

Banking Enquiry



Access and regulation

Banking Enquiry - Technical Team

Presentation

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Access and regulation

- Subject matter and objects of the Banking Enquiry
- Access and banks
- Innovation and the NPS
- Access and non-banks
- Risk and the NPS
- Governance and oversight



Subject matter and objectives of the Enquiry

The subject matter of the Banking Enquiry includes:

- 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

The objectives of the Banking Enquiry are:

- To increase transparency and competition in the relevant markets;
- To ascertain whether there are grounds upon which the Competition Commissioner should initiate, and the Commission should consequently use its powers to investigate, any specific complaints or contraventions of the Competition Act;
- To engage with the banks, other providers of payment services, the appropriate regulatory authorities and other stakeholders in order to ascertain the extent to which, consistent with the soundness of the banking and payments system, there could realistically be improvements in the conditions affecting competition in the relevant markets, including increased access to the national payments system infrastructure;
- To enable the Commission to report to the Minister and make recommendations on any matter needing legislative or regulatory attention.

Access and Banks

- Clearing and settlement activity
- Non-clearing and clearing banks
- Sponsorship and mentorship
- Exempted and excluded entities
- Constraints on new clearing banks



Clearing and settlement activity

Clearing is defined in Section 1 of the National Payment System Act No 78 of 1998 as amended (“the NPS Act”) as the “**exchange of payment instructions**”. The exchange of a payment instruction (i.e. clearing) is something that occurs between two deposit-taking institutions (i.e. banks).

One bank is instructed (by its customer) to make the payment (and debit the customer’s account). The other bank is obliged to collect on the payment instruction or simply receive the payment (and credit the customer’s account).



Clearing and settlement activity

Whenever a payment instruction is cleared, the PCH system operator issues on behalf of the paying bank a “settlement instruction”, giving rise to an obligation on the part of that bank to pay the other bank by way of settlement through SAMOS. Clearing thus merges seamlessly with the settlement process.

The clearing of a payment instruction is always **bilateral** - it involves a paying bank and a collecting or receiving bank.

Logically, a PCH agreement standardises the arrangements for clearing that are entered into between individual banks, in order to streamline and regulate the process.



Clearing and non-clearing banks

As a registered entity, *a non-clearing bank* is regulated by the Registrar of banks, but is *not* a system participant as defined in the NPS Act and may not provide payment services to its clients, clear domestic payment instructions to or from banks, be a signatory to any payment clearing agreement, operate a SAMOS account or enjoy membership of PASA.

While a non-clearing bank may allow its customers to withdraw their deposits and transfer amounts within its own customer base, using its own ATM infrastructure, say, it may not facilitate any payment where another bank is involved. When another bank is involved as a payer or collector of funds, the exchange of clearing instructions is involved – and this exchange of instructions is the exclusive domain of clearing banks.



Clearing and non-clearing banks (cont)

A clearing bank (regulated by the Registrar of Banks):

- Is required to be a member of PASA in terms of the NPS Act
- Is a system participant as defined in the Act and therefore has to:
 - Operate a SAMOS account at the SARB, unless operating by arrangement with the SARB as a sponsored clearer
 - Be a member of one or more payment stream associations (PSAs)
 - Provide to its clients payment services as defined in the position paper
 - Clear domestic payment instructions to or from other banks as part of its business
 - Be a signatory to a clearing agreement and consequently be a member of a payment clearing house (PCH) and be subject to the entry and participation criteria of each applicable PCH.



Sponsorship and mentorship

Mentorship is associated with apprenticeship where a bank wishes to participate in an existing PCH (Mentorship is waived where a new PCH is established, however.) In the words of one commentator, mentorship is associated with education, sponsorship with participation.

A mentored bank participates in clearing within the PCH and so is responsible for the clearing of payment instructions with other banks in the PCH. It also participates in settlement, having its own SAMOS account. However, it is subject to guidance and assistance from a more experienced participant. (NPSD, 2000, Section 5.2)



Sponsorship and mentorship

In the case of a **sponsored clearing** bank, while it engages directly in clearing payment instructions, the settlement of its obligations towards other participants in the PCH is undertaken on its behalf by the sponsoring bank. Hence, strictly speaking this is about sponsored *settlement*.

“This is the model for a bank that, in a specific PCH, provides some of the payment services as defined above, by virtue of an agreement with a direct clearing bank, in terms of which agreement the sponsored clearing bank’s settlement obligation within the PCH is fulfilled by the sponsoring bank on behalf of the sponsored clearing bank.” (NPSD, 2000, Section 5.3).



Exempted and excluded entities

- The NPSD position paper 02/2000 evidently did not contemplate sponsorship or mentorship arrangements other than among clearing banks participating in PCH
- Some confusion arises as while only registered banks are entitled to take deposits and participate in clearing and settlement, there are a number of institutions exempted or excluded from the Banks Act that are permitted to take deposits. Based on the definitions of participants in the NPS Act, these institutions cannot be participants in clearing and settlement. However, they have been accommodated as sponsored banks.



Constraints on new clearing banks

- A non-clearing bank is disadvantaged - cannot acquire
- Application of the sponsorship route unclear
- Development route for new 2nd and 3rd tier banks unclear
- Volume based pricing and participation



Innovation in the NPS

- Bank-led system
- EDO – brand new payment stream – took 3 years to develop and price – innovation is clearly possible
- Inertia – unwillingness to co-operate if it does not benefit. PASA rules have been tightened
- Different bank representatives as the PCH (where the technical and risk associated aspects should dominate) and the PSA (for commercial arrangements)



Access and non-banks

- Largely an unregulated space – although there are two directives pending from the NPSD – apply to Third Party Payments and System Operators
- Requirement to acquire transactions and gain access to a portal into the clearing space.
- In most cases, Bankserv would be the portal, although there may be some entities that would like to compete with Bankserv in facilitating clearing instructions.



Acquiring transactions

- Acquiring has a connection with clearing – but is distinct from clearing in that the acquirer as such merely introduces (or “delivers”) properly authorised payment instructions into the clearing process.
- Obtaining authorisation prior to the coming into existence of a payment instruction is quite distinct from clearing. The latter takes place in respect of payment instructions once they are completed. In principle, an acquirer need not engage in exchanging payment instructions itself, i.e. clearing.



Access and non-banks

- It is perhaps because of the confusion between acquiring and clearing that non-bank acquiring is often described as such entities “wanting to have access to the customer accounts”.
- In fact, it may be more accurate to say that an acquirer merely introduces into the clearing and settlement process a payment instruction issued by a participating bank’s customer, and, assuming the instruction is cleared, is consequently able to obtain payment from the bank for the debit of the customer’s account.
- In other words, it is the paying bank itself (or its clearing agent, e.g. Bankserv) which “accesses” its customer’s account. If this is correct, then the proper focus would be upon ensuring the reliability of the payment instructions so introduced.



Risks and the NPS

- Risk and Liabilities
- FATF requirements and monitoring of risk
- Technical standards and disaster recovery
- Multiple acquiring and sorting at source



Bureaux: Risk and liabilities

- **Technical Bureaux** – In this case the *client* obtains a user code from a sponsoring bank, which is used to submit transactions into Bankserv. The requirement of a user code from the sponsoring bank allows it to assess the risk and assign the appropriate limit for the client. None of the funds get transmitted directly into the bureau's account at any stage. They merely collect and collate electronic transactions on behalf of clients and submit them to the system operator.
- **Float bureaux** - In this case the *bureau* obtains a user code and credit limit from the sponsoring bank. The bureau then signs up clients without the bank being informed of the underlying risks of clients. The bureau then processes all the transactions under the bureau's assigned user code and receives funds or makes payments on behalf of its clients, using its own account and user code.
- Whether the bank signs up the client with a user code or whether the bureau processes the transaction using the bureau's assigned user code, the sponsoring bank (i.e. the beneficiary's bank which collects the payment) is held responsible for the fraudulent transactions and risk associated with the transactions.



FATF and monitoring

- Per Financial Action Task Force (FATF) requirements, the bank is required to do on-going due diligence on a customer's account and some banks claim that this is not possible without the bank owning the process.
- It may be possible to design a monitoring system that facilitates the bank's due diligence without eliminating technical bureaux. Is it not possible to mimic that which the banks do?



Multiple acquiring and sorting at source

Multiple acquiring (e.g. Payment cards)

- The merchant has an acquiring relationship with more than one bank. Restricted multiple acquiring where transactions can be split into credit and debit or Mastercard and VISA cards permissible

Sorting at source (e.g. EFTs)

- Enables merchants or their payment facilitators to sort transactions per bank and deliver these directly to each bank bypassing the clearing process



Multiple acquiring and sorting at source: Risks

Multiple acquiring	Sorting at source
<p>Low usage of the payments system means the cost of such usage will be higher and the investment return is placed at a higher risk.</p>	<p>Leads to low usage of the payments system means the cost of such usage will be higher and the investment return is placed at a higher risk.</p>
<p>An increase in cost of operations to the bank would ultimately lead to the cost being passed onto the consumer</p>	<p>An increase in cost of operations to the bank would ultimately lead to the cost being passed onto the consumer.</p>
<p>No single bank has the total view of the customer, as that exposure is spread across a number of banks.</p>	<p>This practice hides the total risk exposure in the system as no single bank has the total view of the customer, (exposure is spread across a number of banks).</p>
<p>The central bank in its oversight role is not able to monitor the exposures in the payment system as the payments are taken out of the system.</p>	<p>The central bank is constrained in its oversight role as payments are taken out of the system</p>

Source: Banks' submissions

Multiple acquiring and sorting at source: Consequences

Multiple acquiring	Sorting at source
Leads to arbitrage destroys industry value .	Destroys overall payments industry value ultimately affecting the economy and posing a reputational risk for the country.
<p>In situations where merchants own their own infrastructure, lack of common standards and protocols of infrastructure could introduce risk into the NPS.</p> <p>The merchant is also provided with undue power to dictate price, which affects the stability of the payments value chain, ultimately impacting the customer.</p>	<p>As sort at source activity increases, so does non-bank payment facilitators in the NPS, who may not necessarily adopt diligent DRP / BCP to deal with potential outages / disasters, and who are not monitored / regulated, leading to exposure risks.</p> <p>It impacts the man on the street, e.g. where a salary system administrator is unable to pay salaries on time</p>
Smaller merchants are required to replicate POS infrastructure for each bank.	An increase in NPS operator costs per transaction due to the reduced volumes flowing through.
Smaller volume merchants and banks do not get the benefit of industry economies of scale, i.e., only large merchants may benefit	It introduces liquidity imbalances in country.

Source: Banks' submissions

Multiple acquiring and sorting at source: Summary

- Restricted multiple acquiring – some “off-us” transactions and via Bankserv
- Sorting at source – all transactions “on-us” – possibly not via Bankserv

Governance and oversight

- The FeasibilitY (2006) report flagged the following areas of concern:
 - Control and ownership of Bankserv as essential infrastructure and the possibility of broader representation on the board of Bankserv
 - Concerns around self-regulation in which the clearing banks set the rules for participation



Bankserv

- Bankserv made clear at the beginning of 2007 that they are in the process of modifying their board structure from:
 - 10 non-executive directors: the Big 4 and Dandishelf, appointed by shareholders (2 each)
 - 2 executive directors appointed by the Board
- To the following:
 - 1 board member where shareholding exceeds 5%
 - 5 independent non-executive directors
 - 2 executive directors
- Shareholder members: Big 4 banks and Dandishelf.
- The new structure would have as many independent non-executive directors as board members representing shareholders' interests.



Setting the Rules

- In the new vision, PASA continues to be the sole payment system management body, but there are a number of Payment System Forums (PSSFs), including one each for System Operators and Third Party Providers. Their existence is authorized by NPSD.
- The PSSFs consult and engage with PASA and a new Advisory body – whose membership will extend to the National Treasury and the Banking Association – as well as NPSD. Policy will continue to be set by NPSD, enacted by PASA, and it is PASA that will set the rules for participation by the System Operators and banks may well play a gate-keeping role as regards the activities of Third Party Payments service providers.
- While providing a voice for non-banks, the proposed changes do not appear to address the concern of banks setting the rules for participation.



Setting the Rules

- The NPS Act, in terms of which PASA has its payment system management body status, requires that such a body represents the interest of its members. Nowhere, however, does it explicitly indicate that such membership is restricted to one category of institution. Hence it is not altogether clear why PASA could not have broader based membership, including non-banks for example.
- The case of LINK in the UK may be instructive. While not strictly comparable with PASA or Bankserv – although there are elements of each - it is an example where both banks and non-banks together manage the operation of a retail payment stream. LINK is the leading automated teller machine (ATM) switching network in the UK, with almost 57,900 ATMs, with both banks and non-banks as members to both of its two constituent parts.
- It may be useful to probe why it is that PASA is seen as a body whose membership is restricted to banks, and why this appears to be an inviolate principle. In particular, what violence would be done to the body were its membership to be broadened? Alternatively, to what extent does the new structure proposed by the NPSD really provide a voice for non-banks and help facilitate innovation in the system?

