Subject matter of the enquiry

Bank Enquiry Public Hearings

1 November 2006

Second Session

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FEASibilitY

Financial Economic Analysis Strategy

This document provides an outline of a presentation and is incomplete without the accompanying oral commentary and discussion.

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Agenda

- International comparison
- Costs and Pricing
- Payment card systems
- Access to the national payments system infrastructure

International Background

Payment systems have come under scrutiny of consumer protection agencies around the world for number of reasons:

- Consumers complain that bank fees are too high
- Banks own essential payment system infrastructure
- Perceptions of high-entry barriers
- Ownership & control allow banks to further own business interests to the detriment of other competitors in certain market segments

International background: other similar studies

Country	**Year**	**Area**
Australia	1997 2002	Competition (Wallis), Payment cards
US	1998	Card association rules
Korea	1998	Payment cards
UK	2000 2005	Competition (Cruikshank), Small business and interchange
Botswana	2001	Bank charges; transparency
Europe	2005	Competition in retail banking, payment cards
India	2006	Bank charges

Cost and Pricing 1

- The pricing arrangement for each payment stream falls outside the remit of regulation and in the past have been negotiated on a multilateral basis

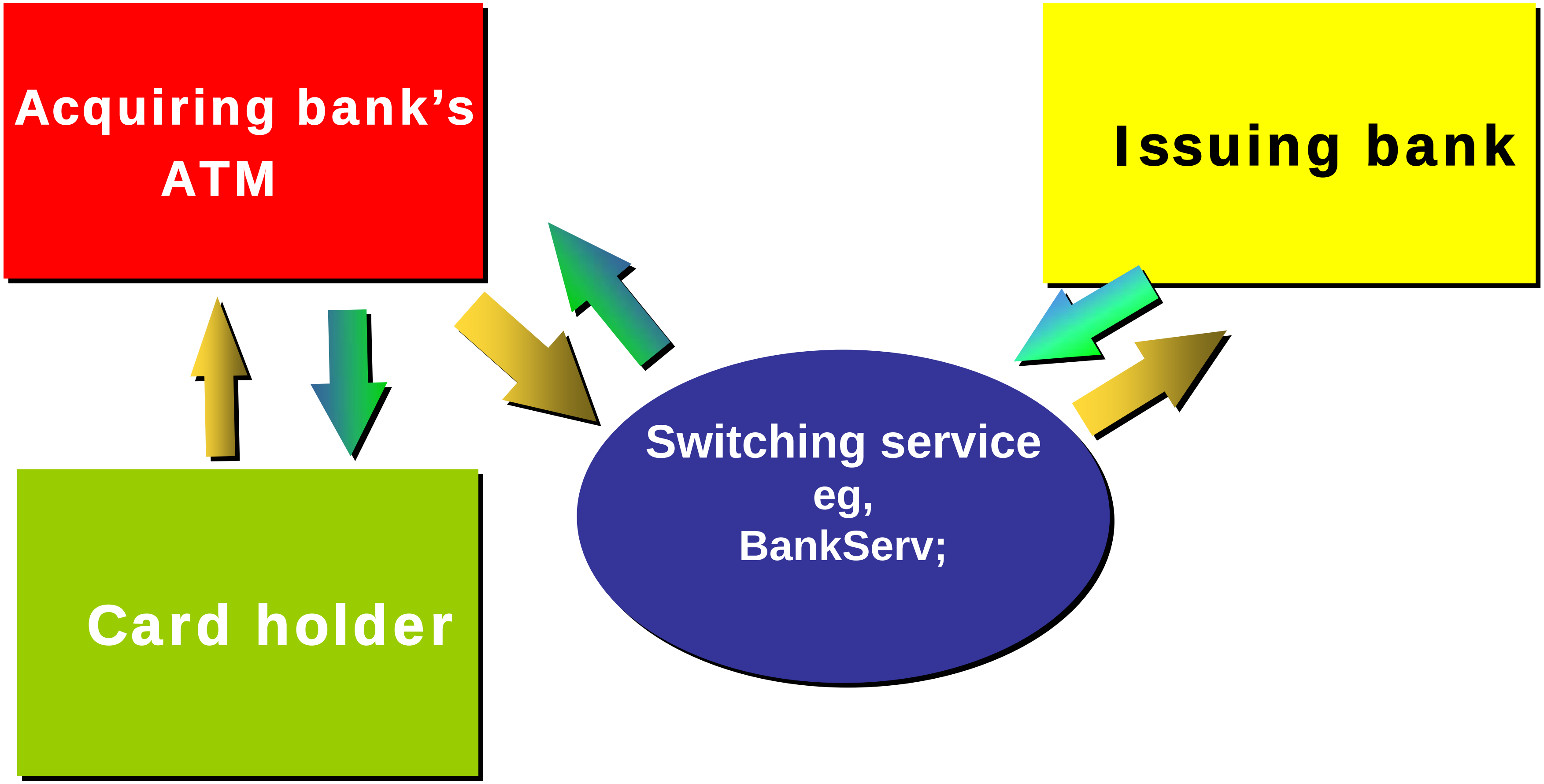
- Traditionally, the banks have set the prices by agreeing between themselves on the appropriate fee to be paid by one bank, when its customer uses another bank's ATM infrastructure, for example. Generally known as interchange, these fees are compensation for using another bank's infrastructure.

- In some jurisdictions these fees have been regarded as very high and indicative of market power rather than cost.

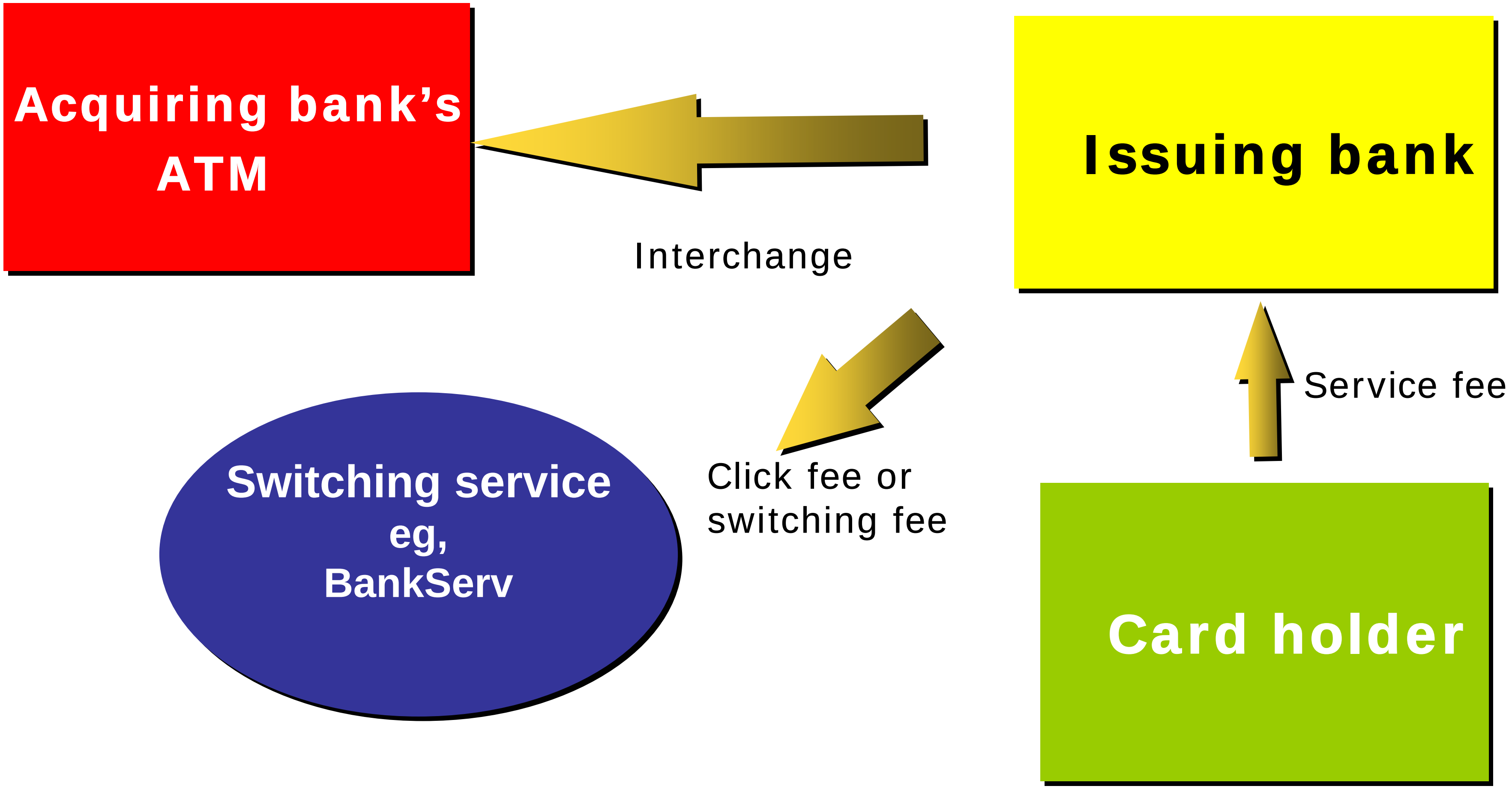
Cost and Pricing 2

- Clearing banks – members of the payment system, PASA, Card Association, Payment System Operator (eg. Bankserv, VISA, Mastercard)
- Bankserv – largest operator – interbank electronic transction switching services to the banking sector
- Wholly owned by the banks. Five shareholders (Big four own 92% and Dandishelf - seven smaller banks – owns 8%).

Cost and Pricing:
Using another bank’s ATM



Cost and Pricing:
Flow of fees: Another bank's ATM



Off-Us ATM cash-withdrawal

Fee / Cost (based on R100)	From	To	Value
Service or transaction Charge	*Consumer*	*Issuing Bank*	*R9.35*
Interchange	*Issuing Bank*	*Acquiring Bank*	*R3.25*
Bankserv	*Issuing Bank*	*Bankserv*	*R0.13*
Total			***9.35***

Assumption:

ATM Charges: R3.25 + 65 c per R100

Institution	Amount earned from transaction	Share of revenue
Bank (Acquirer)	*R3.25*	*35%*
Bank (Issuer)	*R5.97*	*64%*
Bankserv	*R0.13*	*1%*
Total	***R9.35***	***100%***

Cost & Pricing 2

Key concerns:

- Little apparent link between costs (such as Bankserv fee) and customer fee
- But draw this conclusion based on information in public domain; further inquiry might reveal a more nuanced picture
- The question of whether the level of bank charges is cost-related and competitive or whether it is a pricing consequence of the dominance of the retail banking sector through the account holding of big banks needs further investigation

Cost & Pricing 3

Key concerns:

- The distribution of income from payment activities appears to be influenced by ownership of acquiring infrastructure. Further consideration is needed on whether interchange benefits large banks
- Relative roles of interchange and service fees need to be considered in this regard

Cost and Pricing 4: Market conduct

Absence of market conduct regulation throughout the banking industry and the NPS in particular

- The lack of a transparent, unbundled price guide for consumers
- Inability to compare between providers
- Although consumers are charged explicit fees in SA, they are not transparent and potentially mask cross-subsidisation between payment streams.
- Incidence of cost (who pays)

Charges based on Average Transaction Values

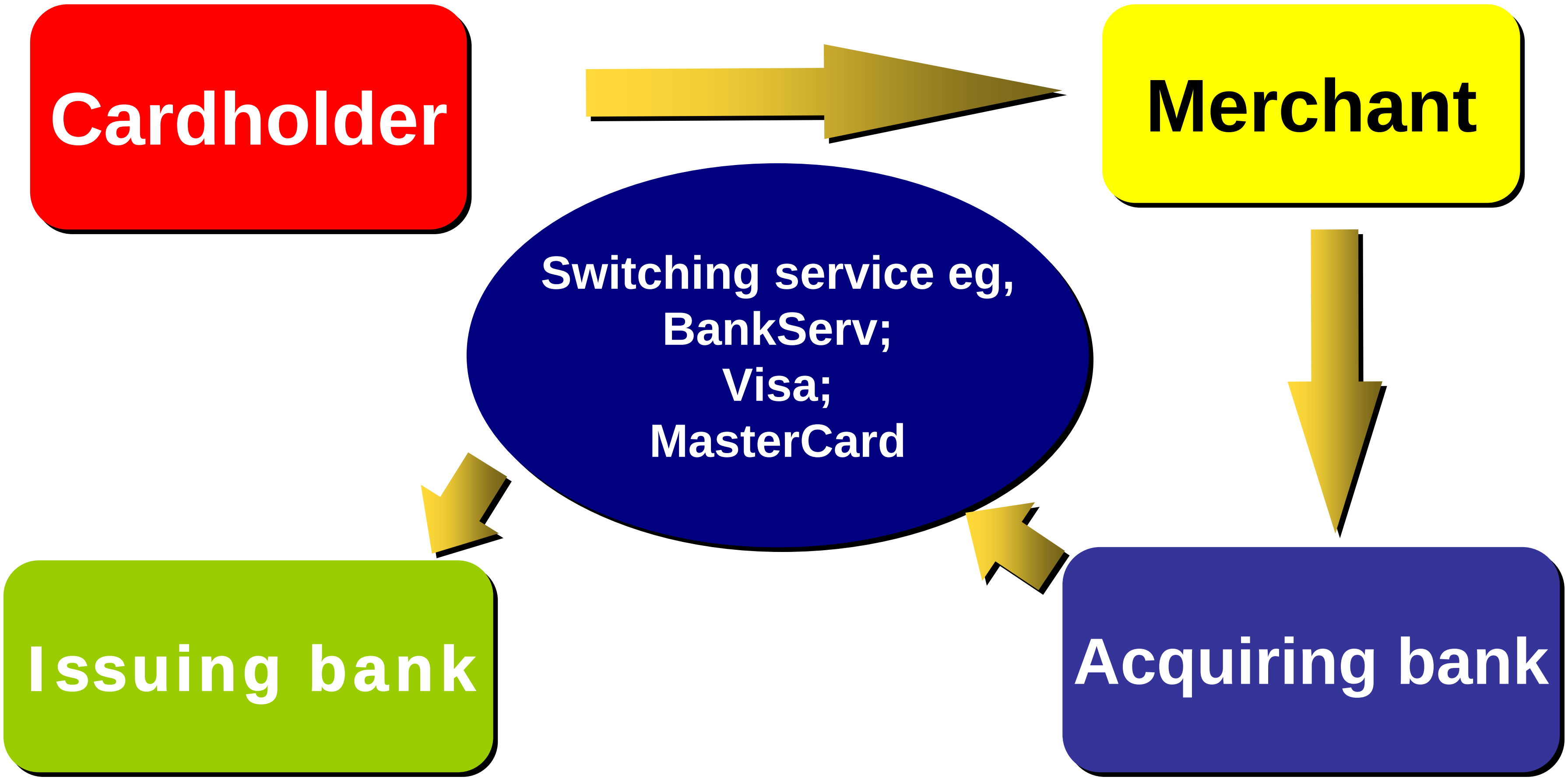
Transaction type (Cheque or current accounts)	***Average transaction size in 2005***	***Average consumer fee***	***Fee as a % of the average transaction size***
Counter Cash withdrawal	*R 1,000*	*R 20.90*	*2.1%*
ATM cash withdrawal "on-us"	*R 240*	*R 4.65*	*1.9%*
ATM cash withdrawal "off-us"	*R 240*	*R 10.77*	*4.5%*
Debit card payment	*R 220*	*R 2.46*	*1.1%*
Cheque payment	*R 13,400*	*R 24.00*	*0.2%*
EFT (Credit and Debit) payment	*R 5,700*	*R 20.50*	*0.4%*

Source: Average transaction sizes for 2005 – Bankserv (except for counter cash withdrawal – estimated). Various bank web sites; cheque account pay per transaction fees.

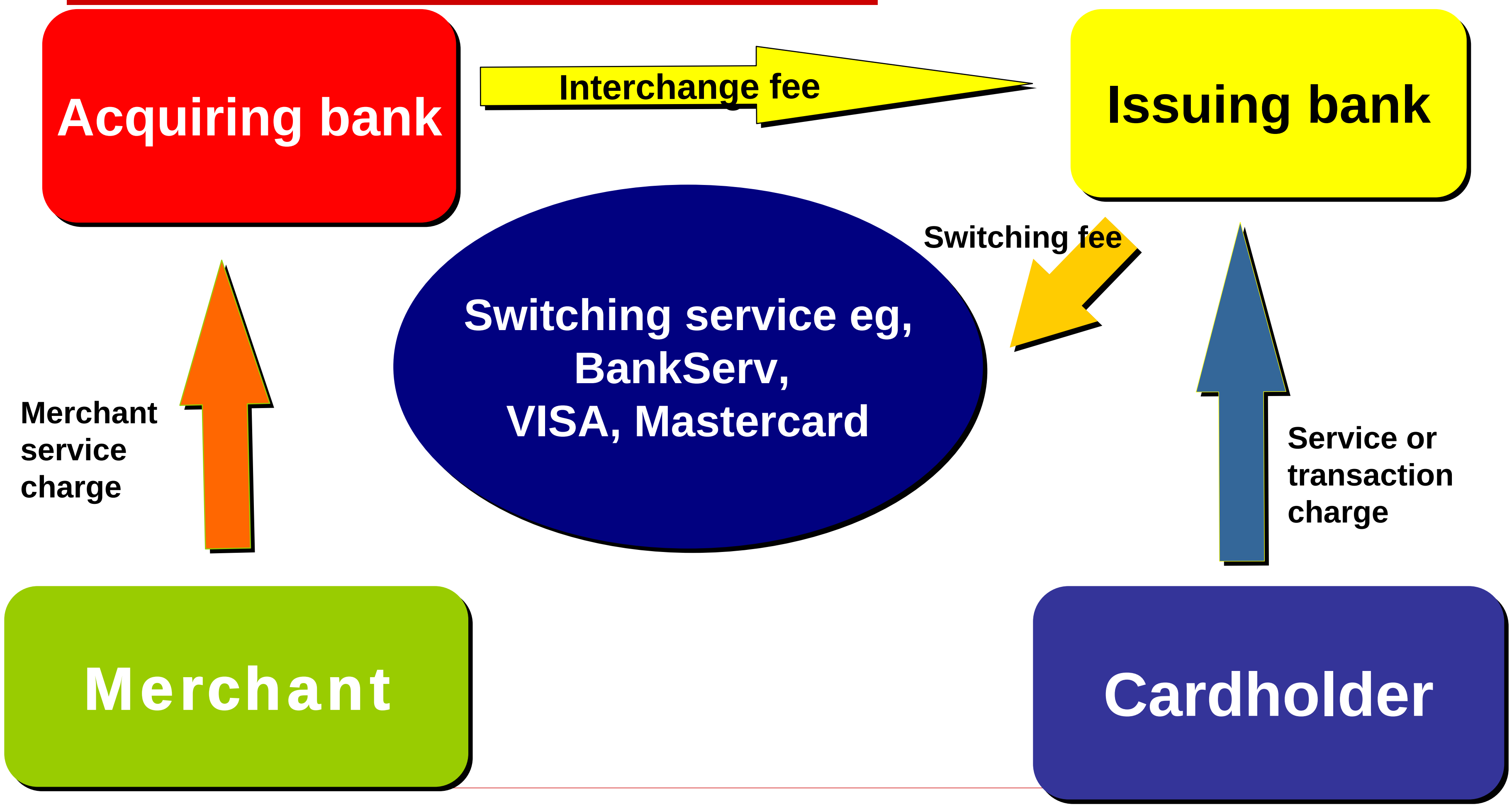
Payment card systems 1

- For any bank to offer banking services to its customers, it ultimately needs to have the ability to issue payment cards of one sort or another, be they debit or credit cards
- These cards needs to be widely accepted in the payments system network
- Therefore they need to be members of at least one card association, such as VISA or Mastercard.

Flow of information eg Four party model (debit card)



Flow of fees eg Debit card transaction



Payment cards:
Flow of fees eg Debit card

Cost	From	To	Value (based on R100)
Service or transaction charge	Consumer	Issuing Bank	R2.33
Interchange	Acquiring Bank	Issuing Bank	R0.55
Bankserv/Operator	Issuing Bank	Bankserv	R0.09
Merchant Fee	Merchant	Acquiring Bank	R2.50
Total			**R4.83**

Institution	Amount earned from transaction	Share of revenue
Bank (Acquirer)	R1.95	40%
Bank (Issuer)	R2.79	58%
Bankserv	R0.09	2%
Total	**R4.83**	**100%**

Payment card systems 2

Key concerns:

- Both the quantum and the direction of flow of interchange raise some questions: especially in the case of debit cards, is such interchange necessary, and at what level?
- Key to the existing debates around pricing is the role of interchange and merchant service charge and how they are determined through negotiation. The relationship between bilateral price negotiation and multilateral price setting needs to be probed.
- The distribution of income from payment activities appears to be influenced by ownership of acquiring infrastructure. Further consideration is needed on whether interchange benefits large banks

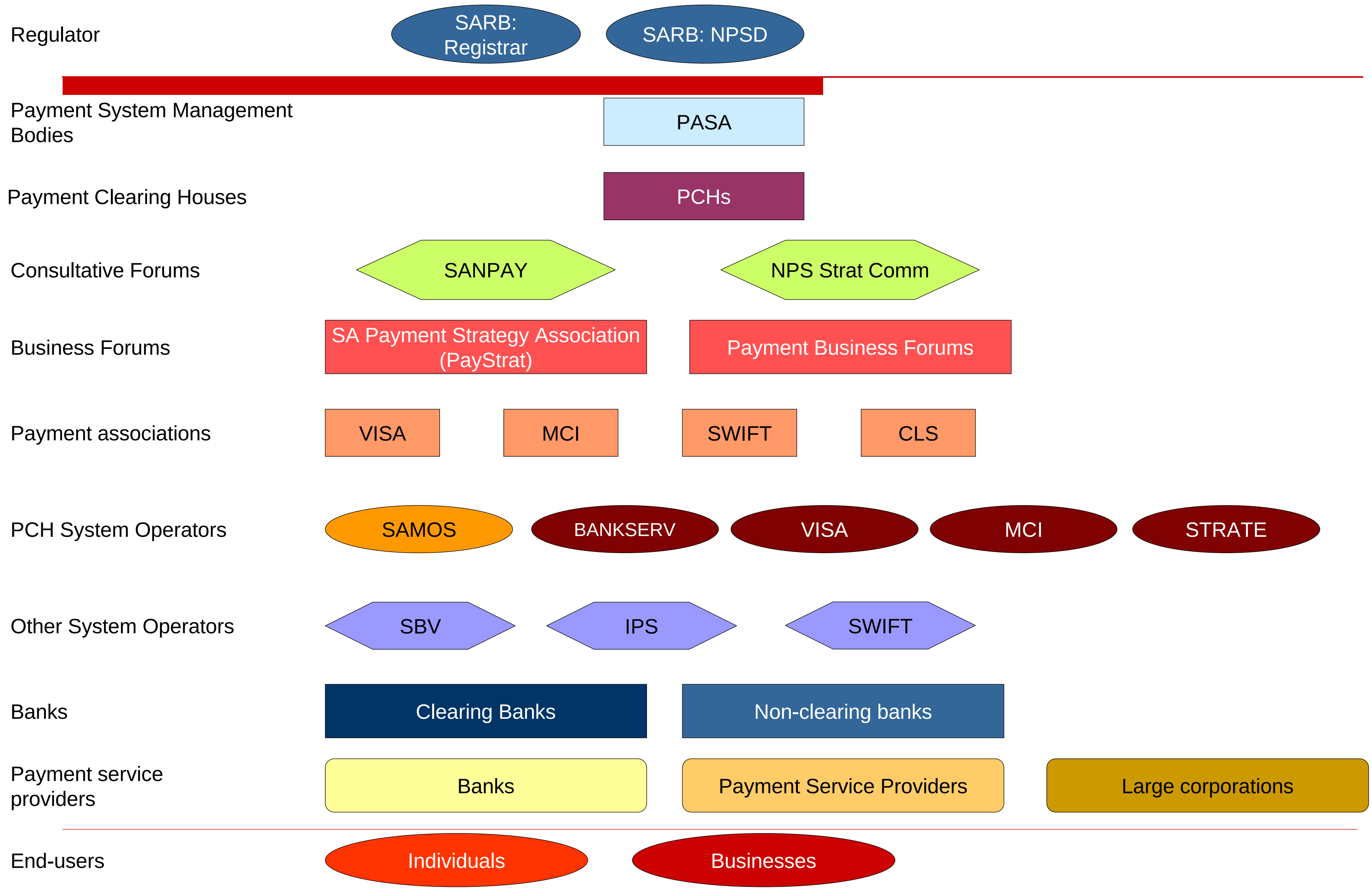
Access to the NPS 1

- NPS lies at the heart of the banking system
  - Complex national network that facilitates the transfer of funds between parties who do not know each other and have no reason to trust each other
  - Plays an essential role in smooth functioning of economy

Access to the NPS 2

- SA system is a national network that embraces:
  - the SARB's SAMOS system
  - National Payment System Department (NPSD)
  - PASA, the industry body with its payment clearing houses (PCHs)
  - Payment clearing house system operators (eg Bankserv and STRATE)
  - Registered banks
  - The Post Office
  - A number of payment processing providers, switches and retailers

SA Payment Landscape



Access to the NPS 3

- Not only the banks, but all payment system participants appear to find payment system activity profitable – indeed this might be the motivation for the clamour to gain access. Only SAMOS appears to work on a cost recovery basis.
- Payment systems tend to be viewed as a privileged banking space – role in monetary transmission process, ability to create credit and the fact that they are regulated as deposit takers.
- Access (by small banks, non-banks and would-be banks means different things to different stakeholders. Access may be important to the Enquiry to the extent that barriers may be preventing effective provision of payment services to consumers.

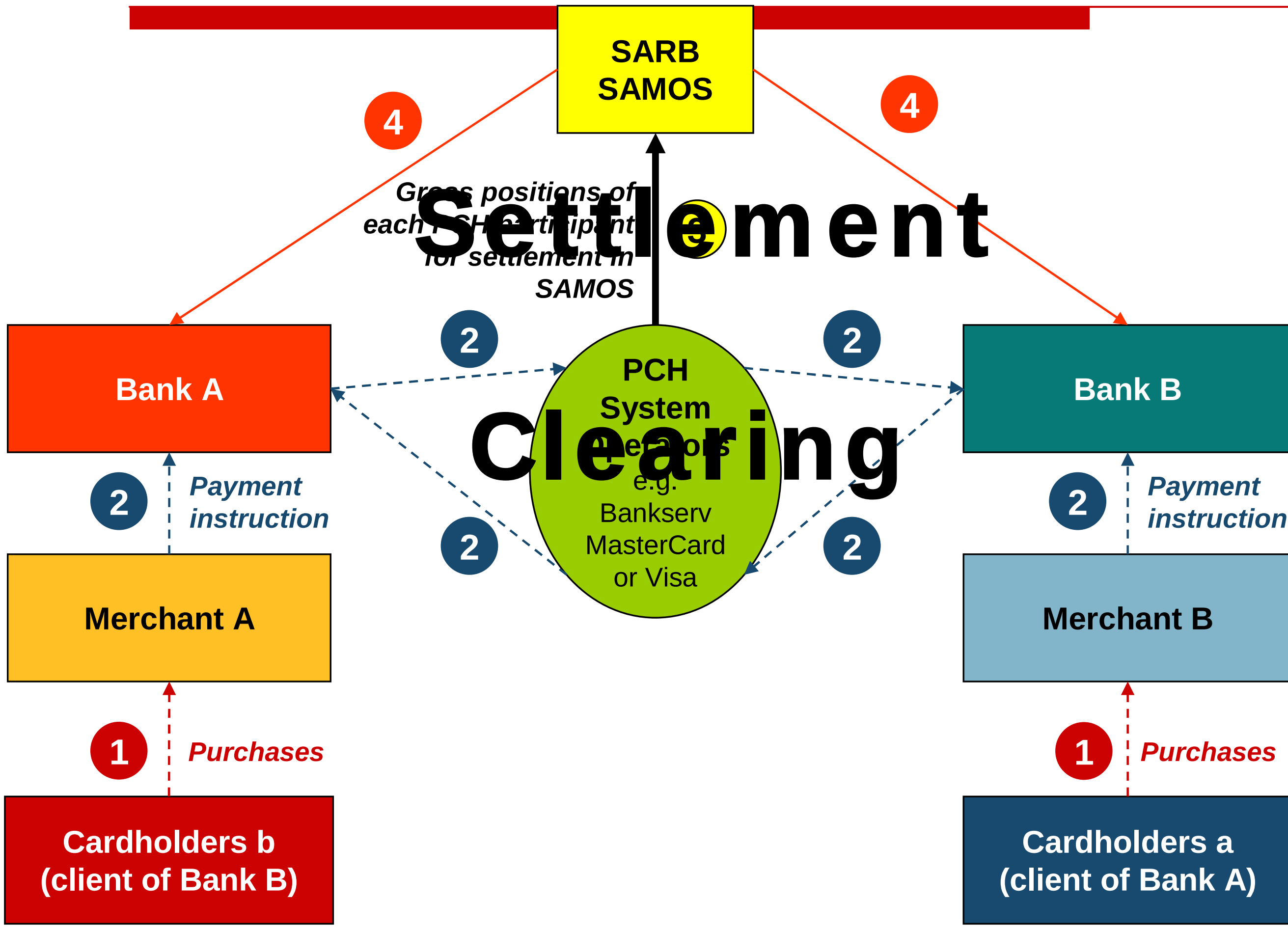
Access to the NPS 4

- While the most obvious concern regarding access may be seen as access by would-be or small banks to the payments system, others also talk of access, but they appear to mean access to only a part of the system. The "others" include a broad array of non-banks.
- Improving access does not imply disregarding any necessary distinction between banks as registered deposit-taking and others involved in various aspects of the payment system.

Access by banks 1

Access problem of existing banks		
Access by whom?	**Access to what?**	**For what purposes?**
Banks. This includes small banks, mutual banks and international banks as well as future dedicated banks.	**Clearing and settlement activity.** A bank needs to be a registered entity, licenced by the Registrar. Once it has met these requirements, a bank will not be a **clearing and settlement bank unless it is a member of PASA, at least one Payment Clearing House and a member of the Banking Association. It will also need to have a SAMOS account** with the SARB. Since the acquiring network in South Africa is card based, it will also need to become a member of a card association, if its interested in issuing debit or credit cards with widespread operability. (White label cards for ATM SASWICH are possible, however).	To do **clearing (exchange of payment instructions and calculation of claims for settlement) and settlement (discharging of the valid claims between banking institutions), i.e. to offer the services of a "clearing" bank.** Once a bank is a clearing and settlement participant, it can earn fees for these activities from customers, rather than paying fees to a clearing bank for carrying them out on its behalf. Ithala is an example of a sponsored entity.

The clearing and settling process



1. Cardholders **a** and **b** make purchases though merchants **A** and **B**
2. Banks **A** and **B** send matching payment instructions to the PCH system operator
3. The PCH system operator sends the net position of each PCH member to SARB
4. SAMOS ensures (by means of an EFT instruction) that the net positions of the bank for each PCH are squared and settled

Access by banks 2

- Consideration needs to be given as to whether barriers to participation of small and mutual banks to the clearing and settlement infrastructure could be reduced.

- Even as regards clearing banks, there are issues of disparities in pricing which may favour the large over the small and act as barriers to small clearing banks wishing to gain access (e.g. the volume based pricing approach of Bankserv).

- Issues of representivity within PASA and Bankserv are also relevant in this regard.

Access to NPS: Control and ownership

- Bankserv is majority owned by big banks, rest by smaller banks (Dandishelf).
- Current control and ownership of Bankserv raises the possibility of broader representation on the Board of Bankserv
- This is especially pertinent if it is considered that Bankserv is an essential infrastructure, which allows interoperability and is key to trust in the system.
- SAMOS – another essential infrastructure - is owned by SARB, cost recovery of operational costs is claimed from users

Access of banks 3

- The proliferation of a number of proprietary systems as an alternative to Bankserv would not necessarily lead to lower prices if it had a negative impact on efficiency.
- However, the established principle that new operators may be permitted should remain.
- In addition, expansion of board participation (with voting rights) beyond the big four and Dandishelf to include the regulator or banking adjudicator, at least, could address the some of the governance concerns.
- The representation of Dandishelf members at board level is also of concern in this regard

Access of non-banks 1: retailers

Access problems of non-banks		
Access by whom?	**Access to what?**	**For what purposes?**
Retailers (through Easy pay) Especially large retailers that process many transactions through their switch.	To **Bankserv (the payment system operator).** May be expressed as "bringing Bankserv in front of the banks". This will enable the retailers' switch to transmit all card transactions to Bankserv, thereby avoiding interchange fees associated with interbank transactions. Hence EasyPay, as the retailers' switch, will connect direct to Bankserv. This may result in a lower banking charges for the big retailers, and a reduced stream of revenue for the banks.	Two purposes have been enumerated (commercial and technical): I)To enable retailers to have better negotiating power with the banks in terms of fee reduction and II)to ensure a more stable system. Retailers argue they will not be reliant on the back-up systems of individual banks, but can rely on the back-up systems of EasyPay and Bankserv.

Access of non-banks 2

- In the past, the facilitation of transaction switching was bundled with the banking services that the acquiring bank offered the retailer.
- It has been argued that existing technology allows for the switching service and the banking service to be separated out and provided individually on a more cost effective basis
- Attention needs to be given to the outcomes of possible changes on small retailers. They are likely to continue to rent the point of sale devices from their bankers and have all transactions (both “on-us” and “off-us”) relayed via the bank to Bankserv.
- The role of super acquirers – or independents - who provide POS devices and who offer switching services to retailers may enhance competition. This occurs in other countries – and needs to be given consideration

Access of non-banks 3: Private bureaux

Private bureaux corporations	To **Bankserv**. This enables the bureaux – who gather payment instructions (typically debit orders) on behalf of clients, such as insurers - to conduct their business, without having to go through a bank or banks. Without this access, they argue they would typically be unviable, as fees charged by banks would include the “off-us” premium. The big banks also all have their own bureaux.	To conduct their business in such a way that they remain commercially viable.

Access to the NPS

- It appears that non-banks typically want access to the official utility company of the banking industry, or Bankserv, when they say they want access to the NPS

- Hence they want access to the switching service that gives rise to the settlement function, without wanting to become banks themselves

Conclusion: Terms of Reference

1. The subject matter of the enquiry will be:
   a. the **level and structure of charges** made by banks, as well as by other providers of payment services, including:
      i. the relation between the costs of providing retail banking and/or payment services and the charges for such services;
      ii. the process by which charges are set; and
      iii. the level and scope of existing and potential competition in this regard;
   b. the **feasibility of improving access** by non-banks and would-be banks to the national payment system infrastructure, so that they can compete more effectively in providing payment services to consumers;
   c. any other aspect relating to the payment system or the above-mentioned charges which could be regarded as anti-competitive.