

# The Competition Commission Enquiry

PRESENTATION BY THE ABSA GROUP

25 May 2007

National Payment System

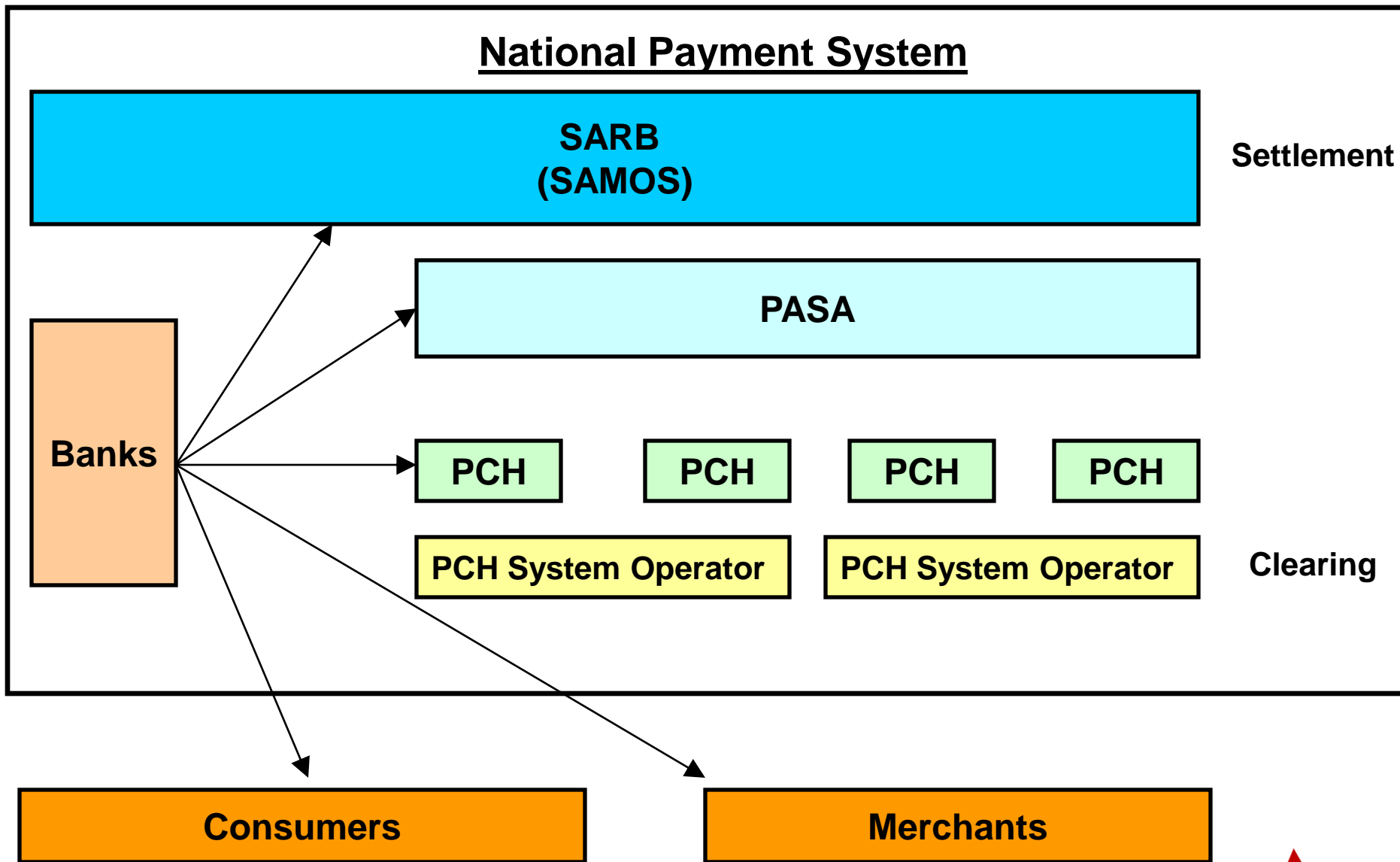
# The National Payment System

- The National Payment System (NPS) is the behind-the-scenes infrastructure that enables individuals and firms to transact with one another, efficiently and reliably, using a variety of means of payments
- Having a trusted and secure payment system benefits everyone in the country
- Because the NPS is critical to the smooth workings of the South African economy, the South African Reserve Bank (SARB) monitors the NPS closely and has ultimate regulatory authority
- Any adjustment to the NPS will need to be made in consultation with the SARB and should be judged by specific criteria
  - Benefits and value to the full spectrum of consumers
  - Impact on security and stability of the system
  - Benefits to South African economic growth

## Specific topics addressed in this presentation

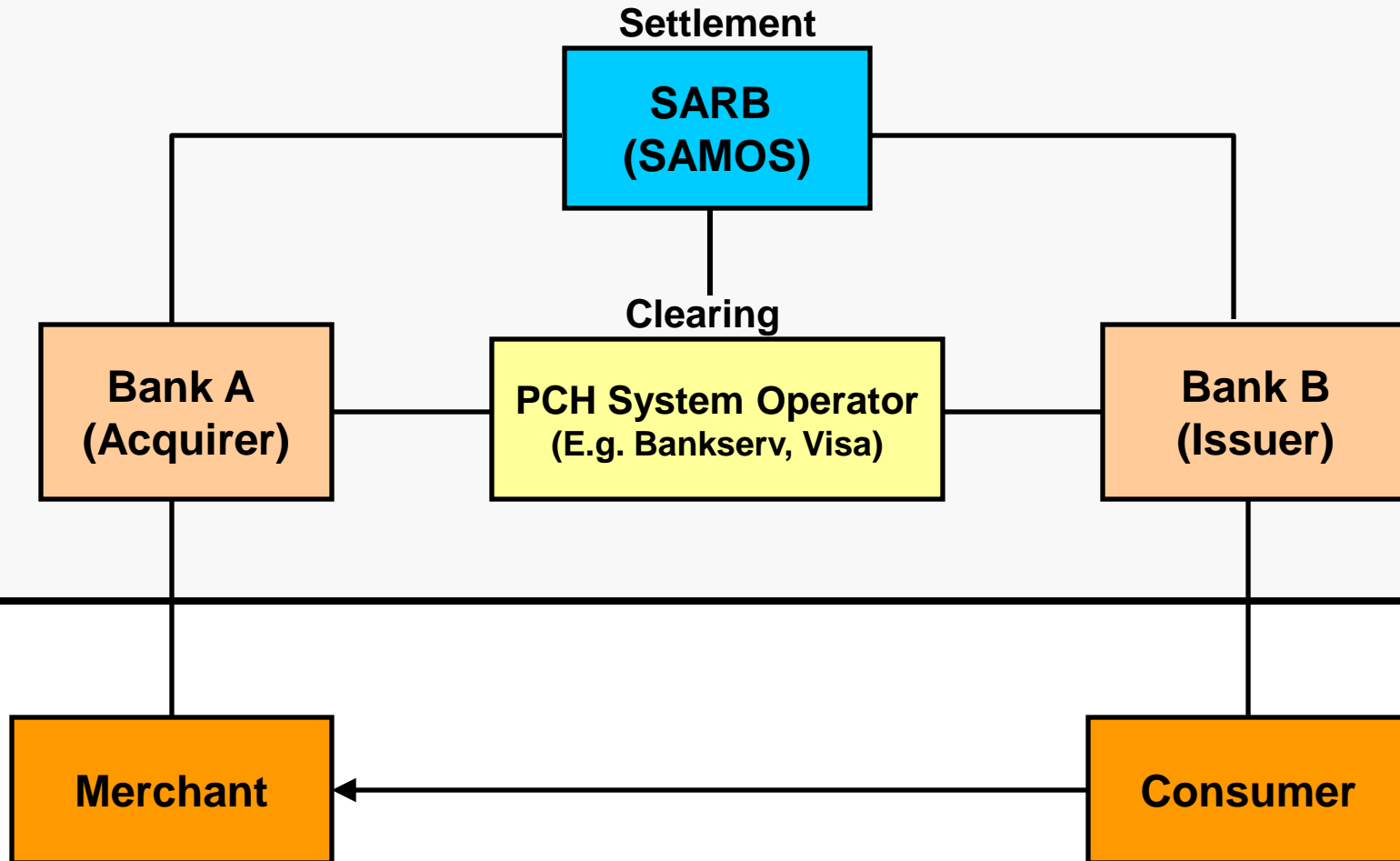
- Smaller banks and new entrants into banking have various ways of becoming participants in the NPS
- Smaller banks are also able to enter into acquiring, but may not do so because of commercial or business hurdles
- Apart from clearing and settlement, non-banks have ready access to the payment system, and can provide acquiring services by partnering with a registered bank
- The current structure facilitates payment system innovation
- Sorting at source would result in less efficient use of the payment system, and raises regulatory concerns. It could also undermine the ability in a 2-sided market of a 4-party model to get the right costs and benefits allocation between the issuing and acquiring sides

# National Payment System (NPS) – overview



# NPS – overview

## Payment card transaction under the current model (four-party)



## Non-banks have ready access to the payment system

- Non-banks already provide a variety of payment services to the public and corporates including infrastructure capability in a range of areas such as bureaux, terminals, bill payments. Non-banks also provide front-end and back-end switching
- However, in accordance with international best practices, the National Payment System Act provides that only banks (including mutual banks and branches of foreign institutions), designated settlement system operators and the SARB may participate in SAMOS
- Non-banks can partner with a bank for clearing and settlement
  - There are 21 member-banks of PASA who compete to partner with non-banks

# Small banks can easily access the NPS

- In order for a bank to become a direct participant in the NPS (direct access), it would need to:
  - Have a settlement account at the SARB
    - *Costs involved: R250,000 start-up, plus transaction fees and required collateral*
  - Become a member of PASA
    - *Costs involved: Membership fees according to the volume and value of bank's transactions (R150,000-1.5 million per-annum)*
  - Become a participant of at least one PCH
    - *Costs involved: One-off application fee (R6,000) and annual fees*
- However, banks can also obtain indirect access through sponsorship arrangements
  - Sponsorship enables low-cost access to clearing and settlement, and is faster than gaining direct access to the system
  - Absa has never declined a request to act as a sponsor



## Access to the NPS is already being widened

- The legislature has already taken steps to widen access to the NPS through
  - Dedicated Banks Bill
  - Co-operative Banks Bill
- Both of these Bills will reduce the cost of becoming a bank and hence make it easier to access the NPS
- SARB has already taken steps to widen access through Vision 2010 which partly aims at providing for new types of payment participants

# Commercial considerations drive the decision to offer payment services

- Any player can provide payment services (although non-banks need to partner with a bank for access to clearing and settlement)
- The main reason that players decide to enter or not to enter these markets is commercial and will depend on
  - Expected overall size of the market
  - Extent of economies of scale
  - Internal costs such as infrastructure investment and personnel
- Different numbers of banks are observed in different payment streams because of the combination of these factors
  - EFT user agreements (8 banks, as well as 7 non-bank bureaus)
  - NAEDO acquiring (7 banks and several non-bank bureaus)
  - AEDO acquiring (3 banks, 3 non-bank infrastructure providers)
  - Card acquiring (5 banks, and many non-bank infrastructure providers)

# The current structure facilitates payment system innovation

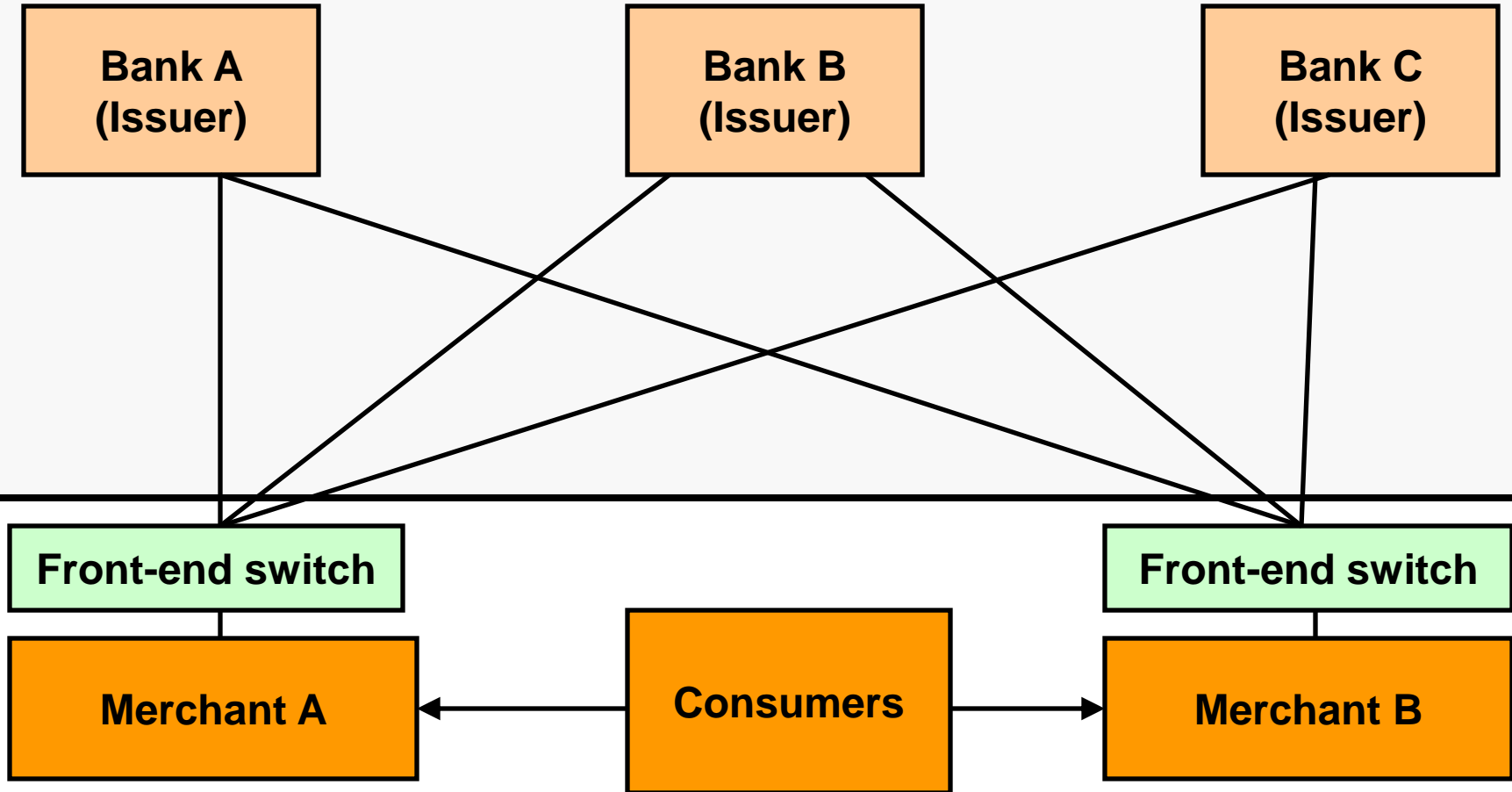
- Banks have incentives to improve the efficiency and capabilities of the payment system. Innovations in the system permit banks to expand business to new clients/users and increase transaction volumes and revenues
- The existing system facilitates innovation:
  - allows standardisation on business, technology, and risk rules
  - enables stability, security, and confidence in the system
  - encourages adoption of new innovations
- Recent innovations in the payment system include:
  - AEDO/NAEDO
  - Mzansi Money Transfer
  - Real-time clearing: This functionality allows customers to make immediate inter-bank payments across the relevant channels and products
  - Partnership between banks and non-banks has produced innovations such as biometric IDs, smart cards, credit cards (Absa/Virgin), and mobile payments

## Sorting at source – definition

- Retailers (or other institutions) sort payment instructions and submit them directly to the issuing bank holding the payer's account
- In effect, sorting at source includes functions that the BIS would see as clearing (i.e. submission and execution of a payment instruction) by a non-bank
- SARB subscribes to the BIS “Core Principles” for systemically important payment systems

# Sorting at source

## Payment card transaction: sorting at source



# Consequences of sorting at source

- No international precedent for sorting at source
- Sorting at source gives direct access to bank accounts – this requires regulatory oversight, yet sorting at source avoids the regulated NPS
- SARB has expressed concerns about sorting at source, and are continually monitoring their position
- Less efficient
  - No real benefits from sorting at source
  - No reduction in existing processing requirements/systems costs
  - Duplicate investment in payments infrastructure
  - Lower utilisation of existing switches means higher Bankserv fees for smaller retailers and smaller banks
- It could undermine the ability in a 2-sided market of a 4-party model to get the right allocation between the issuing and acquiring sides

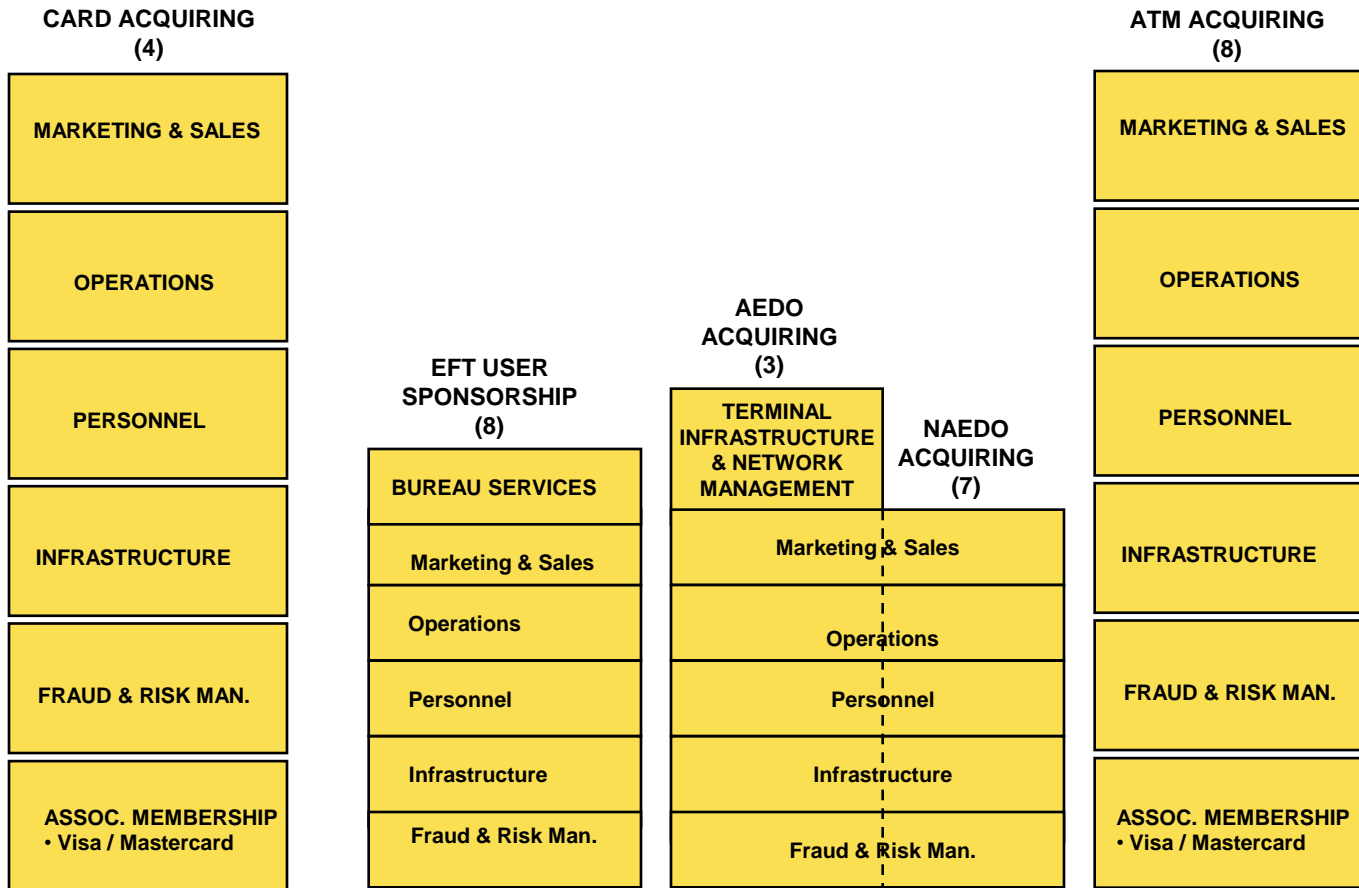
## Summary of Absa's views on the NPS

- Absa has no objection to allowing additional access to the NPS to non-banks:
  - provided access is subject to SARB oversight in accordance with SARB directives and regulations
  - the SARB Directives on Bureaux and Payment System Operators are addressing risks relating to non-bank payment service providers
- Absa does not believe there are any significant commercial benefits from sorting at source and that, in fact, it could have negative consequences for the NPS

## *Annex: NPS*

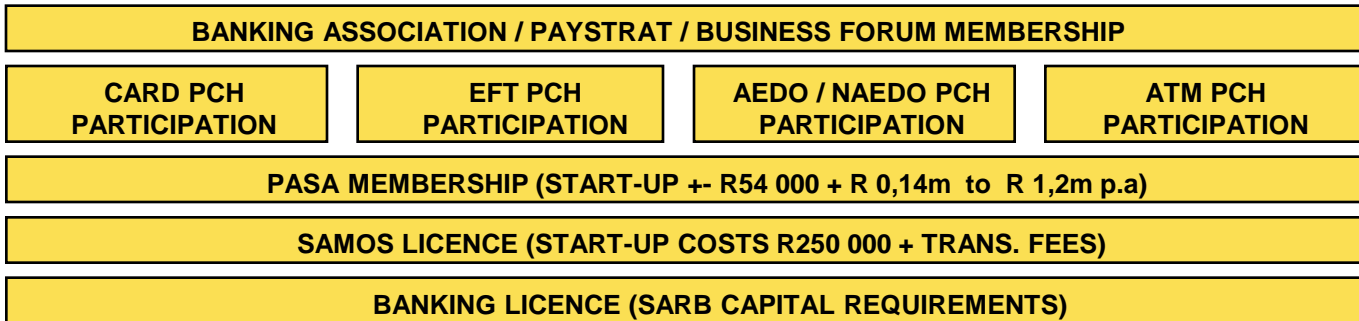
# Acquiring/Sponsorship set-up costs and requirements

COMMERCIAL / BUSINESS REQUIREMENTS



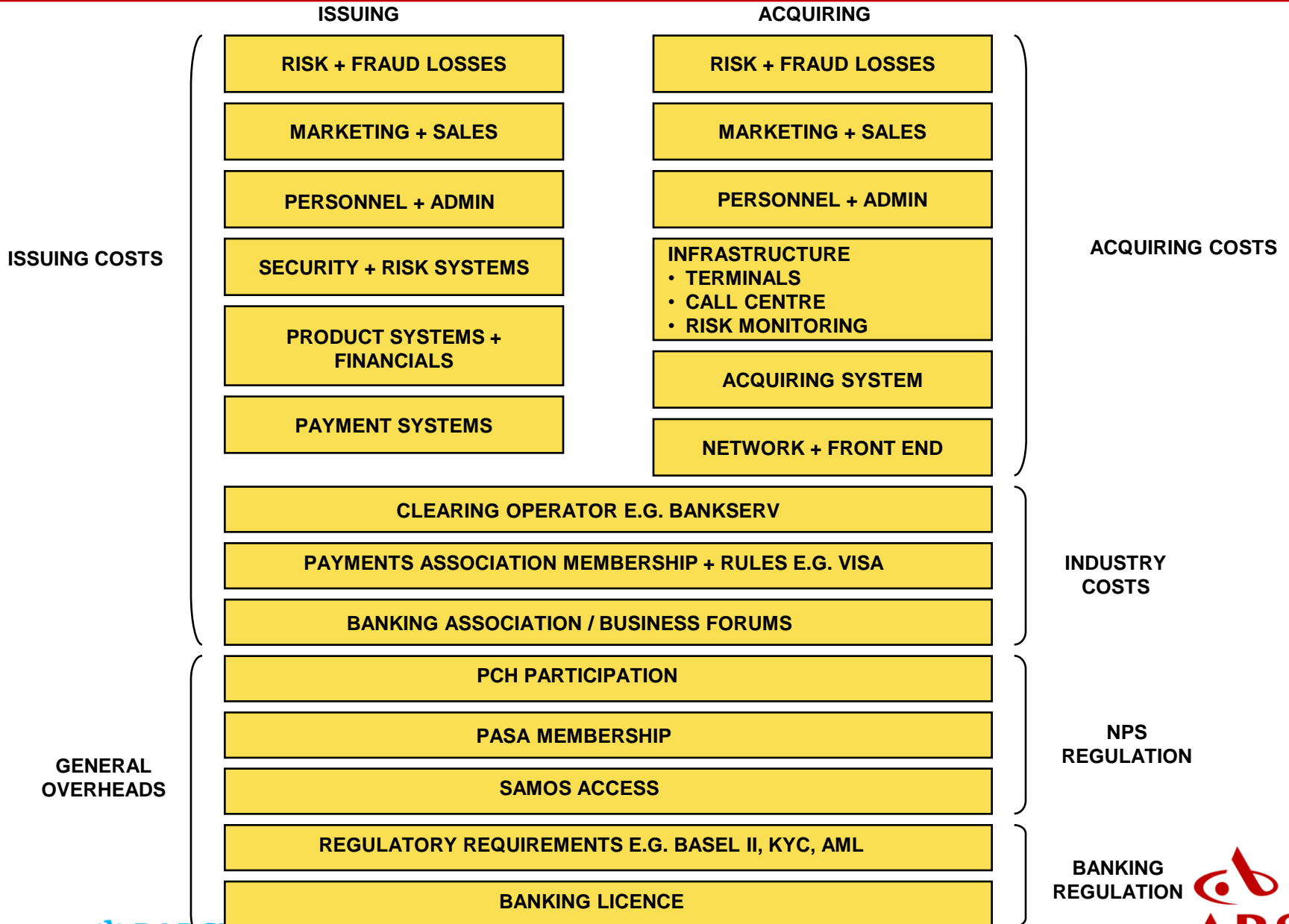
- KEY SUCCESS FACTORS**
- Capital investment
  - Volumes
  - Average Tran. Value
  - Margins + Pricing
  - Fraud / Risk Man.
  - Outsourcing / JV Partners
  - Own Technology / Systems

REGULATORY REQUIREMENTS



- KEY SUCCESS FACTORS**
- Int. Standards
  - Inter-operability
  - No. of participants
  - Risk Man. + Compliance
  - Financial Stability
  - Trust + Confidence in System (safe / secure)
  - Fair Access
  - Robust Regulation

# Cost components of issuing and acquiring



# Alternative options for card acquiring

- Single acquiring - current model in South Africa and global norm
- Multiple acquiring
  - Already permitted by credit/debit PCH and associations (Visa/MasterCard)
  - Only used by Pick 'n Pay (risk minimisation)
- Industry acquiring
  - Competition concerns identified in Belgium and the Netherlands
- Three-party schemes (Amex, Diners)
  - Loss of competition between issuers and between acquirers
- Sorting at source
  - Reduction in economies of scale and efficiency

# Pricing

- Volume-based
  - Reflects economies of scale
  - High-volume users pay less per transaction than low-volume users
- Fixed access fee
  - Costs are 90% fixed
  - Low-volume users face high entry fee
- Fixed fee and volume-based
  - Balances fixed and variable costs
- Flat transaction fee
  - High-volume users may seek alternatives
    - Direct clearing
    - International switches