The higher per transaction costs of the switch (due to loss of economies of scale) will increase the cost base of the smaller banks, and negatively impact their ability to compete. The higher costs would also ultimately be passed on to the customer.

##### 4.4.3.2 *Flawed reasoning*

The key motivation on the part of the merchant appears to be the assumption that "on us" transactions do not attract interchange, and that merchants can eliminate unnecessary costs in the payment system through multiple acquiring and sorting-at-source. This is incorrect. Although an "on us" transaction by-passes the switch (Bankserv or card association), and thereby obviates the (small) operator fee, it does not avoid interchange. The cost base of the issuing business in the bank is unaffected, and interchange is still payable from the acquiring business to the issuing business of the (acquiring and issuing) bank, and is un-related to the fact

that the transaction is not switched. Interchange and switching are not connected in the way that retailers appear to assume, and interchange does not cover switching costs. So whereas the merchant will in theory be able to negotiate a slightly lower merchant fee on the basis that operator fees are not payable by the acquiring and issuing businesses of the bank, the large component of the merchant fee (interchange) is still payable by the acquiring bank, and the merchant will not be able to negotiate a significant reduction in the merchant fee. In fact, the bank's cost base is likely to rise as reporting standards are imposed on banks to enable the regulator to monitor transactions that no longer route through the central switch. On this reasoning, multiple acquiring and sort-at-source do not represent the pro-competitive outcome claimed by those who advocate it.

#### 4.4.3.3 *Reduced ability to monitor systemic risk*

The fact that currently, the bulk of all inter-bank clearing and settlement instructions are routed through the PCH operator allows the authorities to monitor systemic risk on a real-time basis. For example, the liquidity problems of Saambou were apparent in the payment system well in advance of signals in any statutory returns<sup>24</sup>. The transfer of credit exposure and clearing and settlement instructions away from the regulated domain reduces the ability of the authorities to efficiently monitor systemic risk.

#### 4.4.3.4 *Increased payment system risk*

##### 4.4.3.4.1

Multiple acquiring and sort-at-source will lead to the disintermediation of regulated PCHs in the payment system, and a consequent shifting of credit exposures from the regulated banking arena into the wholly un-regulated world of the merchants. The systems and procedures that regulated PCHs are subject to have been carefully worked out to maintain credibility and stability in clearing and settlement. The disintermediation of the PCH would therefore represent an unwelcome introduction of un-monitored and unregulated risk into the payment system.

##### 4.4.3.4.2

Given that sorting at source arrangements facilitate the proliferation of non-regulated, non-bank participants (retailers, bureaux, operators / switches etc.) into the NPS, these participants will operate outside of the regulatory, governance and risk mitigation framework, which is the cornerstone of the NPS's stability, leading to no regulatory oversight of their activities. The NPS operator undergoes rigorous approval criteria through PASA, amongst others, with particular emphasis on their BCP/DRP and this rigour extends to the fact that the PCH system operator (i.e. Bankserv) has dual processing sites to ensure that the stability is maintained within the NPS and the appropriate risks associated with payments clearing and settlement are mitigated. With non regulated operators performing clearing with no regulatory oversight and little or no extensive DRP/BCP rigour (as compared to PCH System operator's dual processing capabilities) the stability of payments clearing is at risk. Sorting-at-source arrangements will lead banks, including small volume banks, to incur additional costs as they will need to increase their oversight role of their sorting at source participants, operators and bureaux to include acceptable DRP/BCP processes and will necessitate the registering of these arrangements with PASA. The increased risk and costs that banks will have to incur will inevitably hamper key initiatives to fulfil government's mandate within the banking arena and will hamper innovation within this space.

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<sup>24</sup> The Hawkins Report, pg 46

4.4.4 *Conclusions to be drawn*

In summary, our view is that multiple acquiring and sort-at-source will lead to limited benefits to consumers, and will have a number of adverse implications in terms of access by small retailers and small banks to the payment system, payment system risk monitoring and the competitiveness of small banks and/or new bank entrants.

4.5 **Garage cards**

The existence of garage cards has been raised in the context of competition in banking. Retail garage cards were introduced as a response by banks to regulations in the fuel industry that prevent fuel retailers from selling fuel on credit. Under these regulations, credit cards are not a permissible means of payment at forecourts, but customers nevertheless demand a payment instrument other than cash. Garage cards were introduced to meet this need. We can find no feature of garage cards that might be considered anti-competitive.