

Chapter 7

Access to the payment system

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7.1 Introduction and synopsis

The arrangements, networks and institutions associated with making payments are typically referred to collectively as the national payment system. Historically the payment system is a privileged space of banks because banks are the principal – if not the only – providers of transaction accounts and of payment instruments and services to individual customers and firms.

Particularly privileged are the "clearing banks" for they alone are permitted to clear and to settle payment instructions where the customer of one bank makes a payment to the customer of another bank.¹ Clearing involves the verification and calculation of banks' obligations to each other arising from such payment instructions and the issuing of resulting settlement instructions to the central bank. Settlement involves the discharge of the banks' obligations to each other – typically by means of credits and debits to the accounts which the clearing banks have at the central bank. Non-clearing banks do not share this privilege, and have to rely on clearing banks to provide clearing and settlement services on their behalf.

The organisation of the payment system takes into account the fact that the payer and the payee may not bank at the same bank. If they do bank at the same bank, then clearing and settlement do not arise. The process of verification and calculation takes place in-house, and payment is effected by means of a book adjustment within that bank. If the payer and payee bank at different banks, a clearing house and a settlement institution (typically a central bank) will be involved. Our interest is mainly in those situations where the banks of the payer and payee have to interact to complete the payment process.

In recent years, technological innovations have created opportunities for the outsourcing of payment activities and for the direct entry of non-banks into the payment arena. The extent to which these opportunities have been realised within any country is an outcome of a number of factors, not least of which is that the provision of some payment services is intrinsically linked to the provision of deposit accounts. Moreover, in most countries the specific legislation and regulation which governs banking and deposit taking sets banks apart. In spite of technological innovations, the participation of non-bank providers in the payment system is far from resolved.

In this chapter, possibilities for enhancing the access of non-banks and non-clearing banks to the South Africa national payment system (NPS) are explored. Access to the NPS means different things to different stakeholders, but as we shall see, the crux of the matter is who – and under what conditions – can clear and settle payment instructions of various kinds.

¹ Further distinctions within the category of "clearing banks" are discussed below.

The Banking Enquiry is interested in access to the extent that barriers may prevent the effective and competitive provision of payment services to consumers, as can be seen from the Terms of Reference of the Enquiry.

In particular, the subject matter of the Enquiry includes:

The feasibility of improving access by non-banks and would-be banks to the national payments system infrastructure, so that they can compete more effectively in providing payment services to consumers.

Furthermore, one of the objects of the Enquiry is:

to engage with the banks, and 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 infrastructure.

When considering the need for improved access to the NPS, it is important to keep in mind three connected questions:

- *Access to what ?*
- *Access by whom ?*
- *Access to what end ?*

Answering the first question requires an analysis of the various roles and functions carried out within the payment system, as it is now developing.

Answering the second question involves considering who, in addition to participants currently permitted in the system, would be able to participate effectively in performing those roles and functions if criteria for access were to be changed. An answer to the second question implies appropriate selection criteria and is in this way linked to the third question.

Answering the third question requires considering the advantages and the dangers inherent in changes to the access regime. On the one hand, the concern is to remove unnecessary restrictions on access; on the other hand, it must be to ensure and promote the quality rather than merely the quantity of increased participation. An emphasis on the positive regulation of access and participation in the payment system is thus required.

In this chapter, the accent falls on the access that firms – banks and non-bank institutions – have to the payment system as service providers. That this type of access has implications for consumer access to financial services in general is obvious, but matters related to such general (consumer) access are not the focus here.

Essentially, those institutions which have direct access to the payment system are the ones with access to clearing and settlement activity. At present they have to be banks. Over and

above that, they have to be clearing banks. However, other institutions are vying to enter the payment arena. Should the criteria for entry be broadened to include entities that are not banks? Should the institutions simply be told that if they wish to participate (have access) they must first become clearing banks?

Issues of access are thus intimately related to issues about barriers to entry. At present if an institution wishes to become a member of the payment system, it will have to become a clearing bank. From the viewpoint of the regulator – the South African Reserve Bank (SARB) – the process of erecting and maintaining barriers to entry is by no means arbitrary: the idea is to provide an efficient payment system free from systemic risk.

The analysis takes into account the distinction between banks (as registered deposit-taking institutions) and other institutions involved in various aspects of the payment system.

As the following excerpts reveal, the importance and strengths of the current payment system is commonly recognised:

MR JORDAAN (of FNB): ...South Africa does have a world class National Payment System which does not mean it can't be improved but it is something that we as banks and we as South Africans can be proud of.²

MR VON ZEUNER (of ABSA): ...I would like to get to the three areas that the technical committee has pointed out to us, but I think just before getting there and possibly just stating the obvious, the importance of the national payment system particularly [to] uphold, what we believe [is] a world class banking system. This payment system surely is one that [is for the] benefit of all South Africans...³

The Enquiry has led us, however, to conclude that the *regulation* of the South African payments system has fallen behind best practice as it is developing internationally. This conclusion stems from evidence that regulation is failing to adequately address the changes in payment services provision which are resulting from technological change, new payment streams and the increasing provision of payment-related services by non-banks. While our payments system is technically advanced, the structure of our access and regulatory regime remains locked in the past, and rests too much on the laurels of past successes. As the chapter will show, the result is that reluctant and inadequate adaptations are made in this area – whereas in Australia and Europe, for example, the regulatory authorities have taken major initiatives to restructure their access policy to meet the challenges of technological innovation and change and to foster competitive dynamics. This regulatory conservatism, which prevails even though the exclusion of non-banks has been shown to be unnecessary for the maintenance of stability and effective management of risk, has serious implications for competition and needs to be fundamentally reconsidered in the light of more advanced regulatory practices taking hold elsewhere.

² Transcript 28 May 2007, p 2.

³ Transcript 25 May 2007, p 64.

Much of the discussion that follows emphasises the distinction between those participants that are permitted to clear and settle (clearing banks) and those participants that are not permitted to do so. In order to set the scene for this discussion, a few definitional issues need to be addressed.

In South Africa, **clearing** is often referred to as the “exchange of payment instructions”, given that this is how it is defined in the National Payment System Act (NPS) Act 78 of 1998. However, this definition falls short of the Bank for International Settlements (BIS) definition that clearing is the process of transmitting, reconciling and, in some cases, confirming payment orders or security transfer instructions prior to settlement.⁴ As the BIS has it, clearing includes all of this, as well as possibly the netting of instructions and the establishment of final positions for settlement.⁵

Settlement is the act that discharges obligations in respect of funds (or securities) transfers between two parties. Settlement typically takes place via the transfer of funds between the clearing banks through their accounts at the central bank. This settlement effectively encompasses settlement at payer-payee level as the successful settlement at interbank level is associated with the transfer of funds between individual accounts at different banks.

Clearing and settlement are related activities; the former ensures the calculation and transmission of obligations and the latter involves the discharge of those obligations. Hence, it is no surprise that they are typically referred to as a single activity; *clearing* banks are banks that clear *and* settle.

In the BIS definition, and indeed in practice in South Africa and elsewhere, clearing encompasses a broad range of activities. Take, for instance, a payment service provider like a bureau that collects payment instructions from third parties – such as small businesses that have monthly debit orders against the accounts of customers for gardening or cleaning services – and transmits these into the payment system via a system operator. Such a service provider is engaged (at least in part) in clearing. Even although the bureau is not exchanging payment instructions, as per the NPS Act, the mere transmission of such instructions is part of the process of clearing. In South Africa, where clearing and settlement are restricted to clearing banks, such activity by a bureau must be done under the auspices of a clearing bank.

⁴ BIS, CPSS, 2003, A glossary of terms used in payments and settlement systems, p 13.

⁵ While clearing is often associated with netting, in the South African NPS there is no netting in the clearing activity as each transaction is separately recorded and aggregated in terms of each clearing bank's position against the other. Gross obligations are hence calculated for settlement. This allows transactions to be tracked with greater ease through the system. In South Africa, the clearing house is responsible for the establishment of the final gross positions for settlement vis-à-vis each bank in each stream.

In the same way, the dominant Payment Clearing House (PCH) system operator, Bankserv, is also involved in clearing because it has been appointed by two or more clearing banks in each retail payment stream.⁶ As a PCH system operator, Bankserv is the institution which receives and transmits retail payment instructions from different payment streams, such as ATMs and payment cards, when more than one bank is involved. This position makes it the ideal candidate to calculate the obligations of clearing banks in all the relevant payment streams, which it does on a continuous basis and transmits the gross obligations to the settlement system of the SARB. In the low-value, or retail streams, settlement takes place on a delayed basis at a specific time or times of the day.

The examples above show that while the act of clearing and settlement is *legally* the preserve of clearing banks in South Africa, others may be involved. However, this involvement is predicated on such others operating under the auspices of one or more clearing banks.

As the discussion below will reveal, the debate centres around whether such legal privilege is justified and whether or not technical access under the auspices of the clearing banks sufficiently stimulates competition and innovation in the payment system.

The discussion below is organised along the following lines. Section 7.2 provides an introduction to the importance of the payment system and presents a brief historical overview of the payment instruments. The discussion sets out the risks that can arise in the payment system and distinguishes between high and low-value payment streams. In general, high-value payments are more likely to generate systemic settlement risk (where one bank fails to honour its financial obligations resulting from payments instructions) than low-value payments. For this reason, high-value payments are typically processed in real-time through the central bank's settlement system. Low-value payments, like cheque payments, ATM transactions, electronic fund transfers (EFTs) and credit and debit card purchases are defined as such in terms of some value threshold. In South Africa, all payment transactions below R500 000 are seen as low value payments.⁷ These are settled on a deferred basis at a specific time or times of the day.

Section 7.3 focuses on international approaches to the regulation of clearing and settlement in retail payment systems. The discussion shows that several countries are moving towards a functional – rather than institutional – based approach to regulation in the payment system. This means that the function performed by a firm, rather than its institutional identity, is the more important issue in its regulatory treatment. This approach has allowed countries such

⁶ The card PCH agreements allow for more than one PCH system operator to be appointed if participants so choose.

⁷ For cheques, values up to R5 million fall into the retail category. See section 7.4 for more detail.

as Australia to define explicit access regimes for non-banks into clearing and settlement activity alike.

Section 7.4 provides an overview of the South African payment system, including the participants, regulatory structure and payment streams. Details as to how the high and low-value payment streams are processed are provided. Data is presented that shows that all the low-value streams together account for less than 10 per cent of the value flowing through the NPS. This means that in general, low-value payments streams hold far less inherent risk than high value streams.

Section 7.5 presents the current regulatory and legislative framework in South Africa. The status quo supports the exclusive access of banks to the clearing and settlement arena, and the self-regulatory structure means that clearing banks set the operational rules of each payment stream – although the National Payments System Department (NPSD) retains oversight of the payments system. The section sets out the prevailing regulatory "models" for participation by clearing banks and points out that these models do not in fact reflect the realities of the participation of exempted institutions like the Postbank and Ithala (which are excluded or exempted from the application of the Banks Act). Inadequate regulatory treatment of such institutions may well increase risk within the system, which a more developed and active regulatory approach to access would serve to reduce. Other non-banks, which introduce transactions under the auspices of clearing banks, are also not adequately regulated and monitored. The discussion shows the need for better quality of access where all those permitted access are effectively regulated. It also shows that there is little in the new NPS Governance structure that deals with the inadequate and piecemeal regulation of non-banks.

Section 7.6 considers particular matters of concern related to the NPS. The key concerns relate to the conservatism in the regulatory approach which relies on its existing approach of preserving clearing and settlement activity as the privilege of clearing banks. Where there are exceptions to this, like Postbank and Ithala, such arrangements present a de facto challenge to the one recorded in law. But there are also concerns raised about the access of smaller banks and the discrimination between large and small clearing banks, with the latter encountering additional barriers to entry. The discussion further shows that the approach to non-banks in terms of the recently issued directives does not provide an adequate framework for their regulation. Moreover, since PASA's membership continues to be confined essentially to clearing banks, and since PASA will be enforcing the directives, they ultimately entrench the power of the clearing banks over their non-bank competitors.

Section 7.7 focuses on one of the matters brought to the attention of the Enquiry – multiple acquiring and "sorting at source". While the latter has been presented as a mechanism to improve access, we do not find it so.

The final section provides concluding remarks and recommendations.

7.2 Importance of the payment system and historical overview

Much like power supply, the importance of the payment system is often only obvious at a time of failure. For this reason it is necessary to spell out how the payment system affects the daily lives of all individuals and firms.

For an economic system to function properly, a payment system is required so that buyers can pay sellers for goods and services. In its most familiar form, notes and coins operate as a payment stream, allowing for the physical exchange of cash for goods and services. As economies and technologies have developed, payment instruments have evolved, so that for example, a cheque is a paper payment instrument which, under certain circumstances, can be used as a substitute for notes and coins. The means of payment may include electronic fund transfers (such as debit orders for standing obligations or once-off bill payments) and debit and credit card transactions. All of these payment instruments allow for payment and settlement of financial obligations.

Different payment instruments give rise to different payment streams, for which rules are generally set in terms of operations, item limits and so on, by the participating payment system members. The rules relating to operation of a payment stream are determined by the members of the respective payment clearing houses (PCHs).

As payment instruments have evolved, so have the systems for clearing and settlement between banks on behalf of their account holders. The speed, efficiency and seamlessness of payment system structures mean for instance that a municipal account can be paid by means of an internet banking instruction or by means of a credit card, and the customer has the assurance that the municipality has received it and attributed it to the correct account, even though the process may take several days to complete.

7.2.1 Security, efficiency and accuracy of the payment system

Regulatory authorities raise the importance of security, efficiency and accuracy in the payment system to underpin consumer confidence in the system. These features give consumers reason to believe that payment instructions from their bank to another bank have been settled and have gone through to completion at account level, once so instructed. While for the most part, payment instructions can be re-issued if they fail, there may be crucial missed opportunities (for example in the case of equity purchase or sale) or a crucial chain of events set in motion by the failure of payment instructions. For example, an individual may believe that he has paid all outstanding traffic fines at his bank's ATM, but be arrested for non-payment of fines the following evening in a road block. Clearly, the failure

of payment instructions to go to completion can have harmful negative effects on individuals and firms, and ultimately, the performance of the economy.

As Mr Shuter of Nedbank set out during the hearing on 29 May 2007:

There has been quite a lot of talk around confidence, stability and integrity. I think the only slight nuance we would like to bring into the discussion is that obviously what the system really requires is trust, faith for end users to be comfortable that, if they present a card at a merchant, their confidential information will not be stored, they will be settled, [and] that, if they provide payment details to somebody else, only those amounts will be drawn off their account.

So trust is very, very important for the system to operate efficiently and I think the point is that the existing regulatory framework has accommodated that.⁸

If the payment system were vulnerable to security breaches or if it were inefficient or inaccurate, the public would lose faith in dematerialised payment streams and revert to notes and coins. This would introduce transaction costs into the payment activity and would not be optimal. By contrast, efficient and secure payment systems enhance the transparency of transactions, lower transaction costs, improve operational efficiency of trade and commerce and provide support to the globalisation of the economy. This can ultimately improve the quality of living for the population.

7.2.2 Risk and the payment system

Systemic risk

In a payment system, if one bank fails to honour the financial obligations resulting from the payment instructions during the course of a day, the net position of other banks may be so compromised that clearing and settlement fail. This is known as systemic risk, and typically arises because one party's failure to pay can cause others also to fail to pay when due. The classic case in banking is where the failure of one bank can lead to a run on other banks – pushing them into illiquidity and even, in some extreme cases, insolvency. Hence liquidity risk, where a participant cannot settle in full when the obligation is due, but only at some unspecified time later, can lead to credit risk, where the participant is ultimately unable to settle in full, whether at the specified time or any other.⁹

This can lead to losses in the real economy through both direct and indirect effects. Directly, because payments have been delayed, or have not been effected at all and indirectly

⁸ Transcript 29 May 2007, pp 140-141.

⁹ Although in practice the two forms of risk may be difficult to distinguish from each other. BIS, CPSS (2000), p 11.

because failure of one participant has caused losses among one or other participant.¹⁰ If a participant and the payment system itself becomes illiquid then the remaining participants may be open to losses based on their positions vis-à-vis the insolvent party, and one or more could even themselves be rendered insolvent.

Efficient and reliable payment systems contribute to overall financial system stability by providing the certainty associated with settlement and completion of transactions. Settlement is an act that discharges obligations in respect of funds (or securities transfers – the case of a securities settlement system) between two or more parties. In a national payment system, the central bank generally acts as the settlement institution. The paying and receiving institutions (typically clearing banks – which in turn provide accounts and payment services to their own customers) are both direct participants in the payment system and hold accounts at the settlement institution.¹¹

Settlement takes place by means of book entries at the central bank, with both paying and receiving banks having accounts at that institution. It is effected by a debit from the account of the paying bank and a credit to the account of the receiving bank. Both clearing banks are reliant on the settlement institution's (the central bank's) operational soundness. The larger the value and volume of payments the institution settles, the more important are its creditworthiness and operational reliability.¹²

In payment settlement systems, high-value (or wholesale) payments are typically viewed as systemically important. Individual low-value (or retail) payment streams do not typically pose an immediate threat to systemic stability because of their smaller values. For this reason, the real-time high value clearing and settlement systems around the world tend to be owned and operated by central banks. In contrast, within low-value payment streams there is extensive use of private sector systems for transactions processing and clearing (although the settlement institution – for the most part – remains the central bank).

The mechanisms, procedures and technology to ensure that the payment system does not fail (in both clearing and in settlement) are high on the agenda of the regulatory authorities. Surveillance of payment system behaviour provides an early warning mechanism for supervisory authorities – in the case of the failure of Saambou¹³ in 2001, its liquidity problems were apparent in the payment system long before they were apparent in any statutory Deposit-Taking Institution (DI) returns.

¹⁰ Bank of England (2006), p 5.

¹¹ BIS, CPSS (2003), p 9.

¹² *Id.*, p 10.

¹³ The seventh biggest bank in terms of assets in South Africa, at the time.

System-wide risks

The Bank of England uses the phrase “system-wide risks” for those risks that do not immediately pose systemic risk or threaten financial stability, but may still cause system-wide disruption.

System-wide risks include operational risks where a system operator or core infrastructure provider is unable to process payments – as a consequence of human error or breakdown in systems – and business risks where a provider of infrastructure fails financially and can no longer operate as a going concern.¹⁴

Operational risk is the risk of incurring a financial loss because of various types of human or technical error. This can range from having one terminal down for a few minutes because of telecommunications failure to a whole authorising system for card payments failing for a few hours or longer.

Fraud risk is the risk that a wrongful or criminal deception will lead to financial loss for one of the parties involved. Examples range from forging a signature on a payment instruction, such as a cheque, to obtaining access to the computer of a financial institution under a false identity from a remote location.

Legal risk arises when the rights and obligations of parties in the payment system are subject to the uncertainty that a participant’s bankruptcy may mean that the multilateral arrangements between clearing members and the clearing organisation will not be upheld under national law.¹⁵

Various risk reduction measures may be used – even in retail systems – including the use of anti-fraud technologies, system controls and standards for technical features of payment instruments¹⁶ and the appropriate legal foundations, to reduce the advent of such risks.

Importance of high-value vs low-value payment streams

Low-value payment systems and instruments are significant contributors to the financial system as they facilitate commerce and support consumer confidence in the medium of exchange. Low-value payments are made in large numbers by transactors and are the ones most consumers and firms are familiar with in purchasing goods and services.

¹⁴ Bank of England (2006), p 8.

¹⁵ BIS, CPSS, 2000, p 10.

¹⁶ *Id.*

While most ubiquitous, the value of the flows through low-value payment streams is small in comparison with high-value streams. In South Africa, for example, all the low-value streams together account for less than 10 per cent of the value flowing through the payment system.

Low-value payment systems tend to include a wide range of payment instruments such as cash, cheques, electronic funds transfers and payment cards facilitated through different payment streams such as ATMs, the internet, cellular telephony, point of sale devices and so on, but up to certain threshold amounts.

By definition, high value payment streams are those that carry higher systemic risk and hence tend to be processed in real-time. For example, in South Africa, the Real Time Line is a facility for settling single-settlement instructions *immediately* on a gross basis. Currently all credit transactions exceeding R5 million must be processed through this facility, and electronic fund transfers above a certain value will fall into the high-value stream.

From the perspective of risk associated with clearing and settlement, low-value payment systems are generally deemed to be of less systemic importance than the high-value streams.¹⁷ For this reason, the BIS through its Committee on Payment and Settlement Systems (CPSS), typically distinguishes between Systemically Important Payment systems (SIPS) and low-value payment systems and the relevant oversight and regulation in each case. This will be the focus of the discussion in Section 7.3.

7.3 The regulation of clearing and settlement

At the risk of oversimplifying things, for most payments to occur three elements must exist.

The first is that there must be a store of value that can be accessed. The second is that there needs to be a system for exchanging payment instructions between institutions, sometimes loosely referred to as clearing arrangements. And third, there needs to be a settlement system, whereby value is moved from one account to another.

In the world of a few decades ago, all three functions – maintaining the store of value, developing and running messaging and processing systems, and having access to settlement systems – were almost always the exclusive preserve of banks. The world of payments was the world of banks and that was that. This was reflected in the view that it was only banks that could be allowed into the inner sanctum of the payments process – the settlement accounts at the central bank. In some countries, including my own, this idea led to legislative restrictions on the type of institutions that could issue cheques and other payment instruments.

The world of today is a lot different...Messaging and processing systems do not need to be run by banks. And in some countries, non-bank providers of payment services are able to have accounts at the central bank. As we have been discussing over the past couple of days, this new world opens up a whole range of possibilities. From my perspective, the central

¹⁷ In countries where a particular stream dominates and the aggregate value of payments handled by a retail stream is very large, such a stream may be deemed to be systemically important irrespective of the size of individual payments.

issue seems to be how you can best take advantage of these possibilities, without adding unnecessarily to the risk in the system.

*Phillip Lowe, Assistant Governor of the Reserve Bank of Australia.*¹⁸

The discussion so far has shown that clearing and settlement is a regulated activity throughout the world, with international standards promoted by the BIS. It is apparent that in low-value payment systems, there are a number of inter-country differences in the approaches of regulators, all purporting to meet the BIS standards. Differences in regulatory approaches affect the payments landscape in the different countries, as we shall see below.

We begin by providing an overview of the processes involved in clearing and settlement. Then BIS's recommended approach to regulatory supervision of low-value payment systems is presented. This is followed by a review of the regulatory approaches towards clearing and settlement that have been adopted in several countries.

7.3.1 Clearing and settlement

The processes involved in completing a payment can be described by examining the authorisation and authentication process and then the clearing and settlement processes, in turn.

The process of making a transaction requires the creation, validation and transmission of a payment instruction. It can be divided into a number of main steps:¹⁹

- Verification of the identity of the involved parties
- Validation of the payment instrument
- Verification of the ability to pay
- Authorisation of the transfer of the funds by both the payer and the payer's financial institution
- Communication of the information by the payer's financial institution to the payee's financial institution
- Processing of the transaction

The structure of such steps varies considerably with the type of payment instrument and in practice the steps may not be performed sequentially. Moreover, there are different procedures for authenticating and authorising payments. Again, the variation has to do with payment instruments used: for example, a debit card transaction at the point of sale (POS)

¹⁸ In a speech at the Non-banks in the Payment system Conference of the Federal Reserve Bank of Kansas City, in May 2007.

¹⁹ BIS, CPSS, 2000, p 3.

with the use of a PIN code²⁰ generally involves both authentication (by keying in the PIN) and authorisation (confirmation of the transaction and initiating the online approval by pressing the OK key). Authentication and authorisation can be immediate (given by the payer's financial institution at the initiation of the payment transaction process, such as for card payments) or deferred. If it is deferred, it is given by the payer's financial institution at the end of the transaction process following the request of the payee's financial institution handling the payment information.²¹

During the *clearing process* two main functions may be performed: (a) the exchange of the payment instrument or of relevant payment information between the payer's and the payee's financial institutions, and (b) the calculation of claims for settlement. The outcome of this process is a fully processed payment transaction from payer to payee as well as a valid claim by the payee's institution on the payer's institution.

In general, four types of arrangements for the clearing of payment instructions can be identified. The first arrangement takes place within one and the same financial institution, the other three types require interbank arrangements:

- In-house transactions – the verification of information and the calculation of balances that characterise the clearing process can be performed within the single financial institution.
- In a bilateral arrangement, the exchange of instructions and the sorting and processing of payments flowing between two financial institutions is handled by the institutions themselves.
- Alternatively, financial institutions may employ a common third party – a separate financial institution known as a correspondent – for clearing, with one or more institutions forwarding payment instructions to the correspondent for sorting and processing. Correspondents generally provide services to other financial institutions according to contracts that are negotiated bilaterally.
- Multilateral clearing arrangements are based on a set of procedures whereby financial institutions present and exchange data and/or documents relating to funds transfers to other financial institutions under a common set of rules. One example of such an arrangement is a clearing house: an organisation that operates central facilities and which may also act as a central counterparty in the settlement of the payment obligations under a multilateral netting arrangement.²²

²⁰ Personal Identification Number.

²¹ BIS, CPSS, 2000, p 11.

²² BIS, CPSS, 2000, p 13.

In the *settlement process*, the valid claim from the payee's institution is discharged by means of a payment from the payer's institution to the payee's institution. Specifically, the steps in the settlement process are:

- Collection and integrity check of the claims to be settled
- Ensuring the availability of funds for settlement
- Settling the claims between the financial institutions
- Logging and communication of settlement to the parties concerned.

Settlement balances resulting from multilateral clearing organisations are posted to participants' individual accounts at the settlement institution, which is typically the central bank.

Access to settlement accounts at the central bank may be either open to all institutions participating directly in clearing arrangements or limited to financial institutions satisfying specific criteria (such as being deposit-taking institutions). In the latter case, institutions that do not have access to a central bank account settle their payments with a direct participant in settlement, which, in turn, settles across the books of the central bank.

For low-value payments, settlement is usually on a deferred basis once a day, after the clearing balances have been calculated, whereas for large volume, real time systems, the transactions are settled individually, and in real-time.²³

7.3.2 Central banks and their role in low-value payment systems

Central banks play three possible roles in low-value payment systems. This includes an operational role, their role in the oversight of the payment system and their role as catalysts or facilitators of market and regulatory evolution.

In the case of the operational role, most central banks provide settlement services for at least some of their low-value payment systems. In addition, there are still central banks that provide the clearing services for low-value payments, although in many countries the view appears to have been taken that the objectives of efficiency and safety are best served if clearing services are developed and provided solely by the private sector.²⁴

²³ BIS, CPSS, (2000), pp 8 and 16. In South Africa, low-value settlements take place several times a day in some payment streams.

²⁴ BIS, CPSS (2003), p 10.

The provision of services may be seen as a mechanism to enhance understanding and influence over the low-value payment system – and in so doing assist central banks in their role as overseers.

The oversight role of central banks over the low-value payment system arises, in most cases, from their responsibility for safety and efficiency in SIPS. At the very least, it is the central banks that set or advise on the thresholds that distinguish between low and high-value payments. Hence their explicit legal authority with respect to the SIPS extends from the high value payment streams to the low-value streams.²⁵

In most cases, the chief concern of the regulatory authority in low-value payment systems is efficiency and safety. In other cases, it extends to consumer protection and the prevention of money laundering.²⁶ The BIS, CPSS points out that the role of central banks in low-value systems should be cognisant of the fact that those systems with greater significance require greater regulatory attention. From this perspective, a central bank may restrict its actions and monitoring to the recommended minimum.

These minimum regulatory functions indicated for low-value payment systems are:

- Address legal and regulatory impediments to market development and innovation
- Foster competitive market conditions and behaviours
- Support the development of effective standards and infrastructure arrangements
- Provide central bank services in the manner most effective for the particular market.²⁷

The role of *catalyst or facilitator* provides for many central banks a policy tool to guide market and regulatory evolution. Through their co-operation with the private sector, including their formal governance role of low-value payment systems in some countries, central banks can apply their research and analytical capabilities to support or speed up market outcomes. In addition, liaison and information sharing between the payment system regulators and other public authorities can enable their influence in the design and operation of payment systems. This can include memoranda of understanding between the central bank and the competition authority, as in Australia, or between payment overseers and financial and banking regulators, as in the EU, or between the central bank and the ministry of finance, as in the case of Canada.²⁸

²⁵ BIS, CPSS (2000), p 17.

²⁶ BIS, CPSS (2003), p 12.

²⁷ *Id*, pp 4-6.

²⁸ *Id*, p 14.

7.3.3 New participants and the low-value payment system

As early as 2000, the BIS noted that:

The role of the private sector in providing clearing services, already significant today, is becoming more important. Furthermore, in almost all countries clearing arrangements for payment cards are solely operated by the private sector. As the share of these instruments in the overall use of payment instruments rises, so will the share of private sector arrangements in the overall provision of clearing arrangements.²⁹

The increasing role for non-traditional, non-bank providers in the payment system has been linked, in part, to technological innovation:

The application of information and communication technology to payment processes has made it possible to meet the increasing demands of end users through innovations in delivery channels, products and clearing arrangements. The availability of new products and delivery channels, such as the internet, has allowed financial institutions to review their distribution strategy and has given customers the possibility to choose from a wider variety of payment services. Furthermore, the application of new technology, together with the efforts by market players to reduce costs, has been encouraging greater standardisation. The widespread application of technology and standardisation also favours the restructuring of payment processes, which tends to become separable into various activities, thereby facilitating the entry of new service providers into the market for clearing services.³⁰

This discussion suggests an accepted, and perhaps even encouraged, role for non-traditional participants (i.e. non-banks) to become involved in transaction processing and clearing. In large part, such a role has evolved as an outsourcing role from the clearing banks, where consolidation of technical processes has potential to lead to economies of scale.

Some have linked the rise in non-bank participation with the trend towards using electronic means for making payments, as these new forms of payments are more advanced.³¹ Banks may feel that developing such expertise is not their core business and the complexity of electronic payments offers opportunity for specialisation which may attract non-bank specialists into the field. In one example of electronic payments – those that take place via ATMs – the rise in participation of non-banks has been marked. In the US, for example, the share of ATM transaction volume accounted for by non-bank owned infrastructure rose to 65 per cent in 2005, from less than 5 per cent in 1995.

In many countries, however, both non-bank financial and non-financial institutions providing low-value payment services or involved in processing are not able to access the arrangements for settling low-value payments, as a result of statute or policy. The BIS maintains that in principle, access to central bank liquidity is not a necessary condition for

²⁹ BIS, CPSS, 2000, p 1.

³⁰ BIS, CPSS, 2000, pp 1-2.

³¹ Sullivan, 2006, p 9.

the provision of payment services, and non-banks still rely largely on the provision of liquidity by a clearing bank for settlement to take place.³² However, the regulatory trends in Australia, the UK and the EU suggest this may not always be the case. In the discussion below, the examples of a few countries that offer different clearing and settlement models are briefly examined.

In this regard, there are a number of factors to consider:

- Who has access to the clearing and settlement mechanisms?
- Who provides the clearing and settlement services?
- Where non-banks have access to either clearing or settlement – what are the conditions of such arrangements?

7.3.4 Access to national payment systems

A number of countries have recently completed – or are in the process of completing – a review of the restrictions associated with access to clearing and settlement. Some of these are reviewed below.

Canada

Canada's clearing and settlement systems have developed historically into hierarchical or tiered arrangements. The tiered arrangement in the Automated Clearing Settlement System (ACSS) has existed since inception – given that membership was granted to deposit-taking institutions of all kinds (banks, credit unions and trusts). The two-tier structure allows for direct participants – Direct Clearers and Clearing Agents – and indirect participants – referred to as Indirect Clearers, with rules governing each.

In 2001, following a review of policy by the Department of Finance and the Bank of Canada, the Canadian Payments Act (2001) opened membership of the Canadian Payments Association (CPA) to non-bank financial institutions such as life insurance companies, securities dealers and money market mutual funds.

The CPA currently has 123 members, of which 62 are registered banks, the rest are trust and loan companies and credit unions. Of the banks, 12 are direct clearers, all the rest are indirect clearers.³³ To become a direct clearer, a CPA member must:

- be a deposit-taking institution or a securities dealer (“institutional restrictions”)

³² BIS, 2003. The role of central bank money in settlement systems.

³³ CPA website: www.cdnpay.ca/membership.

- have a settlement account and standing loan facility at the Bank of Canada
- process 0.5 per cent of the total national clearing volumes (“the volume requirement”)
- meet the technical and other requirements outlined in the By-laws and Rules.

The opening of the CPA membership led to questions around the relevance of these eligibility requirements (in particular, the volume requirement and institutional restrictions) for participation as a direct participant in the ACSS. This is in spite of the fact that since 2001, no non-deposit-taking institution has applied for membership of the CPA. A process of review followed. In their June 2006 report, the Tripartite Study Group into eligibility criteria – comprising members of CPA, the Bank of Canada and the Department of Finance – recommended the following:³⁴

- The current institutional restrictions be retained; in particular, life insurance companies and money market mutual funds be restricted to Indirect Clearer status. This means such institutions, while members of the CPA, and hence within the regulatory framework of the payment system and its rules, would have to use the services of one of the clearing agents (i.e. one of the 12 direct clearers). The reasoning behind this centres around retaining the position of a relatively few direct clearers in the system, which supports their volumes (and hence economies of scale) and encourages mutual trust. The review suggested that indirect clearers saved on back office costs when using a clearing agent. Part of the reasoning in retaining the status quo was that to date, no non-deposit-taking institution had sought membership of the CPA.
- The volume requirement be removed and replaced with appropriate alternative criteria. The rationale for this is that volume is *not* indicative of the operational or financial capability of an institution to clear and settle payment transactions. Accordingly, it was argued that volume should not be used to restrict direct access to the ACSS, but that instead the following requirements be imposed: a prime credit rating on short-term paper; participation in the Large Value Transfer System (LVTS) and meeting certification testing on entry and material change.

The Canadian example provides an example of broad based access to clearing, at least in principle, which enables standardised regulations and rules. While the discussion above has focussed on participation in the CPA, non-deposit-taking access to participation in the country’s ATM and electronic fund transfers at point of sale (EFTPOS) network, known as Interac, has been facilitated since 1996.³⁵ The Canadian authorities have, however, retained a tiered structure in settlement, which effectively keeps this as the preserve of the clearing banks.

³⁴ Tripartite Study Group Final Report, 2006.

³⁵ RBA, 2007, p 14.

Australia

The Reserve Bank of Australia (RBA) widened the eligibility for exchange settlement (ES) accounts at the central bank in March 1999. Applicants for ES accounts do not need to be banks, but must be an actual or prospective provider of third party payment services, with a need to settle clearing obligations with other providers,³⁶ and must be able to demonstrate they have the liquidity to meet settlement obligations at all times.

There are two categories of possible applicant – those that are regulated by the Australian Prudential Regulation Authority (APRA) (for financial institutions) and those which are not (non-financial institutions). Those regulated by APRA and which can satisfy the RBA they are able to meet their settlement obligations are eligible for ES accounts, without special conditions, except that such accounts must be in credit at all times. Those not regulated by APRA will have to meet collateral requirements on an ongoing basis, except where they are net receivers in payment clearing arrangements.³⁷

The general approach of the RBA has been to adopt a functional rather than an institutional approach. In the words of Assistant Governor Lowe:

This approach reflects the fact that many types of payment can be broken down into a number of separate functions. Each of these functions is potentially contestable, including by non-banks. What we have been trying to do is to obtain the benefits of this contestability, without unnecessarily adding to the risks in the system. *Where non-banks do bring extra risks – as they sometimes do – we have asked how the risks can best be managed, rather than simply excluding non-banks from the system.*³⁸

The RBA has played a significant role in improving access in the payments landscape. This intervention³⁹ includes:

- Setting out an access regime for credit and debit cards, where applications from non-banks (known as Specialist Credit Card Institutions, in this instance) need to be treated on the same basis as banks. In addition, MasterCard and VISA may not penalise any participant based on its issuing activity relative to its acquiring activity or vice versa.
- In the case of EFTPOS, the RBA has set a price cap on the cost of a standard direct connection with another participant to AUS\$ 78,000.
- In the ATM stream, the RBA have facilitated the encouragement of a new regime for ATMs, and the industry will shift to a direct charging approach in October 2008.

³⁶ So retailers that acquire their own debit transactions, but are not providing services to others, do not qualify for settlement accounts. They can however be clearers and members of APACS.

³⁷ RBA, 2007.

³⁸ Lowe, 2007. Emphasis in the original.

³⁹ RBA, 2007 p 6.

The Australian example of intervention of the RBA as overseer and catalyst in the payments arena has much to do with their explicit legislated objectives, i.e., not only of stability, but also of efficiency and competition.

UK

In 2002, the Bank of England published its policy for granting access to settlement accounts to any direct participant in a payment system. The Bank of England argued that provision of such accounts enables the central bank to act as the settlement agent, bringing with it the advantages of risk reduction, service assurance, competitive neutrality and efficiency.

Intraday credit would typically be provided by the Bank of England only where the scale of the account holder's payment activities would make it a significant direct participant in a systemically important payment system and where its direct membership would reduce risk for the financial system.

The Bank's review was motivated by a range of factors, including the desire – reflected in the Core Principles for regulation of SIPS – to implement transparent and objective access criteria, and the fact that a number of non-bank payment service providers applied for access to accounts in the context of the Bank of England's role as settlement institution for the LINK ATM network.⁴⁰

European Union

The European Union has recently issued a Payment Services Directive (PSD) which provides a legal framework to “ensure the coordination of national provisions on prudential requirements, the access of new payment service providers to the market, information requirements, and the respective rights and obligations of payment services users and providers.”⁴¹

Previous EU directives had laid down prudential requirements and other supervisory provisions for existing providers of payment services involving deposit-taking and the issue of electronic money, while post office giro (i.e. credit transfer) institutions obtained their entitlement to provide payment services under national law.⁴²

⁴⁰ BIS, CPSS, 2003, p 35.

⁴¹ EU, 13 November 2007 (OJ 5.12.2007 L 319/1-36), *Directive on payment services in the internal market*, para (5) of the preamble.

⁴² *Id.*, para (8).

The PSD recognised, however, that

... in order to remove legal barriers to market entry, it is necessary to establish a single licence for all providers of payment services which are not connected to taking deposits or issuing electronic money. It is appropriate, therefore, to introduce a new category of payment service providers, 'payment institutions', by providing for the authorisation, subject to a set of strict and comprehensive conditions, of legal persons outside the existing categories to provide payment services throughout the Community. Thus, the same conditions would apply Community-wide to such services.⁴³

The prudential and other regulatory requirements applicable to such payment institutions should reflect the fact that they

engage in more specialised and limited activities, thus generating risks that are narrower and easier to monitor and control than those that arise across the broader spectrum of activities of credit institutions. In particular, payment institutions should be prohibited from accepting deposits from users and permitted to use funds received from users only for rendering payment services. Provision should be made for client funds to be kept separate from the payment institution's funds for other business activities. Payment institutions should also be made subject to effective anti-money laundering and anti-terrorist financing requirements.⁴⁴

The fundamental principle behind the PSD appears to be non-discriminatory access of non-banks to clearing and settlement facilities. The idea is that payment institutions will have non-discriminatory rights of access to interbank payment systems, or switches (or PCH system operators) as they have been referred to in this chapter. While the directive does not explicitly say so, it appears that if participation in these systems requires certain access to services or accounts provided by central banks, then the same principles of non-discrimination should also apply to the central banks.⁴⁵

EU member states have until November 2009 to transpose the PSD into national law, and this will mark just the beginning of putting the PSD into practice.

The PSD is part of a larger initiative, led by the EU institutions and industry bodies, to eliminate barriers to the realisation of a single internal market across Europe for payment services. This initiative is referred to as "SEPA" (Single Euro Payments Area). By harmonising the laws and regulatory requirements that govern the provision of payment services across the EU member states, and thereby eliminating national legal and regulatory barriers, the PSD helps to create a level playing field across Europe.

⁴³ *Id.*, para (10). As to the rigorous approach taken to the authorisation of payment institutions, see Article 10 of the PSD. As to the control of outsourcing by payment institutions, see Article 17.

⁴⁴ *Id.*, para (11).

⁴⁵ "Provision should be made for the non-discriminatory treatment of authorised payment institutions and credit institutions so that any payment service provider competing in the internal market is able to use the services of the technical infrastructures of these payment systems under the same conditions." *Id.*, para (16). "Payment system" is defined in Article 4 of the PSD as meaning "a funds transfer system with formal and standardised arrangements and common rules for the processing, clearing and/or settlement of payment transactions".

The aim of Article 28 of the PSD is to ensure non-discriminatory access to payment systems so that competition is stimulated as SEPA becomes reality:

1. Member states shall ensure that the rules on access of authorised or registered payment service providers that are legal persons to payment systems shall be objective, non-discriminatory and proportionate and that those rules do not inhibit access more than is necessary to safeguard against specific risks such as settlement risk, operational risk and business risk and to protect the financial and operational stability of the payment system.

Payment systems shall impose on payment service providers, on payment service users or on other payment systems none of the following:

- any restrictive rule on effective participation in other payment systems;
- any rule which discriminates between authorised payment service providers or between registered payment service providers in relation to rights, obligations and entitlements of participants;
- any restriction on the basis of institutional status.

The PSD is clearly a mechanism intended to ensure, inter alia, that SEPA does not reinforce the dominance of banks in the payments industry.

7.4 An overview of the payment system in South Africa

Sections 223-225 of the Constitution⁴⁶ provide for the SARB to be the central bank of the Republic, subject to an Act of Parliament, having the powers and functions customarily exercised and performed by central banks, and having as its primary (but not sole) object the protection of the value of the currency in the interests of balanced and sustainable economic growth. Section 10 (1) (c) (i) of the South African Reserve Bank Act⁴⁷ empowers the SARB to

perform such functions, implement such rules and procedures and, in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing or settlement systems.

In the words of Mr T. T. Mboweni, the Governor of the SARB:⁴⁸

In February 1994, the banking industry requested the South African Reserve Bank to take the lead in the modernisation process of the domestic payment system. The NPS project, which was initiated by the Bank in April 1994, was launched as a collaborative effort between the Bank and the banking industry and the initial focus was to formulate a long term strategy for the modernisation and development of the domestic payment system. This initial work resulted in the development of the South African National Payment System Framework and Strategy document (the so-called Blue Book) which was published by the Bank in 1995. The Blue Book contained the vision and strategy for the NPS up to 2004.

An important component of the implementation strategy entailed the establishment of an umbrella body, the Payment Association of South Africa. It was envisaged that PASA would

⁴⁶ Constitution of the Republic of South Africa, Act 108 of 1996.

⁴⁷ Act 90 of 1989 as amended.

⁴⁸ Address on 15 November 2006 marking the 10th anniversary of PASA.

play a central role in establishing and controlling Payment Stream Associations representing the banks participating in each particular payment stream. It was the view at the time that although the Bank would remain responsible for the overall safety and soundness of the NPS, the clearing environment should be managed by an association made up of participants in that environment.

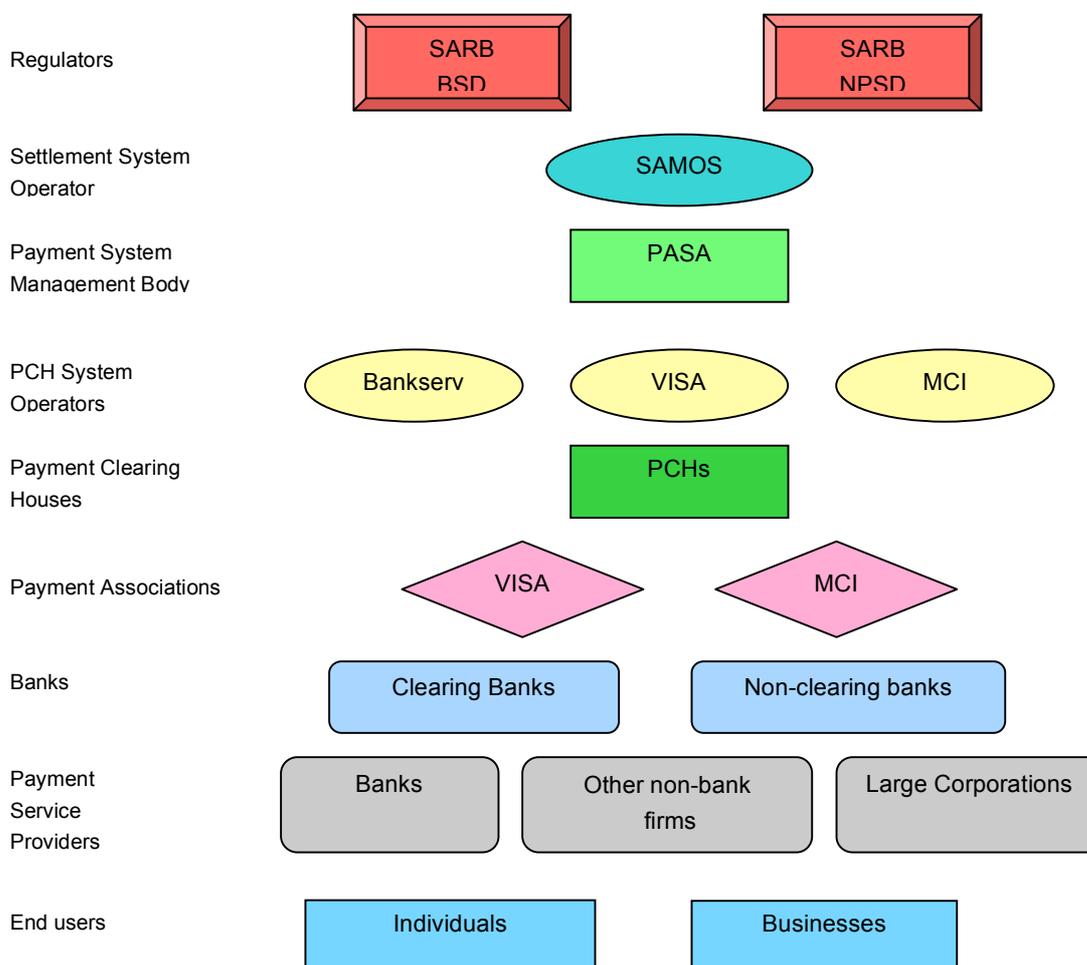
Although the NPS Act,⁴⁹ which makes provision for a Payment System Management Body, was only promulgated in October 1998, PASA was already formally established on 26 September 1996. The Act made provision for a Payment System Management Body, not only to manage the affairs of its members in relation to payment instructions, but also to act as a medium of communication with the different stakeholders, namely the Bank, Government, public bodies, the media and even the general public.

We shall first outline the structure and mode of operation of the national payment system before turning to questions concerning its governance and the regulation of access to the system on the part of payment service providers.

⁴⁹ The National Payment System Act 78 of 1998.

7.4.1 The payment system infrastructure and participation

Figure 1 Payment participants by category



The categorisation above gives an overview of the types of institutions and their roles in the South African low-value payment system.⁵⁰

End-users (businesses and individuals) obtain payments services from a range of possible suppliers. Key among them are the banks. Indeed, it is true to say that a bank account remains a key component to payments services. Even where a non-bank payments service provider such as a bureau is involved, the finalisation of a transaction currently still needs to be effected from a customer's bank account. In some cases, large corporations, such as utilities or insurance companies, act like payment service providers when they transmit into

⁵⁰ Our focus is on the low-value or retail system. For this reason, we have excluded discussion of the wholesale or systemically important Real Time Line stream, as well as the clearing system associated with securities and bonds. This is to ensure as much simplicity as possible, although when equities or bonds are traded, funds will have to be exchanged and final settlement reached through the same settlement system described here.

the payments system electronic fund transfer (EFT) instructions (such as debit orders) signed by their customers to pay for monthly service agreements.

As has been mentioned earlier, there are both clearing and non-clearing banks. Any transaction involving two different banks (i.e. where the payer and payee bank with different banks) requires a clearing bank to effect the transaction as non-clearing banks can only deal directly with transactions between their own clients.

The clearing banks may participate in some or all of the low-value payment streams, depending on their business models. In each case however, they are required to be part of a PCH. Under the auspices of the payment system management body, the Payments Association of South Africa (PASA), the PCHs set the rules for technical and operational participation. Separate PCHs exist for the common low-value payment instruments such as ATMs, credit card, debit card and cheque payment streams. Where clearing banks wish to be involved in credit and debit card payment instruments, they will be required to be members of at least one of the two international card associations, VISA or MasterCard International. Their membership will be predicated on meeting each association's requirements.

The PCH system operators are those institutions that are empowered by the PCHs to switch payment messages between banks (for example, to confirm availability of funds in the case of a debit card transaction) and to perform the processing associated with clearing. The most significant of the PCH system operators in low-value payments is Bankserv, although both MasterCard and VISA also perform this role for selected transactions for some banks. (A fuller description of Bankserv and its role is provided below.) In the case of ATMs, cheques, EFTs and most debit and credit cards, Bankserv will ensure that the net obligations of each clearing bank are relayed every night to SAMOS (the settlement system operated by the SARB). Once settlement is completed by SAMOS, this information is relayed back to the clearing banks, via Bankserv.

The low-value payment system is operationally managed by PASA, but the SARB has regulatory oversight of the whole system and has appointed PASA as payment system management body in terms of the NPS Act. In this sphere the relevant department of the SARB is the NPSD. At the same time, operating through its Bank Supervision Department (BSD), the SARB licences both clearing and non-clearing banks. On the basis of each clearing bank's liabilities, the liquidity requirement for their settlement accounts at the Reserve Bank is set. Hence both regulators have a crucial role to play in the payment system. More detail on legislation and regulation pertaining to the payment system is provided in Section 7.5.

SAMOS

The South African Multiple Options System (SAMOS) provides for immediate finality and irrevocability of settlement. Introduced in March 1998, SAMOS is owned and operated by the SARB.⁵¹ It is described as forming “the core of the South African payment system”.⁵²

The fundamental principles formulated to reduce systemic risk in the South African payment system which formed the basis of the 1995 *Blue Book*, included the following:

- Settlement will be subject to the availability of funds (explained below)
- A balance will be maintained between risk reduction and cost
- The Reserve Bank's response to a problem in the NPS will be in the interest of the system, not that of individual participants.

The *Blue Book* furthermore prescribes two strategies specifically aimed at reducing interbank settlement risk, namely the introduction of an online central bank settlement system so as to enable banks to transfer interbank funds electronically, and the implementation of risk-reduction measures in the Payment Clearing Houses (PCHs).

As, the Vision 2010 document of the SARB states:

This real-time gross interbank settlement system provides the banks with multiple settlement options, including liquidity-optimising functions. The SAMOS system caters for the settlement of individual high-value transactions, batched retail obligations, as well as financial-market obligations emanating from the bond and equity markets thus enabling delivery versus payment (DvP).⁵³

The quote references three aspects of the settlement system, two of which will concern us. The third relates to the settling of obligations emanating from the bond and equities market. In South Africa, this involves STRATE (for equities) and BESA (for bonds). Both of these transaction types clear through the Real Time Line system and shall not further concern us. The two SAMOS settlement systems we shall concentrate on here are: Real Time Gross Settlement (RTGS), referred to in the SAMOS system as the Real Time Line (RTL), and the deferred low-value settlement system. The RTL is a facility for settling single-settlement instructions immediately on a gross basis. Currently all credit transactions exceeding R5 million must be processed through SAMOS RTL. The low-value settlement system is a delayed (or deferred) settlement facility developed to settle low-value payment instructions

⁵¹ South African Reserve Bank, NPSD, (undated). *The National Payment System in South Africa, 1995 to 2005*, p 7.

⁵² *Id.*

⁵³ SARB, 2006, para 1.3.1. Delivery versus payment (delivery against payment, in other words) is defined by the BIS as a link between a securities transfer system and a funds transfer system that ensures that delivery occurs if, and only if, payment occurs. (BIS CPSS (2003) p 20.) Note that we will not focus on the settlement that is associated with the securities and bond markets, although it is acknowledged that they are settled through the Real Time Line of SAMOS.

on a gross basis. Typically settlement would occur between the various banks at the close of business each day, but some streams have more than one settlement run at specific times of the day.

The SAMOS system settles on a pre-funded basis. If a bank has insufficient funds available in its settlement account, the SAMOS system will automatically grant a loan to the bank against acceptable collateral. The amount of such a loan is limited to the collateral value of the collateral reserved for this purpose and is based on the statutory liquid asset reserve of 5 per cent of the bank's liabilities.⁵⁴

Bankserv

Bankserv is the largest PCH system operator in the South African payment and clearing system. It is involved with the processing and clearing of low-value payment instructions in the ATM, card, EFT (electronic fund transfer) and cheque streams and delivers the resulting instructions to SAMOS for settlement.

Prior to the establishment of Bankserv in the first half of 1993, the banking industry in South Africa jointly owned several companies that provided shared services to the banks in a number of different payment channels. The companies in this sector each followed their own direction and operated in their separate silos. An interbank task group was appointed to investigate the feasibility of a new operator and in March 1993, the banking industry reached agreement and founded Bankserv. Bankserv was the result of incorporating a number of entities: The Automated Clearing Bureau (ACB) which processed cheques and EFT; Bankscan, which was the paper credit-card clearing voucher service; JBCB, a credit bureau and Saswitch (Pty) Ltd, the ATM transaction system.

Bankserv provides interbank electronic transaction switching services to the banking sector. Essentially its role is to ensure that payment instructions (messages) are securely and rapidly switched between the various participants.

Bankserv is currently wholly owned by banks. Its current five shareholders comprise the big four banks (who own equally the majority share of 92.5 per cent) as well as a consortium of seven smaller banks in a entity known as Dandyshelf 3 (which holds the rest). The shareholders of the Dandyshelf 3 holding have changed from time to time. Currently they are: Bidvest Bank, Citigroup, Capitec Bank, Investec Bank, Mercantile Bank, South African Bank of Athens and Teba Bank. The Board of Bankserv has historically comprised two members each from the Big four banks as well as the other shareholder (Dandyshelf 3), and two executive directors appointed by the Board. However, in the light of various pressures

⁵⁴ This value is determined under the Banks Act, not the NPS Act. Typically the NPSD sees available collateral as those liquid assets which exceed 50 per cent of the statutory minimum.

this has recently been changed. Bankserv's memorandum and articles were amended by way of special resolutions passed by the members at a general meeting held on 23 January 2007.

The new board structure comprises one board member for each of the shareholders with a greater than 5 per cent interest, 5 independent non-executive directors and two executive directors.⁵⁵ The appointment of independent directors has not yet been completed. At the time of writing, there was only one independent board member, but it was expected that during the course of 2008, the full complement of five would be reached.⁵⁶

7.4.2 Low-value payment instruments and streams

The payment system represents an evolving set of payment streams or instruments that allows the settlement of obligations. While notes and coins are still widely used, other instruments such as cheques, debit and credit cards and EFTs now dominate proceedings. The differences between the payment instruments lie in the technology, the customer interface, the processes and risk involved, the pricing and who bears the cost.

Over time, there has been a migration of usage from cash to cheque to electronic instrument (which includes cards and EFTs). Electronic fund transfers may be credit or debit transfers. An example of a credit transfer is a salary payment, and an example of a debit transfer is a debit order.

As technology has evolved, debit and credit cards have become more ubiquitous. Payments made by telephone, cellular phone and internet are also increasingly used and are termed electronic payment instruments, with such instructions reflected in the EFT credit stream. The technological development of payment streams has led to the possibility of non-bank technology companies providing payment services, which has contributed to the debate for access to the payment system and the regulation of non-bank service providers.

⁵⁵ As set out in a presentation to the Panel dated 23 January 2007.

⁵⁶ Correspondence from Mr Pieter Cilliers, CEO of Bankserv, 13 February 2008.

Table 1 Payment instruments

Instrument	Description
Cash	Notes and coins
Cheque	A written order from one party (the drawer) to another (the drawee, normally a bank) requiring the drawee to pay a specified sum on demand to the drawer or to a third party specified by the drawer. Cheques may be used for settling debts and withdrawing money from banks.
EFT	Electronic funds transfers may be credit or debit transfers. EFT Credit is the mechanism by which payer-initiated payments are facilitated (known as credit-push transactions) wherein the payer instructs his or her bank to pay funds to another bank or beneficiary e.g. salary payments, stop orders and internet payments. EFT debit is a mechanism by which the payee draws down specific values, as specified by the payee on authority of the payer. These are debit-pull transactions, an example of which is a debit order.
Debit Card	Card enabling the holder to have his purchases directly charged to either a credit line (similar to a credit card) or funds on his account at a deposit-taking institution (may sometimes be combined with another function, eg that of a cash card or cheque guarantee card).
Credit Card	A card indicating that the holder has been granted a line of credit. It enables the holder to make purchases and/or withdraw cash up to a prearranged ceiling; the credit granted can be settled in full by the end of a specified period (in the case of a charge card) or can be settled in part, with the balance taken as extended credit. Interest is charged on the amount of any extended credit and the holder is sometimes charged an annual fee.

Source: FEASibility, 2006, Competition in Banking and the National Payment System

7.4.3 South African low-value payment instruments

The following discussion looks at the low-value payment instruments that individuals and households use, rather than large corporations. Hence cash, cheques, EFT and debit and credit card are discussed and the real-time high value SAMOS system, known as Real Time Line (RTL) used for high value transactions is ignored for now.

Cash payments

Since 1963 notes have been printed locally by the South African Bank Note Company (Pty) Ltd, a wholly owned subsidiary of the SARB. The sole right to mint, issue and destroy coins was transferred to the SARB by the Act No 49 of 1989. The South African Mint Company (Pty) Ltd became a wholly owned subsidiary of the SARB.

Five note denominations are being printed and nine coin denominations are being minted, namely:

Table 2 Notes and Coins

Notes	Coins
R10	5 cents
R20	10 cent, 20 cent
R50	50 cent
R100	R1
R200	R2
	R5

By December 2006, the value of notes and coin in circulation in the hands of the public amounted to approximately R49.95 billion. This amount constituted approximately 8.25 per cent of the M1 monetary category, which (over and above notes and coins) includes cheques and transmission deposits and other demand deposits. (SARB QB, December 2007). It made up only 3.7 per cent of M3, which consists of notes and coin in circulation plus cheque and transmission deposits plus other demand deposits plus other short and medium-term deposits plus long-term deposits.

Non-cash payments

Cheque payments

By the mid-1990s, the banked community in South Africa was primarily cheque oriented in payment behaviour. This is no longer the case. The volume of EFT payments (credit and debit) is now more than 6 times that of cheque transactions and the value of EFT transactions just more than double that of cheques (Bankserv, 2006).

South African cheques are MICR encoded which are read by high-speed Magnetic Ink Character Recognition (MICR) reader machines. Payments by cheque accounted for approximately 26 per cent by value and approximately 6 per cent by volume of cashless payments for the year ending October 2007. (These Bankserv figures exclude on-us transactions for some banks, which consist of cheques drawn on and deposited with the same bank.)

Cards

There has been a major growth in EFTPOS terminals, which provide a sophisticated network for electronic-card presentation to clearing banks. In excess of 90 per cent of credit-card payments previously done using paper slips, have been converted to POS payments. These networks are mainly owned by banks. Card-based payments can be effected by means of credit as well as debit cards. Withdrawals and deposits can also be made at automated teller machines (ATMs) of the major retail banks. When withdrawals are made and the

drawer transacts at a different bank from his/her own bank, these ATM transactions are switched through the Saswitch infrastructure of Bankserv.

Estimates show that there are approximately 29 million cards in circulation in South Africa of which 6 million are credit cards and the rest account-linked (debit or cheque) cards.

Credit cards. Credit cards which are affiliated to either VISA, MasterCard, Diners Club or American Express are issued with a pre-set credit limit. Real-time credit card *authorisations* (rather than settlement) are typically conducted via the Saswitch network operated by Bankserv.

Card-holders may choose to settle the total amount of the purchase with the bank before the expiration of an interest free period or pay off a portion (normally a minimum of 5 -10 per cent). Interest is paid on the whole amount from transaction date if it is not settled before the interest free period expires. A budget facility is also available on certain credit-card schemes with periods to pay off instalments normally ranging from 6-48 months. The interest charges on these credit-card facilities are normally higher than retail rates. The number of credit-card transactions processed through Saswitch amounted to 140 million for the year ending October 2007 which represents annual growth of 21 per cent on the previous year. The value of credit card transactions processed, which amounted to R86 billion over this period, is 22 per cent higher than the previous year.

Debit cards. Point of sale devices and ATMs distributed throughout South Africa are used extensively to effect numerous banking transactions via debit cards – for example, to pay for goods and services, to transfer funds and to withdraw cash. Debit card payments are typically authorised on-line. Debit card payments for fuel sales are being introduced via point-of-sale devices at petrol stations.

Debit card transactions increased exponentially over the past few years, and recorded a compound annual growth rate of 124 per cent in volumes and 139 per cent in values between 2002 and 2006. The value of debit card transactions amounted to R34 billion in the year ending October 2007 compared to R56 billion for ATM transactions. Growth rates in ATMs were however significantly lower at a compound annual growth rate of 7 per cent in volumes and 10 per cent in values between 2002 and 2006.⁵⁷

⁵⁷ Bankserv, Nov 2006 .

Electronic instruments

Direct debits and credit

Electronic funds transfer (EFT) in the form of direct debits is usually used for payments of a regular nature, for example, insurance deductions and hire-purchase payments. Direct credit transfers are used for a wide range of applications, from the transfer of low-value amounts for individuals, low-value payments and salary and pension payments. Banks, the government and large corporations normally utilise this form of payment.

The volume of EFT transactions processed through Bankserv amounted to 616 million for the year ending October 2007, which amounted to R4.022 billion in value.⁵⁸

7.4.4 Low- and high-value payments

In South Africa, the distinction between a low-value and high-value payment transaction is based on an item threshold or limit. In South Africa, the item limits for low-value payments typically follow the rule that credit transactions smaller than R5 million are low-value transactions. For values above this, transactions are deemed to be wholesale or high-value and are settled through the real time high value stream. Debit transactions (other than cheques) smaller than R500 000 are deemed to be low-value payment transactions. For cheques, values up to R5 million fall into the low-value category.

Once the value of a transaction exceeds the specified threshold, it can no longer be processed in the low-value streams and is designated a transaction for the Real Time Line stream of SAMOS. As mentioned above, such transactions are processed and settled instantaneously and hence do not form part of the deferred clearing and settlement process from Bankserv to SAMOS for the low-value streams.

⁵⁸ *Id.*

Table 3 Values settled in selected payment instruments

	August 2007		September 2003		January 2001	
Payment Systems	Values R Mil	% of Total	Values R Mil	% of Total	Values R Mil	% of Total ⁵⁹
Total Value Processed	5,951,327		3,591,359		4,074,221	
Real-Time Line (RTL)	5,434,635	91.32	3,290,163	90.90	1,960,491	54.17
Cheques (CLC)	133,909	2.25	115,353	3.19	274,641	7.59
EFT Credits	335,292	5.63	160,186	4.43	246,830	6.82
EFT Debits	41,268	0.69	16,534	0.46	n/a	
ZAPS System⁶⁰	6,130	0.10	5,917	0.16	28,721	0.79
Debit Card⁶¹	2,980	0.05	315	0.01	n/a	
SASWITCH (ATM)	4,927	0.08	2,889	0.08	2,210	0.06

Source : SARB's NPSD, unpublished data approved for use by Enquiry. Dates selected by NPSD.

The real-time settlement of these large transactions means that they do not accumulate for overnight settlement and hence reduce the likelihood of obligations exceeding values held in the banks' accounts at the central bank, during the overnight settlement process. Together with item limits or thresholds, the intra-day monitoring of liquidity usage and the introduction of same-day settlement and same-day square-off,⁶² the real-time nature of the process allows for settlement risk (and hence systemic risk) to be better managed, as liquidity crunches can be monitored and dealt with during the course of the day. It also significantly reduces any knock-on effect of risk in the low-value system.

In Table 3, the values settled through SAMOS are shown for selected months, prior to and subsequent to the implementation of item limits for low-value streams in 2002. The Real-Time Line stream represents high-value payments and all the rest are now, by definition, low-value payment streams. In 2001, the RTL stream accounted for only 54 per cent of the value settled through SAMOS. By 2007, it accounted for more than 91 per cent.⁶³ Hence

⁵⁹ Note that totals do not add up to a 100 per cent in 2001 as certain streams have been phased out, and there is no comparable data to be shown in subsequent years.

⁶⁰ SAMOS was preceded by the South African Payment System (ZAPS) which was used to effect large-value rand-denominated interbank transactions in the settlement accounts of banks at the Reserve Bank. ZAPS is being phased out although there are still some bank processes that feed into this system.

⁶¹ Note that until mid-2007, credit card values were settled through other streams.

⁶² SARB, 2006, p 3. Same-day square-off of SAMOS is the alignment of the opening and closing of the SAMOS settlement cycle date with the start/close of a calendar day.

⁶³ Values through the RTL include values through the equities and bond clearing systems, STRATE and BESA,

clearing and settlement in the low-value streams reflects less than 10 per cent of the value through the payment system on a daily basis. This underpins the significance of the high-value system for systemic risk, relative to the low-value system.

7.5 Regulation of South Africa's payment system

7.5.1 The NPSD, PASA and access

The National Payment System (NPS) Act 78 of 1998, as amended in 2004, 2005 and 2007, provides the legislative framework for the oversight of the payment system.

The NPSD – the operational department of the SARB for regulatory oversight of the payment system – is assisted in this role by a payment system management body (the Payments Association of South Africa, PASA).

In terms of the NPS Act a payment system management body has the object of organising, managing and regulating the participation of its members in the payment system.⁶⁴ It “will enable the Reserve Bank to adequately oversee the affairs of the payment system management body and its members and will assist the Reserve Bank in the discharge of the Reserve Bank’s responsibilities, specified in section 10 (1) (c) (i) of the South African Reserve Bank Act, regarding the monitoring, regulation and supervision, clearing and settlement systems.”⁶⁵

PASA is recognised by the SARB in terms of the NPS Act.⁶⁶ Section 3 (3) of the Act provides that the SARB itself may be a member of PASA, and restricts the further membership to:

- banks, mutual banks, co-operative banks and branches of foreign banks
- institutions or bodies “referred to in section 2 of the Banks Act, 1990, and in paragraph (dd) (i) of the definition of ‘the business of a bank’ in section 1 of that Act”, if the entity concerned “complies with the entrance and other applicable requirements laid down in the rules of the payment system management body” (i.e., of PASA itself).

The institutions or bodies referred to in section 2 of the Banks Act are those specially excluded from its provisions – among them being the Land Bank, the Development Bank of

respectively.

⁶⁴ Section 3 (1).

⁶⁵ Section 3 (2) (c).

⁶⁶ “The [Reserve] Bank recognised PASA as a payment system management body in June 1999 under the provisions of the NPS Act.” (*The National Payment System in South Africa, 1995 to 2005, supra*, p 9.)

Southern Africa, and (by Ministerial designation) the Postbank. Those referred to in paragraph (dd) (i) of the definition of ‘the business of a bank’ in section 1 of the Banks Act include (by Ministerial designation from time to time) Ithala Limited, the banking arm of what was formerly the Kwa-Zulu Finance and Investment Corporation. Its banking business is, by virtue of this designation, deemed not to be “the business of a bank” requiring regulation under the Banks Act.

Section 3 (3A) of the NPS Act allows the above-mentioned institutions or bodies to be granted “limited membership” (not defined) of PASA, subject to approved criteria. Non-banks generally do not have this facility notwithstanding that, as “system operators” authorised to provide payment services, they will be subject to PASA’s supervision and control.

Even the institutions or bodies such as Postbank and Ithala which may in principle become PASA members, may not engage in clearing or settlement. Section 3 (4) of the NPS Act stipulates that:⁶⁷

No person may participate in the Reserve Bank Settlement System unless –

- (a) such a person is the Reserve Bank, a bank, a mutual bank, a co-operative bank or a branch of a foreign institution and, in the case where a payment system management body has been recognised by the Reserve Bank as contemplated in subsection (1), such a person is a member of the payment system management body so recognised; or
- (b) such a person is a designated settlement system operator

Section 6 of the NPS Act prohibits persons from clearing payment instructions unless they are Reserve Bank settlement system participants (or unless they are a bank, mutual bank, co-operative bank or branch of a foreign bank specially authorised to do so). This excludes all non-banks, apart from designated settlement system operators. Of course, as we shall go on to show, Postbank’s access to clearing is an anomaly in this regard. Presumably, the pending change to the NPS Act (recently published as part of the Financial Services Laws Amendment Bill), which will allow the NPSD to designate a clearing settlement participant other than a bank, mutual bank, co-operative bank or branch of a foreign bank, will create a mechanism to deal with this anomalous situation.

In effect, as a general rule, and as PASA’s Mr Coetzee expressed it during the hearings, “only banks who are members of PASA may clear and settle”.⁶⁸ This follows from section 3 (4) of the NPS Act, which provides that (apart from designated settlement system operators) no person may participate in the Reserve Bank settlement system unless such person is a member of the payment system management body recognised by the Reserve Bank – i.e., PASA. PASA membership, in turn, is restricted as we have seen above.

⁶⁷ NPS Act Section 3 (4).

⁶⁸ Transcript 29 May 2007, p 24.

The regulation of the NPS can effectively be termed "self-regulatory", in that while the NPSD has oversight of payment activities, PASA, which is made up of clearing bank members, creates the rules for participation and operations (which are subject to approval by the NPSD). This will be a theme that will be examined in later sections of the chapter.

The objects of PASA as the payment system management body are to organise, manage and regulate, in relation to its members, all matters affecting payment instructions and

- (a) to provide a forum for the consideration of matters of policy and mutual interest concerning its members;
- (b) to act as a medium for communication by its members with the South African Government, the Reserve Bank, the Registrar of Banks, the Co-operative Bank Supervisors, the Registrar of Financial Institutions, any financial or other exchange, other public bodies, authorities and officials, the news media, the general public and other private associations and institutions; and
- (c) to deal with and promote any other matter of interest to its members and to foster co-operation between them.⁶⁹

In addition the payment system management body is empowered:

- (a) to admit members and to regulate, control and, with the approval of the Reserve Bank, terminate membership;
- (b) to constitute, establish or dissolve any body, committee or forum consisting of its members and which has an impact on, interacts with, has access to or makes use of payment, clearing or settlement systems or operations;
- (c) to –
 - (i) recommend for approval by the Reserve Bank, criteria subject to which any person is granted limited membership of the payment system management body or is to be authorised to act as a system operator or a PCH system operator within a payment system; and
 - (ii) authorise that person to act as a system operator or PCH system operator in accordance with those criteria; and
- (d) to recommend for approval by the Reserve Bank criteria subject to and in accordance with which a member that is also a Reserve Bank settlement system participant may be authorised to –
 - (i) allow a bank, mutual bank, co-operative bank or branch of a foreign institution that is not a Reserve Bank settlement system participant to clear; or
 - (ii) clear on behalf of a bank, a mutual bank, co-operative bank or a branch of a foreign institution that is not a Reserve Bank settlement system participant: Provided that the member shall settle payment obligations on behalf of such bank, mutual bank or branch of a foreign institution referred to in subparagraphs (i) and (ii).⁷⁰

We shall return to the matters under (d) below.

⁶⁹ NPS Act Section 4 (1)

⁷⁰ NPS Act Section 4 (2).

PASA's role and powers are also set out in its constitution, which shows that it is required to play both the role of advocate on behalf of the banks and regulator of the banks' activity within the payment system. In terms of its constitution, PASA (Clause 5.1) is required:

To sponsor, oppose, support, procure amendment of, or make representations in regard to any legislation, official regulations, directives or circulars as proposed or issued by the Reserve Bank, Registrar of Banks or the Department of Finance, or any other Department of the Central or Provincial Government, deemed capable of affecting members directly or indirectly.

The matter of a dual role was raised in the hearings, initially by Mrs Nyasulu (of the Panel) who expressed her discomfort with a body that has been set up by an Act of Parliament, that acts for a small group of members, and has such powers.⁷¹ The same issue was pursued by Mr Bodibe (of the Panel):

MR BODIBE: It seems to me the way your objects and powers are defined, you have a dual role, an advocacy lobby on the one hand, and an institution or organisation that has been delegated power of regulation and in a way, what makes you different then from the Banking Association and how do you mediate these roles? Specifically with these areas that Mrs Nyasulu has pointed out because by your constitution you are obliged to advocate and put forward the interests of your members and at the same time you have a duty to look at the interests of the system and that seems to me to be a conflation of roles.

MR COETZEE: I think ultimately that the objective of PASA is to ensure that there is an efficient National Payment System but the Act specifically provides for the regulation, organisation and management of its members, being banks. Now the Act restricted the members of the payment system ... [and it restricted] membership of the payment system management body, and PASA has to regulate and manage within that domain. I do not understand clearly what is meant with the conflict with the interests of the members, the interests of the NPS, because the two according to me go hand in hand. And also if you refer to the admission of a new participant, the rules are clear. ... [In] terms of this process the criteria ... [are] ... fair and objective and as we have stated in our submission, we have not had one rejection of any application in the past.

MRS NYASULU: The problem Mr Coetzee arrives...not...when things are going smoothly but when things become a problem. So in pursuance of that little article that I read, if there was ever an occasion where the banks felt threatened, in other words the entry of a particular participant was deemed capable of threatening the banks you would have a serious problem on your hands because your role is to then protect the interest of that to the point where you have to oppose as specified in your constitution. That is the conflict, it has not arisen and I am really happy for you, but it may just arise and the question is how then do you extricate yourself from a position where it does not threaten the NPS in whatever manner, but it threatens the members of PASA.

MR COETZEE: It might [be] perceive[d] to be a conflict of interest if I may put it that way, but that is why PASA and the Reserve Bank have introduced these clear processes, these objective criteria to ensure that there is no stumbling block and that if a competitor for instance comes in that competitor is assessed objectively and that it has the mechanisms if any such assessment is subjective and unfair to escalate to the Reserve Bank.

MR BODIBE: Sorry Chair..., 5.1 [of the PASA constitution] actually creates that scenario much more clearly, if you really say your role is to sponsor, oppose, support, procure amendment of or make representations in regard to any legislation, official regulations, directives or circulars proposed or issues by the Reserve Bank, Registrar of Banks or the Department of Finance or any other department of the Central or Provincial Government

⁷¹ Transcript 19 June 2007, pp 116-119.

deemed capable of affecting members directly or indirectly. I read that to mean, if national policy was to suggest ... [w]hat is deemed to be against the interest of your members, in that specific situation you would be called upon to act as an advocacy group and you are no longer acting as a body mandated with a role to manage and regulate their payment system. You are now acting more like the banking council and I think that specifically for me conflates the role of a [regulatory body] with the role of a body that has to advocate the interest of its members.

Of course, this is as it stands now and I do not think going forward the role of PASA should combine these two functions because otherwise it creates a conflict of interest because ... your constitution gives you obligation to represent the interest of your members at all times and you are answerable subsequently to your members and what happens in situations where you now have to oppose a position that may not necessarily be in the interest of your members but is maybe in the public interest?

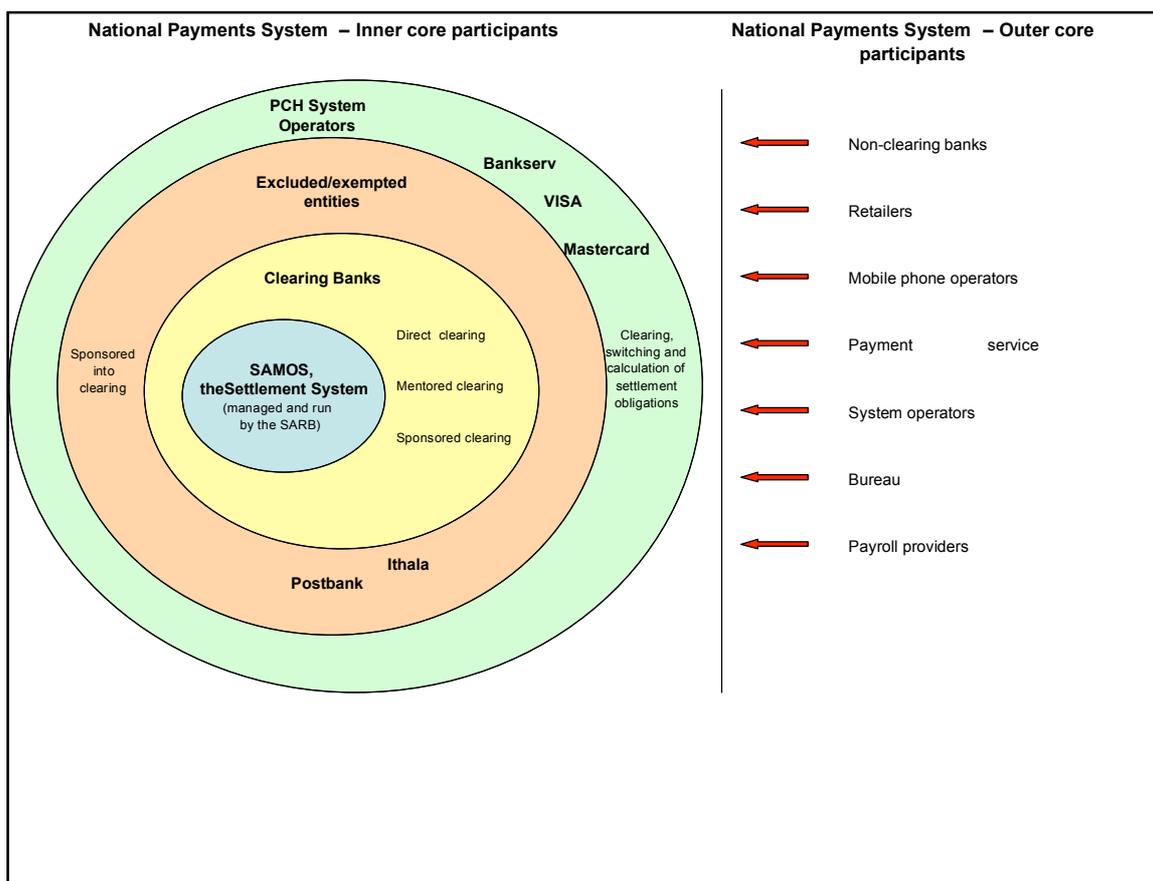
MR PIENAAR: Yes to be quite honest, I do not perceive that to be a problem because at the end of the day should PASA oppose a specific proposal that comes to Parliament or that comes from Parliament, certainly PASA cannot decide for Parliament so if Parliament would like to override PASA, they will. They will create an Act and we will have to play and our members will have to play in that particular Act from that perspective.⁷²

PASA's point, that the interests of the payment system are the interest of its members, appears to stem from the restriction of the inner core of the system to clearing banks and "designated settlement system operators".

The concept of the inner core and outer core was presented in a number of submissions to the Enquiry, and was frequently made with reference to a diagram, a variation of which is reproduced below:

⁷² Transcript 19 June 2007, p. 119 -120

Figure 2 Inner and outer core of National Payment System



Source: Variation on Banks' submissions

In Figure 2, the inner core is the clearing and settlement domain. The settlement system is managed and run by the Reserve Bank. The clearing banks operate in the clearing domain, with the technical support of the PCH system operators, of which Bankserv is the most important. In addition, there are excluded and exempted entities which operate in this domain. The entities in question are Ithala Limited and Postbank. These are not fully-fledged banks, although they are permitted to take deposits in terms of provisions excluding or exempting them from the application of the Banks Act.

This latter group represents an anomaly, from a number of perspectives. First, their existence in the left hand side of the diagram goes against the fundamental principle that only regulated entities can enter the clearing and settlement space. Second, it goes against the principle that entities that clear must do so in their own name. Third, there is no definition in the legislation or in directives that matches the way in which these entities have been accommodated in the system. These matters will be discussed in further detail below.

The participants of the outer core of Figure 2 are non-banks and non-clearing banks. The non-banks are typically part of the acquiring infrastructure for transactions (in the case of retailers or mobile phone operators or ATM providers) or outsourced providers to the banks

(such as bureaux, system operators) or payment services to corporates under the auspices of banks (such as payroll providers and payment service providers).

The participation of non-banks in this way means that it is frequently maintained that non-banks have “access” to the NPS – although there is little discussion as to whether it is the kind of access they seek.

MR VON ZEUNER: One of the important issues that we [ABSA] would like to stress is that the NPS is already accessible to many parties including non-banks. Non-banks already participate in many areas of the payment system, for example EFT and NAEDO.

There are a large number of non-bank bureaux ... who provide the infrastructure capability and are sponsored by a bank into the payment system. Currently there are seven active non-bank bureaux in the EFT environment although there are 31 registered parties with Bankserv. On the AEDO services, they are currently provided by Mercantile, Athens and Absa, but in all three cases the infrastructure is provided by a non-bank. NuPay is sponsored by Absa, Intecon is sponsored by Mercantile and MycoMax is sponsored by Athens. And on the card side there are many non-bank infrastructure providers including some of the large retailers and IT companies.⁷³

Of course, given that they are not permitted into the inner core, it could just as well be said that non-banks and non-clearing banks *are* denied access. The regulatory distinction between the treatment of inner and outer core participants (exceptions in the inner core notwithstanding) was emphasised by the banks in the transcripts. (The following two extracts are from Standard Bank and FNB respectively, with Mr Shunmugam appearing for Standard bank and Mr. Jordaan for FNB):

MR SHUNMUGAM: The inner core of the National Payment System is a highly regulated environment whose threads lie in its governance, compliance with the Bank of International Settlement principles, risk reduction measures and a high level corporation to maintain very high standards.

As you see on the right-hand side [of the inner and outer core diagram are] our current non-bank players who participate in or influence the National Payment System with no regulatory oversight in governance. I think if you look at the categories of non-banks that currently exist, they extend from retailers all the way through to money transfers systems including beneficiary service providers, bureaux that we alluded to earlier, system operators and mobile phone operators...

If you look at the current governance on regulatory oversight of banks... although intensive and costly are absolutely necessary to ensure a safe, sound and stable National Payment System.

If you look at banks on the inner core, they are closely monitored for capital adequacy, liquidity which is secured by cash reserves with the SARB, disaster recovery plans and all of these ensure that the confidence in the National Payment System is maintained and promoted...

Nevertheless the NPS is only as strong as its weakest link and the participation of non-banks in the National Payment System should introduce no more risk than banks do, and therefore non-banks must be subject to capital adequacy, liquid reserves, governance and regulation that is appropriate to the risk that they introduce.

⁷³ Transcript 25 May 2007, pp 66-67.

I think the lack of appropriate regulation oversight of non-bank activities such as introduction of payment transactions, deposit taking, multiple acquiring, sorting-at-source, float holding ..., introduces risk which needs to be regulated and overseen.⁷⁴

MR JORDAAN: The point is that there are risks in all of these systems but when it comes to clearing and settling, the core of our system, there are only 21 banks⁷⁵ that can clear and settle. And yet I say "only" at the same time that we believe that is a lot. They can also sponsor other players into that core or the heart of the system.

...Participation in these activities do[es] bring risk ... and we simply believe that with that risk we need to make sure that certain prerequisites are satisfied to maintain the safety and stability which is so important for an economy to function well.

It is so extremely convenient. If one had to start with a clean slate, what would these requirements be? Well they would be capital requirements that are commensurate with the risk ... introduce[d] ... sufficient funding or liquidity, interest in the good functioning of the system and technical competence. Now these are all features that apply to banks. We have very high capital requirements. We do have a culture of compliance believe you me, there is public trust, there is liquidity and we have a very big interest in the payment system functioning well. We have the technical competence and we have another point that applies particularly to banks and it is one we never want to use but there is the ability to have a lender of last resort which is the function the Reserve Bank traditionally plays for the banking system.⁷⁶

Both of these banks argued as if there is no real distinction between clearing and non-clearing banks, which we know to be incorrect. Absa also neglected that distinction:

MR VON ZEUNER: However, as is common across the globe, the National Payment System's Act only allows banks and other regulated entities to participate in the settlement system.⁷⁷

It would be more accurate to say that the NPS Act only allows clearing banks to participate in the clearing and settlement system. To think that such a restriction is common around the globe would be to ignore important developments in other parts of the world, such as Europe and Australia, which are outlined above. Moreover the implication that non-bank entities (apart from a designated settlement system operator) are today potentially able to participate in the settlement system in South Africa is simply not correct.

The point that non-bank entities should be allowed access to the inner core only if adequately regulated was a recurrent theme running through the hearings. This is key to the quality-of-access-principle that we would endorse: no entity should be allowed into the inner core (i.e. clearing and settlement) unless appropriately regulated. But once appropriately regulated, then non-bank access should be allowed.

⁷⁴ Transcript 29 May 2007, p 74.

⁷⁵ There are currently only 20 banks that are members of PASA, 14 South African banks and 6 branches of foreign banks (Source: PASA website List of PASA banks per PCH. Website accessed 15 February 2008).

⁷⁶ Transcript 28 May 2007, p 8 ff.

⁷⁷ Transcript 25 May 2007, p 67.

In recent months, there has been some slight movement on regulation of non-banks with the publication in 2007 of two directives by the NPSD for the conduct of system operators and payments to third persons.⁷⁸ However, this form of regulation is obviously not intended to allow such entities to enter the inner core of the NPS. This was not the objective of the directives, and could not be so in the light of section 6 of the NPS Act as it now stands. Instead, they were designed to address untoward conduct in the hitherto unregulated domain of the outer core. Whether they will achieve even this limited objective, remains to be seen. The matter is addressed further in section 7.6.

7.5.2 Clearing and non-clearing banks

In the SARB Position Paper on Bank Models in the National Payment System (2000),⁷⁹ registered banks (i.e. those supervised by the Registrar of Banks) are separated into clearing banks and non-clearing banks.

As a registered entity, a non-clearing bank is regulated by the Registrar of Banks, but is not a *settlement* system participant⁸⁰ as defined in the NPS Act. In terms of the NPSD Position paper on Bank Models in the National Payment System (01/2007), a non-clearing bank:

- (a) Is regulated by the Registrar of Banks.
- (b) Is not a settlement system participant as defined in the National Payment System Act, (Act No 78 of 1998, NPS Act) and may not:
 - i. Provide to its clients, any of the payment services defined hereunder in section 5, Payment services (see below).
 - ii. Clear domestic payment instructions to, or from, other banks as normal part of its business.
 - iii. Be a signatory to any payment clearing house (PCH) agreement.
 - iv. Operate a South African Multiple Option Settlement (SAMOS) account at the South African Reserve Bank (the Bank).
 - v. 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, 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.

⁷⁸ See also mooted change in the Financial Services Laws Amendment Bill (March 2008), which will allow the NPSD to designate clearing settlement participant

⁷⁹ Published by the National Payment System Department as Position Paper 02/2000, subsequently removed from the SARB website and replaced with certain changes and omissions as 01/2007 in June 2007, after the hearings on this subject.

⁸⁰ In the 01/2007 version of the paper, the word settlement was inserted.

Moreover, the NPSD position paper prohibits a non-clearing bank from giving clients of other banks the facility to withdraw cash at its own ATMs, for example. In the words of the NPSD, the “provision of payment services to clients is what most immediately distinguishes a clearing bank from a non-clearing bank.”⁸¹

A clearing bank:⁸²

- (a) Is regulated by the Registrar of Banks.
- (b) Is required to be a member of PASA in terms of the NPS Act.
- (c) Is a settlement system participant as defined in the NPS Act, and therefore has to:
 - i. Operate a SAMOS account at the Bank, unless operating by the arrangement with the Bank as a sponsored clearer.
 - ii. Be a member of one or more PCH participant groups (PCH PGs).
 - iii. Provide, to its clients, one or more of the payment services defined hereunder in section 5, Payment services, and recognised by the PCH PG of which it is a member.
 - iv. Clear domestic payment instructions to and/or from other banks as a normal part of its business.
 - v. Be a signatory to a clearing agreement and, consequently, be a member of a PCH and be subject to the entry and participation criteria of each applicable PCH.

The Position Paper defines payment services as those whereby a bank enables its clients to:

- (a) Make third-party payments by providing its clients with the means to issue payments to the clients of another bank or the other bank itself, through direct access to their (the bank's clients') bank accounts.
- (b) Receive payments directly into their (the bank's clients') accounts from clients of another bank or the other bank itself.
- (c) Withdraw cash at another bank.⁸³

Currently, there are 17 local banks registered in terms of the Banks Act. Of these, 14 are clearing banks. Moreover, 6 local branches of foreign banks are clearing banks. This makes 20 clearing banks that are members of the 17 payment streams (including STRATE and BESA). Clearing banks do not necessarily belong to all of these, although they all need to belong to the SAMOS Immediate or Real time clearing PCH.

The PASA Banking Models position paper 2001/01 was published subsequent to the NPSD paper of 2000, which sets out the rules for participating in clearing.

⁸¹ NPSD, 01/2007, Section 5, p 5.

⁸² As defined in the NPSD Position Paper 02/2000 and then subsequently in 01/2007.

⁸³ NPSD 01/2007 Section 5.1, p 5.

7.5.3 Sponsorship and mentorship of clearing banks

In the SARB Position Paper on Bank Models in the National Payment System (2000),⁸⁴ there are two categories of participation that apply to clearing banks that have been allowed membership of PASA, but are not yet considered as being “direct clearers” – these are mentorship and sponsorship.⁸⁵

As Dr Hawkins set out at the hearings:

Then we also have two categories, which we refer to as sponsorship and mentorship, which again have been set out within the statutory legislation ...mentorship is associated with an apprenticeship. Now this is where a bank wishes to participate in the existing PCH. Of course, it is a condition that is waived where a brand new PCH is established. But where we have an existing PCH, in other words we already have banks participating in clearing arrangements for a particular payment stream and a new entrant wishes to come in, typically mentorship would be required.⁸⁶

One commentator has suggested that we should see mentorship as an education route whereas sponsorship is a participation route. A mentored bank now participates in clearing within the PCH and so is responsible for the clearing of payment instructions with the other banks in that PCH or Payment Clearing House. It also participates in settlement having its own SAMOS account. However, it is subject to guidance and assistance from a more experienced participant...⁸⁷

In the view of NPSD, mentored clearing is:

... the model for an entrant bank into a particular PCH. The bank will participate as a direct clearer, but will have a contractual arrangement with another direct clearing bank for purposes of guidance and assistance when problems are experienced and or skills that are not available within the entrant bank are required.⁸⁸

In the case of a sponsored clearing bank, however, 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. The conclusion drawn by Dr Hawkins was:

And so when we talk of sponsoring and sponsored clearing, it is probably more correct to actually talk about sponsored settlement because this is the model where in effect, in terms of an agreement, the sponsored clearing bank's *settlement* obligation is fulfilled by a sponsoring bank.⁸⁹

⁸⁴ Published by the National Payment System Department as Position Paper 02/2000.

⁸⁵ The category of “Direct clearers” is confined to clearing banks which are not subject to mentorship or sponsorship, but is something of a misnomer inasmuch as, according to the NPSD position paper referred to above, both mentored and sponsored clearing banks also engage directly in clearing. Indeed, mentored clearing banks also engage directly in settlement.

⁸⁶ This waiver was part of the NPSD Position paper 02/2000, section 5.3, but was omitted in the Position paper of the same name of 01/2007.

⁸⁷ Transcript 25 May 2007 p 9.

⁸⁸ NPSD Position paper 02/2000, Section 5.2.

⁸⁹ Transcript 25 May 2007 p 9.

However, institutions like Ithala are both sponsored in both their clearing and settlement. The NPSD position paper 02/2000 evidently did not contemplate sponsorship or mentorship arrangements other than among clearing banks participating in PCHs.

The existing arrangements with clearing banks, as regards mentoring, are listed below.

Table 4 Mentorships in the system

Clearing Bank	Mentorship	Payment Stream Applicable
Absa	Capitec Bank	Credit cards (previously mentoring related to EFTs and debit cards)
FRB	[REDACTED]	[REDACTED]
FRB	[REDACTED]	[REDACTED]
Standard Bank	Bidvest Bank ⁹¹	ATM, debit card, credit card and EFT

Confidential:
FRB

Source: Banks' submissions, March and April 2007. Second submissions, Access and Interoperability.

Four clearing banks are mentored in the system at the moment. These are Bidvest Bank, Capitec Bank, Grindrod Bank and Investec Bank. Absa mentors Capitec Bank although this assistance is largely a hands-off approach with the exception of some day to day operations and staff training. Their role is therefore mostly in an advisory capacity.⁹²

[REDACTED]

Confidential:
FRB

Definitional difficulty arises in the case of sponsorships. While Bidvest Bank, which is a clearing bank, sponsored for the settlement of international card transactions by Standard Bank, other sponsored entities (such as Postbank and Ithala) have some kind of exceptional status, and are not in fact clearing banks. The details of this anomalous situation are further expanded below (see section 7.6.1).

7.5.4 Non-bank players and their arrangements with clearing banks

There are a number of non-banks which already participate in the payment system, without regulation. Two categories of these are notable – bureaux, or what the SARB refers to as third party payment service providers – and system operators which act as the back offices

⁹⁰ Grindrod Bank was formerly Marriott Bank.

⁹¹ Bidvest Bank was formerly Rennie's Bank.

⁹² Absa, March 2007, Second Submission, Access and Interoperability, p 5.

⁹³ FRB, March 2007, Second Submission, Access and Interoperability, p 4.

for smaller banks and for retailers. The SARB's 1995 Blue Book allowed for a broadly defined category of Customer Payment Service Providers (CPSPs), but never set the rules for their participation. The rules have been (modestly) set out in two new directives that are discussed in Section 7.6.

In this section we set out the existing arrangements which non-banks have with clearing banks. We begin by briefly considering the more general views that banks expressed at the hearings and what non-banks do in the system.

Except for the above directives non-banks are unregulated. This means that any other participation they have in the system is deemed to be carried by what is sometimes referred to as the "sponsoring" bank. This is an unfortunate term as it may carry connotations of sponsorship of clearing, and so on, which we would like to avoid. Also the "sponsoring" bank has a specific meaning in the EFT payment stream, and so where possible we will avoid this and refer instead to the clearing bank with which the non-bank has an arrangement.

Most of the banks alerted the Enquiry to concerns regarding the unregulated behaviour of non-banks. Mr Jordaan, for FNB:

MR JORDAAN: If I could just make an introductory remark and now I ...do not want to [be] at all ...disparaging about any other players in the economic activity but really if you look at the culture of compliance, I would think there is a vast difference between retailers and banks. I honestly believe that the way that we are set up, we really are creatures of compliance of 232 statutes with independent compliance officers.

I mean an interesting example, there was a Carte Blanche exposé of one specific retailer that operates in the credit space and it's a space where we long ... felt very, very uncomfortable operating just from an ethical point of view. You know types of rates that had been charged. We do think our capital that we have to hold is vastly different you know 10% of all the deposits for example. So I..., the first point I would make is technically that there is really, really is a big difference between the[m] ... whether somebody would trust their deposit with a retailer or with the bank...⁹⁴

Mr Shunmugan of Standard Bank compared the rigorous regulatory and compliance requirements facing banks with the lack of appropriate regulation and oversight of the activities of non-banks.⁹⁵

Mr Coaker and Mr Bloem of Mercantile Bank expressed similar concerns:

ADV PETERSEN (of the Panel): Now I am just looking at systemic risk in relation to participation in the National Payment System. On page 7 of your answers on access and interoperability, the next page, you say and I quote "Any increase in the number of participants," you are talking about the settlement system, "will by definition increase systemic risk". Now surely that answer is somewhat one sided, would you agree that sponsorship itself tends to aggregate and concentrate risk into and via the sponsoring bank?

⁹⁴ Transcript 28 May 2007, p 29.

⁹⁵ Transcript 29 May 2007, p 76.

MR COAKER: I think that ... I would agree with your statement.

ADV PETERSEN: Would you agree that direct participation by more smaller participants if properly supervised and regulated, could in fact serve to spread and thus reduce systemic risk?

MR COAKER: Again that is going to be a function of that regulation ...

CHAIRPERSON: Yes the difficult[y] I have with this statement by its very nature seems to suggest that there should not be any new entrants. Tell me if I am wrong, you know because if you say the introduction... of ... non-banks will introduce systemic risks, ... it might give an impression that we are saying nobody else should come into...

MR COAKER: Well, if that is the impression, I apologise but that is certainly not the intent.

MR BLOEM: Definitely not, does that answer your question sir?

MR COAKER: what my answer was trying to allude to was more around the regulatory side of monitoring new entrants needs to be fairly robust and possibly more robust than it is today.⁹⁶

Allowing non-banks into clearing is often equated with such entities “wanting to have access to the customer accounts”. This was a view that was propagated by FNB at the hearings:

MR TAYLOR: The issue of being the core is exactly the ability to reach into somebody’s bank account and to take money out of it and that is clearing and settling and that is the domain that is where the store of value is and the store of value implies that you are a deposit taking institution and part of that remit is why we have all of that governance around it.⁹⁷

In fact, it would seem more accurate to say that a non-bank transmitting a payment instruction merely introduces into the clearing and settlement process an 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 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. This concept was explored in the hearings:

MRS NYASULU: Now ... if we define clearing as the exchange of payment instructions, [a] simple analogy to me is Mr Jordaan and I share a mother and my mother has a packet of sweets which belongs to me so she is the deposit taker, she has got the packet of sweets. I have promised you sweets for whatever reason ... and you and I are able to exchange ... [an] instruction to her to release two sweets to you.

So my question is, why do you have to be a bank because you are not holding deposits and understand I am still just on the clearing, ... why do I have to be a bank to exchange that instruction that says someone else holds the deposits, the packet of sweets ...[we] are just exchanging the instruction to pay, to hand over the two sweets.⁹⁸

After setting the scene for the role of the deposit-taker, Mrs Nyasulu went on to explore the concept of the integrity of the instruction. (Mr Jordaan and Mr Pintusewitz appear here for FNB.)

⁹⁶ Transcript 28 May 2007, p 176.

⁹⁷ *Id.*, p 31.

⁹⁸ *Id.*, p 58 ff.

MRS NYASULU: [Y]ou are really touching on exactly what I want to come to. Is it ... really the integrity of the instruction ... that we have to concern ourselves about?

MR JORDAAN: Correct...

MRS NYASULU: Because [they are my sweets], you just happen to hold them. I can give them to whomsoever I want. Your [the bank's] responsibility as the holder of the packet of sweets is to check the integrity of that instruction.

MR JORDAAN: Yes.

MR PINTUSEWITZ: Can I just add that what gives us comfort is that the people who are accepting those instructions ... – whether we like them, do not like them, know them, do not know them – we know that they have gone through a certain set of hurdles through the SARB and other means to know that we should trust that what comes from has..., is trustworthy I guess. That they ultimately will settle an obligation there or a future obligation that may come from that transaction and that we can go back and have that settled on our behalf.

MRS NYASULU: Thank you.⁹⁹

Non-bank players – be they system operators, providers of ATM or POS devices, or bureaux or micro-lenders – do not appear to be interested in doing the main business of a bank. They do not want to take deposits.¹⁰⁰ Nevertheless, it seems clear from submissions that they can introduce risks of various sorts (relating to fraud, technical standards, disaster recovery and the like) into the system, if they are not adequately regulated. Indeed, this is the crux of the issue. Simply allowing more non-banks into the system is not enhancing the quality of the system. However, allowing more *appropriately regulated* non-banks in the system is likely to enhance the system.

We now turn to the existing activities of non-banks in the clearing and settlement system.

System operators provide technical and information technology services of various kinds to banks and other clients (retailers and non-bank financial intermediaries and other large corporates).

Included among the newly established Association of System Operators (ASO),¹⁰¹ are non-financial firms that facilitate the necessary back office solutions for banks so that they can transmit instructions to Bankserv, those that provide point of sale devices and the associated links for micro-lenders to make use of the Early Debit Order (EDO) payment streams, and those that own and deploy ATM machines¹⁰² around the countryside on behalf of banks. Simply put, they provide services to the banking industry and other clients. Technically, they access Bankserv directly. But they do so under the auspices of the clearing banks and are

⁹⁹ *Id.*

¹⁰⁰ However, they may be interested in doing the business of facilitating or switching clearing instructions – and hence compete with Bankserv.

¹⁰¹ Which came into being as a consequence of the System Operators Directive of the NPSD.

¹⁰² This includes Direct Transact, NuPay, and ATM Solutions, for example.

typically not distinguishable from the clearing banks in terms of the instructions they transmit or facilitate.

Bureaux typically enable their clients to submit payment instructions, such as payroll instructions or claims by clients for payment for services such as life insurance, into the payment system. In order to do so their participation is determined by the assignment of user codes by the bank with which they have an arrangement. Each transaction sent through to Bankserv needs a user code from the bank involved, as the bank is seen to carry the responsibility for any transactions introduced in its name. According to Nedbank and Standard Bank this process can take place in the following ways:

- **Bureaux can submit transactions on behalf of bank clients, also known as Technical Bureaux.** In this case the client has to obtain a user code from a clearing bank, which is used to submit transactions into Bankserv. The requirement of a user code from the bank provides an opportunity for the bank to assess possible risks and assign the appropriate value item limit for the client. None of the funds involved get transmitted directly into the bureau account at any stage. It is the responsibility of the bureau then to ensure that the client is always identifiable through the user codes. The bureau merely collects and collates electronic transactions on behalf of clients and submit[s] them to system operators, including Bankserv. The bureau's main function is to provide software and hardware for the client – in effect provide a back office or accounting function – which is enhanced by its ability to forward instructions to Bankserv.
- **Bureaux processing transactions as third-party participants.** Standard Bank coined the phrase “float bureaux”¹⁰³ to refer to such entities. In this case the bureau itself obtains a user code and credit limit from the clearing bank involved. The bureau signs up clients – typically 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.

The banks can themselves perform the functions of bureaux for clients. Banks also assign user codes to these clients, based on risk and necessary credit assessments, which are then used to process transactions at Bankserv.¹⁰⁴ In spite of being in competition with bureaux, banks acknowledge that the added value propositions of bureaux make their services valuable to some corporates.¹⁰⁵

¹⁰³ SBSA, April 2007, Second Submission, Access and Interoperability, p 28. A float bureau is defined as a bureau that collects and pays away for its corporate client from its own account (which has been pre-funded by the corporate client).

¹⁰⁴ Nedbank, March 2007, Second Submission, Access and Interoperability, p 30.

¹⁰⁵ FRB, March 2007, Second Submission, Access and interoperability, p 8. “Bureaux allow small users to aggregate their

The conditions of participation by bureaux are based on the assigned user codes, even though in certain cases the access is only granted based on the client/bureau's credit limit held at the sponsoring bank. In high risk cases, the banks may request that the client/bureau provides some collateral to mitigate the risks associated with their transactions. According to Nedbank, collateral up to a maximum of ten percent of the value of the transactions of the client/bureau may be requested – regardless of whether it is being processed through the bank or directly into Bankserv. Standard Bank states that the collateral and threshold limits are set on an individual basis for each client according to a credit vetting process and no maximum or minimum values apply.¹⁰⁶ High collateral requirements could obviously be used to restrict participation by bureaux.

Besides the fact that user codes facilitate risk management and govern the payment limits, these user codes also identify which services clients are designated to use and can help trace back any transactions to the sponsored users. In the case of third party processors or “float bureaux”, the risks and ultimate client profiles are typically unknown to the sponsoring bank even though it is liable for the risks. In the words of PASA:

The overarching principle is that “he who allows risk to enter the NPS must manage such risk”, which means the banker... introducing them into the NPS must be responsible for their conduct.¹⁰⁷

However, as was noted in the hearings by Absa's Mr Volker:

MR VOLKER: I think it is true to say that [while] most sponsoring banks ... take cognisance of the credit risks exposure, they are obviously ... driven by commercial interests as well and sometimes some of the criteria that might regulate this better coming from a directive would be missed out on by the normal sponsorship arrangements. So we think that [the Directive] will improve the health of that whole part of the payments value chain.¹⁰⁸

Standard Bank raised the following concerns/risks with regards to third party “float” bureaux:¹⁰⁹

- The float increases the potential for systemic and reputational risk
- Sorting at source and multiple acquiring may arise¹¹⁰
- Direct submission to NPS operators bypasses the banks even though the banks still carry the risks

transactions, benefitting from economies of scale, and often represent the most cost-effective method of processing EFTs for smaller users.”

¹⁰⁶ In a meeting with CIBA, the impression was gained that a 100 per cent collateral requirement from banks is commonplace.

¹⁰⁷ PASA, May 2007, Response to the Technical committee, p 2.

¹⁰⁸ Transcript 25 May 2007, p 151.

¹⁰⁹ SBSA, April 2007, Second Submission, Access and Interoperability, p 30-32.

¹¹⁰ This aspect is dealt with separately below.

- Bureaux are not subjected to any regulation, governance or compliance obligations in the NPS while banks are
- Payment aggregation reduces volumes
- Payment authentication through client user codes is essential to counteract fraud.

What is clear is that the “float” option – where the bureau has its own user code and uses its own account to pay or collect on behalf of a client – is not widely approved of by the banks.¹¹¹ Section 7 of NPS Act makes provision for third party payment providers to accept funds in order to make payments and in keeping with this the Directive for Third party payment providers does not prohibit such activities for bureaux. The EU Payment service directive is instructive here. It too allows for non-banks to hold payment accounts for their clients which are to be used exclusively for payment transactions. Very specific rules govern the activities of non-banks in terms of such payment accounts and how funds in such accounts are to be treated.

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 is held responsible for any fraudulent transactions and risk that may be associated with the transactions e.g. collection of debit orders. Particularly in the case of “float bureaux”, this raises concerns with regard to systemic risk and the governance of the transactions passed through the system.

In terms of Financial Action Task Force (FATF) recommendations,¹¹² the bank is required to do on-going due diligence on a customer’s account and some banks claim that this is not possible where float bureaux are concerned.¹¹³ However, it appears to the Enquiry that the matter of FATF requirements is a red herring as such requirements refer to the banks monitoring their clients, not the clients of their clients. Instead, what is called for is more appropriate regulation of the activities of bureaux.

¹¹¹ See for example, SBSA, April 2007, Second Submission, Access and interoperability pp 30-32 and Nedbank, March 2007. Second Submission, Access and interoperability, p 31.

¹¹² The Financial Action Task Force on Money Laundering (FATF) was established by the G-7 Summit held in Paris in 1989. South Africa is a member of the FATF. In 1990 the FATF issued a report containing Forty Recommendations providing a comprehensive plan of action to fight money-laundering. These were revised in 1996 and 2003. Among the customer due diligence measures expected of financial institutions is “ongoing due diligence on the business relationship [with the customer] and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution’s knowledge of the customer, their business and risk profile, including, where necessary, the source of funds.” (Recommendation 5) While other customer due diligence measures may be carried out for the financial institution by regulated or supervised third parties, this aspect must be performed by the financial institution itself. (Recommendation 9.) Details are accessible at <http://www.fatf-gafi.org>.

¹¹³ Nedbank, March 2007. Second Submission, Access and interoperability, p 31, makes the points that one cannot identify the clients of the bureaux. See also SBSA, 2007 Access and interoperability submission, p 35, where concerns related to introduction of fraudulent debits are raised as well as the fact that bureaux are not subject to FATF.

Standard Bank has indicated that they would not support the model of third-party processors submitting directly to Bankserv,¹¹⁴ and ABSA also appears to have concerns about this model,¹¹⁵ as it would mean that the bureau would be participating in its own right – without its obligations being underwritten by a bank. These submissions make the point that the regulatory framework for such activity is insufficient to ensure that non-bank participation introduces only acceptable risk.

If there is not an adequate system of oversight and supervision, the facilitation of entry by non-banks could lead to disruption of the system. Indeed, one could argue that the current directives notwithstanding, existing access could lead to disruption at any time.

7.5.5 Vision 2010 and regulation of non-banks

Non-banks provide a range of payment services to customers and banks, under the auspices of clearing banks. For the most part, they have remained without any explicit regulation or voice in the South African payment system.

However, the NPS Vision 2010 document, published in 2006,¹¹⁶ indicates that the NPSD is beginning to see an expanded role for itself in the supervision of non-banks.

Payment system participants

Participants in the payment system include registered banks in terms of South African legislation as well as non-bank participants. These non-bank participants include third-person service providers¹¹⁷ as well as system operators.¹¹⁸

¹¹⁴ SBSA, April 2007. Second Submission, Access and interoperability, p 35.

¹¹⁵ ABSA, March 2007. Second Submission, Access and interoperability, p 7.

¹¹⁶ On the same day that the Banking Enquiry was launched by the Competition Commission.

¹¹⁷ The reference here to “third-person service providers” is evidently a reference to non-banks authorised in terms of section 7 (c) of the NPS Act (as amended in 2004) to accept money or payment instructions from others for purposes of making payments on their behalf.

¹¹⁸ The reference to “system operators” is explained as follows in the document: “A system operator provides services to any two or more persons in respect of payment instructions.” The expression “system operator” is defined in section 1 of the NPS Act (as amended) as “a person ... authorised in terms of section 4 (2) (c) to provide services to any two or more persons in respect of payment instructions.” Section 4 (2) (c) provides for the establishment of criteria in terms of which “any person” (i.e. including a non-bank) may be admitted to “limited membership” of PASA (presumably in terms of section 3 (3A)) or be authorised to act as a system operator in providing payment services. In accordance with section 6A of the Act (as amended in 2005), the criteria for access to or participation in a payment system must be “fair, transparent and equitable”, and a criminal offence would be committed by any person who, having set criteria for access or participation, denies the same to anyone who meets the criteria. (The SARB itself is a juristic person in terms of section 2 of the South African Reserve Bank Act 90 of 1989, while PASA is constituted as a “legal entity”, distinct and separate from its members, with the capacity to conduct all administrative and judicial acts in its own name.” (PASA Constitution, clause 1.) By virtue of section 2 of the Interpretation Act 33 of 1957, read with section 1 of the NPS Act, PASA is a “person” for purposes of the latter Act.) Section 6 of the NPS Act, however, despite receiving legislative attention in 2004, continues to exclude non-bank payment service providers from clearing even if they qualify as system operators in terms of section 4 (2) (c). It should be observed that even the limited space for non-bank payment service providers created in principle by the amendments to the NPS Act in 2004 and 2005 have not been turned into reality. The PASA constitution submitted to the Enquiry in 2007 contains no provision for “limited membership”, and only allows new membership by members of PCHs. Non-banks, being excluded from clearing, cannot be members of a PCH.

Non-banks

Non-banks are allowed to issue payment instruments which are linked to a credit line whereby they provide credit to the public. Non-banks may also provide payment services to third persons.

Criteria exist for third-person payment providers and agency agreements are in place between these providers and their principals.

Development paths exist for non-banks to become clearing and settlement banks in the payment system, for example non-banks could become dedicated banks and could then be sponsored and/or mentored into the clearing and settlement system.

Non-bank institutions excluded or exempted from the relevant legislation (or criteria) do not qualify to hold settlement accounts with the [SARB]. Different tiers of banks within the payment system reduce the requirement for exclusion or exemption.¹¹⁹

The vision set out above is one of tiered banking where it is possible for a non-bank to become, for example, a dedicated bank, with lower capital requirements. The last sentence of the above quote suggests this would be a route to regularise the activities of Postbank and Ithala.

Whether or not the tiered banking approach will become a reality remains an open question. The Dedicated Banks Bill was published in 2004, and caused an initial flurry of excitement, but since then nothing has ensued. The Co-operative Banks Bill, was also first published in 2004 and then re-issued in 2006. It went through a process of public comment and amendment and was subsequently passed by parliament. It was signed by the President on 22 February 2008, as Act 40 of 2007. Co-operative banks are membership based banks and it is possible that the two mutual banks may become reclassified as co-operative banks. Other member-based organisations, such as credit unions, may join them. But these are very small institutions in South Africa and the take up of this third tier option is uncertain. Co-operative banks will not be supervised by the Registrar of Banks and the quality of their access to the payment system remains to be seen.

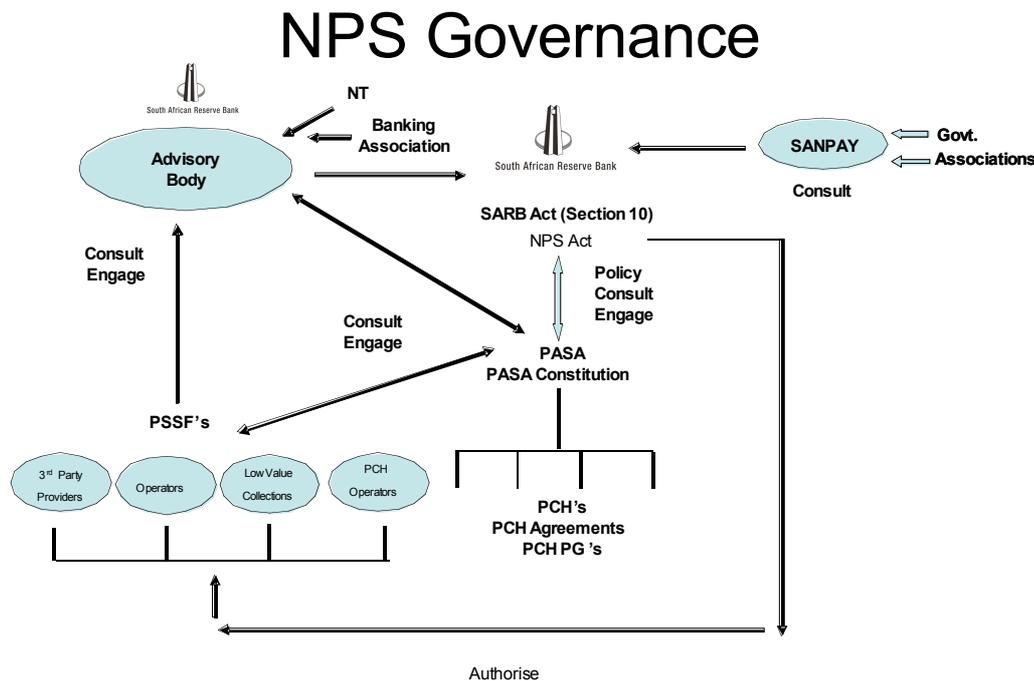
In the NPSD vision, the development route proposed involves a movement from non-bank to clearing bank. Non-banks may be permitted to be involved in the provision of certain payment services, but are to continue to be denied access to the clearing and settlement space. All that is mentioned is that the non-banks specially excluded or exempted from the Banks Act (such as Postbank and Ithala) will not be permitted settlement accounts.

As part of broadening access, where non-banks can issue payment instruments and provide payment services, NPSD have furnished us with a picture of the proposed NPS Governance structure.

¹¹⁹ Section 2.4 of the document.

Figure 3 Proposed NPS Governance Structures

Annexure D



Source: NPSD.

In the proposed scheme, NPSD (represented by the SARB logo) continues to provide oversight. The SARB will establish an Advisory Body whose membership will extend to the National Treasury and the Banking Association – as well as NPSD and representatives from a number of newly formed PSSFs (Payment System Stakeholder Forums).

PASA continues to be the sole payment system management body, engaging, consulting and creating policy together with the NPSD. The PSSFs, including one each for system operators and third party providers, are authorized by NPSD. The PSSFs consult and engage with PASA and the new Advisory body through their representatives. PASA will continue to set the rules for participation by the system operators and banks. SANPAY is an existing association body of retailers and others that meets on an ad hoc basis, whose comments will also feed into the NPSD. The proposed changes do not appear to provide a mechanism for direct participation by non-banks, nor do they provide a voice for non-banks in PASA. It seems that non-bank membership of PASA, as provided for in section 4 (2) (c) of the NPS Act, is not actually envisaged.

For the most part the banks have indicated support for an expanded role for the NPSD in terms of oversight of non-banks.

ABSA, for example, said it "believes that non-banks should be more rigorously regulated as they are currently not regulated despite de facto holding deposits for third parties".¹²⁰ It anticipated that SARB directives for the regulation of bureaux and payment system operators would address such risks.

Nedbank quoted the SARB Governor as saying that

... the bank will soon be issuing Directives in terms of the NPS Act which will regulate non-bank participants in the NPS for the first time. We have noticed that the number of non-bank participants has increased to the extent that the risk associated with their operations and the risk that they bring to the payment clearing and settlement environment requires some formalisation.¹²¹

It went on to say:

Nedbank welcomes the addition of these new parties into the structures of engagement with the NPS either as a new membership category at PASA, or as a new recognised Payment System [Management] Body (a status currently enjoyed by PASA).¹²²

It is clear that Nedbank anticipated that increased regulation of non-banks would come with a voice for them in the system rather different to that which is currently outlined or provided for by the NPSD. Indeed, in Nedbank's view, the critical success factors in applying regulation to non-banks and in defining the necessary structures of engagement between the parties include governance structures that are "neutral in respect of all the stakeholder groupings".¹²³ No such neutrality is apparent in the governance structures envisaged by the NPSD, in which PASA remains both the only payment system management body and one whose membership is confined exclusively to banks.

While deferring pointedly to the SARB, FNB acknowledged that effective competition "requires that the rules do not prejudice against or in favour of non-bank players".¹²⁴ Furthermore:

All banks and non-banks participating in similar activities must be bound by similar rules & sanctions and satisfy oversight requirements.¹²⁵

Saying that the transparency of PASA and its decision-making could be improved, Mr Jordaan added:

¹²⁰ ABSA, March 2007. Second Submission, Access and Interoperability, p 9.

¹²¹ Address of Mr T.T. Mboweni at the PASA 10th anniversary function, 15 November 2006.

¹²² Nedbank, March 2007. Second Submission, Access and Interoperability. p 36.

¹²³ *Id.*

¹²⁴ Exhibit SS, slide 7.

¹²⁵ *Id.*

We can see the benefit of more independent representation on PASA. And to our knowledge this is exactly what the SARB is already exploring, how one can have greater external stakeholder involvement.¹²⁶

He was evidently unaware that the “exploration” by the SARB has not taken the route of independent or non-bank representation in PASA.

Standard Bank, adhering firmly to the division of the payment system between an “inner core” responsible for the governance and regulation of the payments system, and an “outer core” of other role-players performing payment-related functions, placed all its emphasis on the need for a more direct regulatory oversight of non-bank participants.¹²⁷ It saw the need for changes to the NPS Act to ensure (inter alia) that “the scope of duties of the SARB is clearly defined to ensure that the SARB has oversight of all participants and activities of the NPS”.¹²⁸ Moreover:

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 payment service providers, 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.¹²⁹

While we endorse the view that the further development of regulatory oversight of non-banks in the payments system needs concerted attention – along with expanded access on their part – we do not agree that non-bank participants should continue to be excluded from membership of PASA as the payment system management body, and be allowed in future only an advisory or consultative role. This will tend to perpetuate the privilege enjoyed by banks in providing payment services even where these are not by nature peculiar to the business of banking, and so will tend to sustain the shelter that they enjoy from effective competition by other firms.

The SARB, dealing with oversight of the national payment system in its Vision 2010 document, notes that the stated objective of wider access to the payment system for participants (i.e., by providing for different categories of participation) “provides the basis for more competition”. However it goes on to say that “[t]he competitive environment for payment systems and their members is a matter for the Competition Commission.”¹³⁰ The implication is that competition is not a matter that should be of central concern to the regulators of the payment system. We beg to differ.

¹²⁶ Transcript 28 May 2007, pp 13-14.

¹²⁷ SBSA, April 2007. Second Submission, Access and Interoperability, p 46.

¹²⁸ *Id.*, pp 47-48.

¹²⁹ *Id.*

¹³⁰ Para 3.4.12.

We note in this regard that the role of the SARB in ensuring healthy competition between financial institutions, and a financial system in which services are supplied at competitive prices, was recognised by Mr Christo Wiese, then the Registrar of Banks in South Africa, in his article *Competition and stability in the banking sector*.¹³¹

Moreover, the modernisation and development of the payment system, emphasised by the Governor of the SARB, Mr T.T. Mboweni, in the speech quoted earlier in this chapter, depend crucially on competitive conditions being actively promoted by the regulators themselves.

In our view, the Competition Commission should take steps to ensure that the SARB fully appreciates how the existing structure of oversight and regulation of the payments system creates unnecessary obstacles to effective competition – obstacles which could be reduced significantly or overcome by considering instead the different approach to such regulation now being adopted in jurisdictions such as Australia and the European Union.

7.6 Matters of concern in the NPS

7.6.1 Sponsorship of non-clearing, non-banks

The definitions provided by the NPSD and PASA position papers (02/2000 - and 01/2007- and 01/2001 respectively) on sponsorship leave one in some confusion, as they do not capture all the relationships which have actually arisen and are currently allowed to exist in the clearing space. The *de facto* situation does not correspond to the stated *de jure* one.

The fluidity of the term sponsored banks is apparent in the 2007 PASA document submitted to the Enquiry,¹³² in which PASA states:

... the following tiers of operation have been established and are currently operative in the NPS:

Direct clearing banks – which are banks that clear and settle in their own name for longer as five years;

Mentored banks – which are banks that clear and settle in their own names for less than five years with another banks that act as their mentor only if so required by such mentored bank;

Sponsored banks – which are non-banks (such as the Postbank and Ithala) on which behalf PASA member banks clear and settle as indicated in section 4 (2) (d) (ii) of the NPS Act.¹³³

¹³¹ “The goals of the regulator are, firstly, to ensure a safe, sound and stable financial system; secondly, to enhance the confidence of and fairness to investors, by eliminating bad business practices and ensuring healthy competition between financial institutions; and thirdly to ensure an efficient and effective financial system, in which services are supplied at a competitive price and the majority of the population has access to the various financial services offered. ”

¹³² PASA, May 2007, Response to the Technical committee. Note There is some debate as to whether the quoted section in the NPS Act actually does make provision for non-banks asserted in this quotation, a matter that is highlighted further below.

It is confusing to find non-banks being included in the definition of “sponsored banks”. This position is furthermore in contradiction to the PASA Position Paper of 2001, which sees sponsored banks as a category of clearing banks that do their own clearing but are sponsored for purposes of settlement through SAMOS. That Position Paper is consistent with the NPSD Position Paper 02/2000. Neither has been updated, as far as we know.

The clearing banks provided information on their current sponsorship relationships, which are reflected in Table 5. The reality is that apart from Bidvest Bank, which is a clearing bank and is entitled to be sponsored in terms of the NPSD position paper, the sponsored entities all have some exceptional status.

Table 5 Sponsorships in the system

Clearing Bank	Sponsorship	Payment Stream Applicable
Absa	MEEG Bank	All payment streams (except immediate settlement)
Absa	Ithala Limited	Debit cards, ATMs and EFTs
Standard	[REDACTED]	[REDACTED]
Standard	[REDACTED]	[REDACTED]

Confidential:
SBSA

Source: South African banks' submissions on Access and Interoperability.

Postbank, for example, is excluded from the Banks Act, and hence is not regulated by the Registrar of Banks, which undermines the reliance placed on clearing banks being adequately capitalised and regulated. Ithala is exempt from the Banks Act and is not regulated by the Registrar of Banks. Nor is Ithala a member of PASA. Ithala's sponsor, Absa, accepts responsibility for its transactions toward the other participants (While the PASA website now lists Postbank and Ithala as non-banks sponsored into the system, this is somewhat absurd as they are excluded from membership and cannot participate in PCH meetings, etc.) The discussion in the transcript of 19 June 2007 below confirms this.

Absa also sponsors MEEG bank. MEEG is not a clearing bank, although being registered as a bank in terms of the Supervision of Financial institutions Rationalisation Act, no 32 of 1996, it is entitled to be. Given that it is in the process of becoming a fully-owned subsidiary of ABSA, MEEG's clearing is performed by ABSA¹³⁴ and Absa accepts responsibility for all of MEEG's transactions.

Both Ithala and MEEG use card BINs (Bank Identification Numbers) that are linked to Absa. This means that other participants cannot distinguish between Absa's, Ithala's or MEEG's

¹³³ PASA, May 2007, Response to the Technical committee, p 9.

¹³⁴ Bank Supervision Department, Annual Report 2006, p 68.

transactions. Furthermore MEEG makes use of Absa's IT infrastructure and payment systems.

While it could be argued that as exempted and excluded institutions, Ithala Limited and Postbank are in effect the same as banks – as they are permitted to take deposits from the public – they do not meet the NPSD's own stated framework for participation.¹³⁵ In effect, while associated with banking, they are not banks in the way we commonly understand. The exclusion or exemption from regulation is a matter of concern as it undermines the supervision that appears to provide some discipline to what is otherwise a largely self-regulatory approach.¹³⁶

That the arrangements with Postbank are anomalous is acknowledged by Mr Coaker of Mercantile:

MR COAKER: [Y]ou do have that current arrangement whereby the South African Postbank is sponsored by Standard Bank ... They [Postbank] connect directly to Bankserv under their own name and transact in their own name but Standard Bank is responsible for their settlement and Standard Bank is responsible for ensuring that any problems that occur with their transactions get sorted out ... [T]hey are not really a bank, they operate under that exclusion from the [Banks] Act, but nevertheless from a regulatory perspective Standard Bank is held responsible for their transactions.¹³⁷

In the same way, there was agreement from Absa that the sponsorship of Ithala was anomalous:

ADV PETERSEN: Let me preface what I say about it by saying that I have got no doubt that Ithala needs to have the access which it currently has via – would it be right to call it a sponsorship arrangement – with ABSA?

MR VOLKER: It is a sponsorship arrangement.

ADV PETERSEN: We must call it Ithala Limited and not Ithala Bank.

MR VOLKER: Yes.

ADV PETERSEN: Now it is clearly not a clearing bank, it is not entitled to be a participant in any payment clearing houses, am I right?

MR VOLKER: Yes.

ADV PETERSEN: Now the Bank Models directive from the Reserve Bank ... [that] was covered in Dr Hawkins's presentation, made it clear that sponsorship as it was conceived at that time, I think in 2000, was confined to arrangements between PCH participants. Now they would be directly clearing, but a sponsored participant would be sponsored for settlement purposes. In fact the notion of sponsorship for clearing purposes does not come up in that directive, am I right so far?

MR VOLKER: Yes.

¹³⁵ The forthcoming Financial Services Laws Amendment Bill does make allowance for the NPSD to designate a clearing system participant – such as the Postbank or Ithala – which would potentially regularise their participation.

¹³⁶ Membership of the Banking Association provides a similar goal – to ensure that banks have subscribed to the Banking Code of Conduct.

¹³⁷ Transcript 28 May 2007, pp 165-166.

ADV PETERSEN: So here we have an entity [with a] so-called exemption [under the Banks Act]. ... Ithala Limited was designated by the Minister of Finance, by Government Notice R511 of 17 April 2003, and the effect of that is to exempt it from the requirement to be registered as a bank, as I understand it.¹³⁸ Right, so it can take deposits and carry out the functions [of a bank] which it is doing, but what is the legislation or regulation which permits it access to the clearing space by sponsorship. What do you base that on?

MR VOLKER: I think once again ... the Postbank and Ithala are real anomalies and there is still tremendous ambiguity in terms of their position, which we have requested on a number of occasions to be finalised. The current reality in terms of Ithala is [that], because of the current status of the [NPS] Act and the regulations, they may not participate in the clearing system in their own right. As a consequence, Absa clears and settles on behalf of Ithala.

So they are not seen by the other banks. There is an arrangement between us and them in terms of a sponsorship, but in terms of the actual processing through the interbank space, they would see an Absa transaction and not an Ithala transaction.¹³⁹

Standard Bank's submission indicates some concern with sponsorship, even though it states that, "[i]n general, sponsorship arrangements are acceptable to SBSA as a means of facilitating entry into the banking sector".¹⁴⁰

[REDACTED]

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SBSA

138 In fact that designation expired on 31 December 2005. It was subsequently renewed until 31 December 2008 by Government Notice R57 (Government Gazette No. 28414, 27 January 2006).

139 Transcript 25 May 2007, p 144.

140 SBSA, April 2007. Second Submission, Access and Interoperability, p 24 (Section 8.6). Standard Bank is evidently referring here to sponsorship of clearing and/or settlement in respect of firms entitled either by registration or exemption/exclusion under the Banks Act to carry on the business of a bank.

141 Position Paper 1/2001, Banking Models within the NPS – Rules for Participation in Clearing at paragraph 4.3.12.

142 [REDACTED]

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SBSA

143

The concern regarding the volumes that originate from Postbank may be a difficult one for authorities to grapple with, as it could well be that there is no other bank with higher ATM volumes than SBSA. In terms of the current rules, this means that the Postbank can no longer be sponsored into the system. Hence its status must become regularised (i.e. it can no longer be an excluded entity, or the rules governing its sponsorship must be changed).

This volume and value matter aside, there is no doubt that sponsorship of an entity's entire acquiring, clearing and settlement function, may create potential problems for the sponsoring bank, and may increase settlement risk.

In addition, sponsorship may have certain disadvantages for the sponsored entity which has its volumes and values transparent to the sponsoring bank. It is perhaps because sponsorship is currently associated with entities that (apart from Bidvest Bank and MEEG) are not registered banks – and hence by virtue of their current status, cannot become clearing banks, that the sponsorship has come to mean a dependent rather than an enabling route for them. Hence those sponsored have no ambition (nor, as the legal position currently stands, do they have the right) to do the clearing and settlement activity themselves – they leave it up to the sponsoring bank.

The apparent misalignment between the *de jure* and *de facto* positions led to a line of questioning at the hearings that sought to establish if there was some statutory provision that had been missed by the Enquiry Panel and Technical Team. The discussion recorded below¹⁴⁴ indicates on the contrary that there is a legislative omission which has caused the NPSD and PASA to make discretionary adaptations.

MRS NYASULU: [O]ne of the things that is covered in section 3 of the NPS Act is PASA's ability to facilitate limited membership. But you yourselves express a certain frustration because you are unable to invoke that clause.¹⁴⁵

MR COETZEE: Yes.

MRS NYASULU: Could you just explain ... what stops you from being able to invoke that clause to allow limited membership?

MR COETZEE: ...Section 3 (3A) of [the NPS Act provides that] "the institutions or bodies referred to in subsection 3 (3) (b) that comply with the entrance criteria for limited membership as recommended by the payment system management body and approved by the Reserve Bank in terms of section 4 (2) (c) (i) may be granted limited membership." We have identified and we have made proposals in this regard to the Reserve Bank. We have also alluded to this

¹⁴³ SBSA, April 2007. Second Submission, Access and Interoperability, p 23 ff.

¹⁴⁴ Transcript 19 June 2007, p 107 ff.

¹⁴⁵ See PASA, May 2007, Response to Technical Committee (in particular para 5.5).

fact in our submission ... that if you look at Section 6, Section 6 does not make provision for or does not allow limited members to clear. In terms of Section 6 only banks, mutual banks and branches of foreign institutions may clear, but the limited member is not necessarily a bank, mutual bank or a branch of a foreign institution. So that is the technical problem ... with the Act.

MRS NYASULU: And do you as PASA see a discord in those two sections...

MR COETZEE: I think it was...

MRS NYASULU: ... or a misalignment, I should say?

MR COETZEE: It was yes..I think it was an oversight when we drafted the [NPS] Act and that is why, I think it was in 2005, a letter was addressed to the SARB indicating that we [PASA] are sitting with this problem and that we cannot allow limited members to be members of PASA. However we have allowed sponsored participation of Ithala and Postbank into the payment system under sponsorship arrangements. But they effectively clear, and while [they do] not settle, they clear and participate as each and every other member of PASA.

ADV PETERSEN: May I follow that up?

MRS NYASULU: Yes sure.

ADV PETERSEN: Can you..., in developing that practical arrangement which is clearly necessary...

MR COETZEE: Yes?

ADV PETERSEN: Can you find anywhere where that is permitted under the Act?

MR COETZEE: It does refer to in Section 3..., No, well the Act does not allow for membership but it does allow for sponsorship.

ADV PETERSEN: Well, does this kind of sponsorship feature in the existing position paper of the SARB on banking models?

MR COETZEE: No.

ADV PETERSEN: So it is something that has been improvised to meet a practical necessity?

MR COETZEE: Yes this was...

ADV PETERSEN: Caused by an oversight during the drafting of the amendment to the NPS Act?

MR PIENAAR: Yes I think it is actually coming from history because the ones that we allow to operate, the entities that we allow to operate on that basis actually [were] operating in the system ... before the creation of the NPS Act. So we actually had no choice where you cannot simply kick them out, based on a technical error that was made initially.

ADV PETERSEN: But that was an amendment that was enacted in 2004, that error.

MR PIENAAR: That is correct.

ADV PETERSEN: We are now in 2007. I would have thought it might have been corrected in the Act.

MR COETZEE: Mr Petersen, can I just add to that? I was actually aware of some provision in the Act referring to the situation and that is section 3 (3) which says besides the Reserve Bank the following may also be members of the payment system management body and in (b) it says an institution or body referred to in section 2 of the Bank's Act, ... and in terms of that provision we have allowed the Postbank and Ithala to participate under special provisions approved by the Reserve Bank as sponsored entities into the payment system.

ADV PETERSEN: But you will accept that in terms of the [NPS] Act they would be excluded from clearing, Section 6?

MR COETZEE: Yes.

ADV PETERSEN: And they cannot participate in the Reserve Bank settlement system in terms of Section 3 (4).

MR PIENAAR: That is correct.

ADV PETERSEN: So again, as I emphasise, I appreciate the practical necessity of this, it would be absurd otherwise, but what I am driving at is that there appears to be something that has had to be improvised using as it were “discretionary powers” which are not actually provided for in the law of the land.

The point here is not that the participation of Postbank and Ithala should be prohibited, but that their participation should be reflected in appropriate legislation and regulations. There appears to be a disquieting reliance placed on discretionary adaptation by the authorities:

ADV PETERSEN: I think I perceive ... so much in this area resting with the discretion of officials without clearly transparent delineated boundaries to that decision-making, and the fact that the omission in the amendment – anybody drafting an Act can make a mistake – that it has not been corrected since 2004, signals to me that there is an attitude here, that it is enough to have discretionary powers, rather than powers which are subject to the rule of law in the sense that we have come to understand that since the change in this country.¹⁴⁶

Moreover, the access that Postbank and Ithala have is an example of poor access, where the participation of these unregulated entities can be said to raise concerns and risks. By their own lights, this should be unacceptable to the NPSD and PASA. Either these entities need to be regulated as banks, or they need to be regulated for their payment service activities as non-banks.

7.6.2 Governance and self-regulation

Self-regulation emerged as a theme of concern in the hearings. The Enquiry is of the view that the concern is not with self-regulation *per se*, as self-regulation that meets the requirements of appropriate participation, transparency and the establishment of objective criteria can often be the most appropriate regulatory system for an industry or market segment. However, as the discussion reveals not all these criteria are met in the South African payment system.

PASA’s membership is made up of clearing banks, who draft and authorise the rules of participation of each of the PCHs, as well as the composition of the PASA Council, the mechanism and processes for entry, redress and so on. This led to comments about self-regulation, as well as lack of transparency and independence, at the hearings. (Mr Pelser was at the time the Chief Operating Officer and CEO of PASA):

ADV PETERSEN: ... I will ask you a question or two, if I may. I read this whole thing [the NPS Act] as a statutory framework for self-regulation. Would that be correct?

MR PELSER: I believe so, yes.

ADV PETERSEN: So when we come to rules, it is not the whole picture, but fundamentally these are self-generated rules?

MR PELSER: That would be correct, yes.

¹⁴⁶ *Id.*, pp 113-114.

ADV PETERSEN: So it is not really a situation where one can throw up one's hands helplessly and say, these are the rules? I am talking about the banks now, to the extent that they have been involved in generating them.

MR PELSER: You are talking about PCH rules?

ADV PETERSEN: PCH rules and PASA constitution and rules.

MR PELSER: Yes, that would be yes...

ADV PETERSEN: ... And indeed the definition of payment system has altered, so that it now reads very widely, "a system that enables payments to be effected or facilitates the circulation of money and includes any instruments and procedures that relate to the system". That is not intended to be anything other than a very wide net, am I right?

MR PELSER: In terms of the Act, yes.

ADV PETERSEN: Yes. So there will be, potentially at least, ... a number of participants who will be regulated under the system, but who may not be members of PASA.

MR PELSER: That would be correct ...¹⁴⁷

The concerns here are that PASA's self-regulatory remit extends beyond that of its members. Hence participation in the self-regulatory structure is of concern.

Moreover, the matter of transparency and confidentiality also arose. In the transcript below PASA is represented by Mr Coetzee and Ms Ntlha of Cliffe Dekker attorneys:

CHAIRPERSON (MR JALI): [W]hy did you seek confidentiality on the entire [PASA] constitution? I cannot come to terms with why any organisation will say its constitution is confidential, unless it was a secretive organization.

MR COETZEE: It is definitely not a secretive organisation. The constitution is available to any member bank. It is also available on our PASA intranet, so it was just from maybe legal assistance that we have received but as I said...

CHAIRPERSON: Are you saying this was legal advice to say the document is on the internet, it is freely available, yet it's confidential?

MS NTLHA: Mr Jali if I could assist there. I think the submission that Mr Coetzee is making is that the document is not available on the internet. It is available on the intranet, which is a closed system only available to the banks. As far as confidentiality is concerned, from PASA's perspective it would have required the consent of the member banks for them to make it available. On the basis of that it was claimed to be confidential as, at that time, no permission from the member banks had been sought and as I understand, we can take instructions as to whether PASA maintains the confidentiality.

CHAIRPERSON: We will give you opportunity to take those instructions because we really find it difficult ... to operate under these circumstances, when people claim confidentiality even on names of people sitting in committees. That is what is going on here. We get people saying the entire page is confidential and when you look at the page you find that it is just names of people sitting in a certain committee. But let us move on. And why is the PASA regulatory framework including the application form for membership of PASA confidential?

MR COETZEE: Mr Jali...

CHAIRPERSON: Because that is again..., confidentiality has been claimed with regard to that.

¹⁴⁷ Transcript 30 November 2006, pp 214 - 215.

MR COETZEE: Well I have been assisted by Mondo [Ntlha] in the sense that at the time of disclosing this to the Competition Commission, we did not obtain the necessary sign-off from our members and we felt that it might be necessary to do it this way.

CHAIRPERSON: Well your members have been appearing before the commission and all of them have been saying they want to cooperate, saying we will get PASA to come here, we will get documents, we will get PCH agreements to be given to you. Now we do not understand this. That is why we do not understand how we can ... [be] expected to function and to come up with recommendations which will suit the general public of South Africa, if this is happening.

MR COETZEE: Mr Jali yes, we take cognisance of that concern and as I indicated, we do not have a problem in removing confidentiality as far as the constitution and application form is concerned. ...[A]t present we ... have 20 full members and to consult with all members without knowing [what] impact it might have on each of those members because only a few ...of those members appeared in front of this commission. So in consultation with our members we would not have a problem to disclose.

CHAIRPERSON: Well, I know, I think Mrs Nyasulu has got some questions, a follow-up question to these so I will let her ask but I am a bit surprised. ... [T]his [Enquiry] was announced as early as August last year, we are now in May, [and] it has not been possible to round up all the members to get permission? But anyway, I will leave it at that.

MRS NYASULU: Mr Coetzee and your team, thank you very much. Can I just say, you know as a direct follow-up to the questions that the Chairman has asked, that it has come up as a regular feature of the governance structure of PASA that to a large extent the tail wags the dog and I think if I could just really ask PASA to look at how ... it is structured ... that its members are able to tell it what it can and cannot do. It should be the other way round, so if you could in looking at all of these things that we have been asking, have a look at whether the governance structure of PASA and how you relate to your members, is really a healthy relationship? They have a lot more power than members should of a particular system, particularly of a regulatory nature such as yours.¹⁴⁸

The power of PASA members – i.e. the existing clearing banks – to control access for new clearing banks arose in this context. As it stands, participation in any PCH, such as ATM or card, requires written permission from each incumbent – to say that the would-be entrant has met the necessary technical requirements. While in principle objections to providing such letters can only be on the basis of possible risks introduced, there may be frustrating months of delay before an incumbent produces such a letter, after having tested the interoperability of the new entrant's systems.

One of the smaller clearing banks, Mercantile, represented by Mr Coaker, saw it this way:

MR BODIBE: My final question on pages 3 to 6 of your submission, you usefully ...showed us steps that will take a new bank to the requirements to be a full participant in the NPS. Can you clarify how long it will take for a new bank to be a full participant bank in the NPS having set out those steps?

MR COAKER: It is very difficult for us to comment on that in real terms because we did not have to go through the process having been involved at the banking side of things for many years but we have observed some of the other smaller entrants coming into the market in some of the payment streams and I think it is a function of how many payment streams the smaller player would like to play and then generally what you would find is that they would obviously have to get the Reserve Bank and in terms of participating in the payment streams

¹⁴⁸ Transcript 29 May 2007, pp 13-17.

in terms of setting up settlement accounts and all the rest of that. Once that has been done the PASA membership process would have to be engaged in and part of that PASA membership process would be the engagement with whichever particular stream they wanted to participate in.

So if for instance they are going to enter ... into the ATM stream, there is a prescribed process and that can take as long as the slowest player in terms of signing ... off ... letters of authorisation So to put an actual timeframe on it, I think we are the wrong people to answer that. I think you should possibly direct the question to say Capitec or a Rennie's Bank who are relatively new players who probably have been through that process and also possibly TEBA Bank.

MR BODIBE: Are you confirming or are you making a statement that the current PASA rules allow the slowest mover to determine the pace?

MR COAKER: Well not to a 100 per cent extent. I mean obviously if there is a recalcitrant bank, there are ways and means of PASA getting them to sign off because generally you would find it's not because they did not sign off, it gets lost on somebody's desk and that sort of things.¹⁴⁹

In the Technical Team presentation at the start of the hearings on the subject, it was suggested that a model like the LINK ATM network in the UK was an improved model for entry. In the case of LINK, objective criteria for entry are set, and the executive director grants access on the basis of these criteria. (Mr Coetzee and Mr Pienaar represent PASA in this extract from the transcript):

MRS NYASULU: In other words ... the rules say that that new participant would need to get written permission from each and every one of the banks. I am not sure if you were here yesterday but I gave the ... analogy of a polygamous marriage where it is ridiculous to have the two wives who are already in the marriage regulating if a third wife should come in, because they have a vested interest in saying "There are enough of us in this family".

So I am asking whether you anticipate in South Africa that a system where an executive director or in this case someone within PASA is the one that makes a ruling on whether the new or would-be entrant in the ATM PCH or whatever PCH meets all the requirements so that they do not have to ask the wives who are already in the marriage ...

MR COETZEE: Yes there is a requirement that the new entrant must negotiate with each of the participants in a PCH and what we referred to is a letter of confirmation by [each] other participant to allow the new participant in the PCH. Now there was a specific reason for that requirement and the requirement is based on the fact that each other bank will have to make a risk assessment of the new participant and also to expose the new participant to the other banks and to enable them to commence discussion on bilateral pricing. However, do I perceive whether such a decision will [should] vest in the managing or executive director in PASA? It is possible, it could be, but I do not believe the function performed by obtaining letters of confirmation will be achieved by one person sitting in PASA.¹⁵⁰

MR PIENAAR: ...In a sense we may be erring on the conservative side by allowing the people to discuss with that particular bank its position, to understand its position, but in the end finally the decision lies with the Reserve Bank should there be a decline [refusal] on the side of one of the banks. So it is just a question of allowing the banks to go about their business as normal without interference by the Regulator unnecessarily and that is why the term that has been chosen to regulate the National Payment System is also oversight and not regulation. It is in other words, to my mind at least, a lighter sense of regulation than having

149 Transcript 28 May 2007, p 152.

150 Transcript 19 June 2007, p 90.

the Regulator always take the decision from that perspective but rather have the people that is in play, in the system make the decision.

MRS NYASULU: In other words [is] self-regulation ... the term that applies in this case?

MR PIENAAR: It can never be seen as total self regulation it is rather allowance within rules and positions set out by the Regulator ... if they go outside of that then obviously the Regulator will come in. So it is not totally self-regulation, no.¹⁵¹

The notion that the payments system is self-regulated was contested by some of the banks. For example, in their presentation, Mr Jordaan of FNB stated that:

MR JORDAAN: ...The type of regulation that we have in South Africa has been called self-regulation although we believe that to be erroneous. In fact if you broadly distinguish between types of regulation, one gets self-regulation [and] delegated regulation where regulation is formally delegated.

You get the regulation where the regulator will consult with the players in the market or you get regulation where somebody clearly just makes the regulation. We think we fit into the second category because ... it is not self regulation, it is delegated by the South African Reserve Bank in terms of the National Payment Act.¹⁵²

However, it is clear that as it stands, the framework is one of self-regulation, and the banks have been involved from the beginning (see Governor's speech quoted above in Section 7.4, "The NPS project, which was initiated by the Bank in April 1994, was launched as a collaborative effort between the Bank and the banking industry...").

The process of approval of new entry was further explored with Mr Coetzee of PASA:

ADV PETERSEN: Is it true that a would-be new entrant either in coming to PASA or in going to the existing participant banks would be expected to disclose their business plans?

MR COETZEE: No, in the previous presentation I have alluded to this fact. The only business plan that may be disclosed is that if a bank wishes to participate in the EFT environment, it must state its estimated volumes and values, state that I have clients, I have existing client base, this is my estimated values and volumes and I will participate...client names, client details and so on, are not disclosed.

ADV PETERSEN: And does that disclosure take place to PASA, to the participant banks or to whom?

MR COETZEE: In the PCH application form the prospective applicant is required to provide per PCH, for instance if it is an EFT PCH application, it will state on that application form that I am going to participate in this PCH. The PCH system operator is Bankserv, I will have the following estimated volumes and values in this PCH. It addresses issues of DRP, BCP, confirmation that it will sign the PCH agreement, the settlement agreement et cetera. So we do not request them to provide their business model, their details of their clients.

ADV PETERSEN: And then finally before relinquishing this, are you aware of any other country where access to the payment system is regulated in a manner which includes the requirement of consent from each of the existing participants?

MR COETZEE: I will ask Mr Pienaar to address this question.

151 Transcript 19 June 2007, p 94.

152 Transcript 28 May 2007, p 12.

MR PIENAAR: I think we are not that au fait with all the systems in all the other countries but if you think about the Australian model where the banks [have] direct links with each other, it actually comes to that point because if the one does not want to trade with the other one, he would not trade with him. So it is exactly the same. The only difference is that we managed it through a central switch which is very [much] more efficient. It has actually been confirmed to us by the Australians that they deem it to be much more efficient than the direct link scenario they have got.¹⁵³

The Australian regulators have confirmed with the Technical Team that direct connections between banks are the order of the day in that country. In fact they referred several times to a “spaghetti network” being in existence. However, they also pointed out that in some cases this disguises universal access. For example, in the case of ATMs, there are 6 networks in Australia, but any participant, bank or non-bank that participates is in effect a member of them all. In terms of new participants gaining access, the Australian regulator has set an Access code which sets explicit criteria for technical requirements, including the costs and timing associated with participation, so it is difficult for an incumbent to block the entry of a new participant.

In the view of the Panel, the approach adopted by the UK LINK Network would benefit the entry of new participants into existing PCHs. We recommend that such an approach is adopted by PASA.

7.6.3 Ownership and control of infrastructure

There are two key infrastructures of the South African clearing and settlement system as they now stand: SAMOS and Bankserv.

The first is owned by the SARB and the latter by the banks. As has been mentioned earlier, the operational role by the central bank in terms of the provision of the SAMOS infrastructure and the services associated with it is globally common, especially as regards settlement infrastructure. There were no submissions which suggested this was anything but a functional system. The public ownership of SAMOS shall not concern us further here.

Bankserv, on the other hand represents the crucial clearing infrastructure of the SA payments system, as apart from a few exceptions in card payments, the payment instructions from all the payment streams will be accumulated and used to calculate the obligation of each clearing bank vis-à-vis every other clearing bank and submitted to the deferred settlement system each day.

Mr Cilliers of Bankserv set out their activities at the hearings:

¹⁵³ Transcript 19 June 2007, p 105.

MR CILLIERS: Mr Chairman ... we would just like to present Bankserv in two ways this morning. First it is a brief overview of our place in the NPS system and then secondly just a couple of our value propositions and core competencies and core reasons we exist. So we will go through the slides in that order.

Firstly ... we are 35 years old. You well know Bankserv is quite a small company. Just a point on the volumes, we process about two billion transactions a year of which about 1.2 billion is NPS transactions, clearing and settlement transactions ... Mr Jordaan's presentation talked about value of 46 trillion Rand [going through the system each year], we process about 6 trillion Rand a year so it gives you a perspective, our values are a lot lower than our volumes. We have a low value payment process.

High values do not flow through us; they flow directly to the SARB, through the SAMOS system. We have about 45 customers, being the banks and the rest some corporate and other bureaus and customers...¹⁵⁴

The importance of Bankserv, compared to the other PCH System operators, MasterCard and VISA was also emphasised:

MR BODIBE: What is the share of Bankserv relative to other switch[es] like Visa and MasterCard?

MR CILLIERS: I have no idea really but I can make an estimate ... I would estimate we have probably 90% plus of the volumes in our domain which [are] low value transactions, domestic transactions. International transactions we have a 0% share, but domestic transactions I believe we have by far the majority ... [but] not on-us transactions I should add.¹⁵⁵

The change of ownership of Bankserv was explored at the hearings. Ownership was linked to the usage of Bankserv's services and loyalty to it. The spectre was raised that changing ownership could have unforeseen consequences in that banks would be more inclined to shift their volumes to other operators, such as VISA and MasterCard. Should one of the big banks do so, this could seriously undermine the volumes of Bankserv.

The practicality of such a move was explored at the hearings with ABSA's Mr Volker:

ADV PETERSEN: Now to get back to my thread connected with Bankserv, you have raised today and you raised it with respect on a previous occasion that the major banks could find alternatives for themselves to Bankserv if they were not satisfied ... [with] the way Bankserv was going about its business and one of the things you have raised today is that if the major banks, if I understood you correctly, were not happy about non-bank acquirers being allowed to deliver directly into Bankserv, to use my rather crude expression, you could turn your backs on Bankserv and make other arrangements.

MR VOLKER: Yes.

ADV PETERSEN: Is that practically correct?

MR VOLKER: Yes I think it is.¹⁵⁶

The shareholder interests clearly influence the future business strategy of Bankserv. In this regard two alternative futures for Bankserv were explored. The first was presented as its

¹⁵⁴ Transcript 28 May 2007, p 78. We will refer to Bankserv's non-bank customers further below.

¹⁵⁵ Transcript, 28 May 2007, p 88.

¹⁵⁶ Transcript 25 May 2007, p 82.

continued pursuance of “commercialisation”, ie finding other IT business, apart from the clearing service to banks. The second was the alternative of treating Bankserv as a public utility. The latter would mean that clearing banks would be compelled to use the Bankserv infrastructure for low-value payments, which would ensure the retention of volumes through the switch. The suggestion of a move to a national utility was made by Standard Bank in their written submission and repeated by their representative, Mr Shunmugan, at the hearings:

MR SHUNMUGAM: Bankserv was created by the banks for the banks to achieve greater efficiencies and switching and to maintain the safety and soundness of the clearing and settlement system. The move ... of Bankserv [to] becoming a commercial vehicle undermines this and therefore Standard Bank believes that Bankserv should be managed as a national utility on a self-funding non-profit basis.

I think some of the unintended consequences of the commercialisation of Bankserv, may lead to increased cost ... [to] the consumer, cause Bankserv to take its eye off its core function within the NPS of clearing and settlement, thereby jeopardising integrity of the NPS and could ...and may drive behaviour that potentially introduces more risk into the system.

Bankserv is a near monopoly in relation to the provision of domestic clearing switching services. Clearly the alternatives for the banks include direct clearing or switching off shore. However this comes at incurring massive risk in cost. So the banks in South Africa have no viable alternatives to Bankserv in the short to medium term especially in EFT as you have heard from the CEO's presentation yesterday that it covers more than 50 per cent of Bankserv's volumes.¹⁵⁷

The idea of becoming a national utility was tested the day before with the CEO of Bankserv, Mr Cilliers:

ADV PETERSEN: Now it has been raised and I think we may hear this more directly in the course of these hearings that the commercialisation of Bankserv was a bad idea and for policy reasons it should rather be reconsidered and approached as a public utility. Do you have a particular point of view or comment that you would care to make in relation to that idea?

MR CILLIERS: Yes Advocate I certainly have an opinion. I do not believe that going the utility route would be the correct route for a number of reasons. The first thing is it is not ... what is happening internationally. The biggest dynamic going on at the moment in the payment world is the SEPA movement in Europe (the Single European Payments Area).

And what is happening there is more commercialisation of companies like ours and not less through various ways, acquisitions, consolidation of the space and then diversification of their services. In many cases they are moving to exactly the model that we do have in South Africa. They are combining [switches] in the UK for example.

They are combining the EFT space with the LINK, with the card switching space to become more viable internationally speaking. ... So I think the international example is more commercialisation not less. Domestically speaking, I think the risk of being a utility in this space [can be described]... as two big elements to me that go hand in hand.

The one is you are taking choice away from the players in the market, from the participants. ... I mean to make us survive in that mechanism you have to build in regulations to say they have to use our services otherwise we will not be viable. That seems unnatural in this day and age. Secondly the very real risk of a utility so protected to become un-innovative ... it has been there for years in Bankserv's case and we have been over the last five years trying

¹⁵⁷ Transcript 29 May 2007, p 80-81.

to move to be more innovative and more dynamic and ... offer more options to the world rather than less...

At the moment we are surviving because we are more cost effective than international switches and we provide the same levels of service so we have a right of existence.¹⁵⁸

The banking industry appears to have taken the view that rather than tamper with Bankserv ownership at this stage, it would be more acceptable to adopt the formation of an independent board. As has been mentioned above, until very recently, the structure of Bankserv's board mimicked the shareholder structure. In the last year, there has been an attempt to improve the independence of the board with the appointment of five non-bank members to the board.

Bankserv's board structure is modified from:

- 10 non-executive directors: the Big 4 and Dandyshef, appointed by shareholders (2 each)
- 2 executive directors appointed by the Board.

To the following:

- 1 board member where shareholding exceeds 5 per cent
- 5 independent non-executive directors
- 2 executive directors.

In the new structure, there will be as many independent non-executive directors as there would be board members representing shareholders' interests. To date, enactment of this new structure has not been successful, with only one independent being appointed.

The responses of the banks to the restructuring are listed below:¹⁵⁹

Absa

The restructuring of the Bankserv Board was welcomed as it embraces good standards of corporate governance. This means that decisions on pricing and access are made by an executive independent board. It should be noted that representatives of various banks on the board of directors of Bankserv have always had an obligation to act in its best interests – by increasing throughput.

¹⁵⁸ Transcript 28 May 2007, pp 117-118.

¹⁵⁹ Banks' Submissions, March and April 2007, Access and Interoperability, question 3.

FNB

FNB supports Bankserv's efforts to improve its corporate governance structure in line with global trends. The changes made by Bankserv will allow for decision making and participation by independent non-executive directors on the board which should increase transparency and accountability.

Nedbank

To qualify as an independent board member of Bankserv, a candidate must have:

No direct, indirect or implied relationship between shareholders and board members.

No relationship with any shareholder that may interfere with their ability to act in an independent manner.

In addition to the above, there may be no voting pool arrangements between shareholders, the chairman has no second or deciding vote and executive directors have no voting rights as they are employees of Bankserv.

The recent changes have been to a large extent to distance the shareholders from the board. Nedbank supports this rationale as well as the changes to the board's structure.

Standard Bank

Historically, major shareholders had the power to elect the chairman of the Bankserv board on condition that their candidate had sufficient knowledge of:

- The functioning of NPS operators in terms of the NPS Act.
- Interoperability of the banking sector and the role of the operator.
- The importance of protecting the economy from systemic risk.

Should the chairman not have extensive knowledge in these areas this would certainly have an adverse impact on effectiveness, efficiency and interoperability due to bad decision-making. This would result in a loss of focus and increased systemic risk.

Previously the board of directors was made up of executives appointed by shareholders based on their knowledge of banking with specific reference to payment sectors. Similar issues as related to the chairmanship are relevant to the members of the board.

From the submissions, it appears that three of the big four support Bankserv's board restructuring, while Standard Bank has various caveats with regard to the necessary and appropriate expertise. This was tested at the hearings with Mr Le Sar of Standard Bank:

CHAIRPERSON: Yesterday there was also... reference to the restructuring of the Board, and do you think that will also affect the manner in which Bankserv works?

MR LE SAR: Mr Chairman exactly to my point earlier that the Board will now have ... a fiduciary role to focus purely on the good of Bankserv, as ...opposed to – if you were under the utility focus that we are looking at – [on] the broader domain. So it is ... [focussed] purely on a profit motive. To now be appointing members to the Board who have little or no payments related knowledge to be driving the company and making decisions on its behalf, I shudder to think where that could possibly impact on this industry relevant to the risk and stability and efficiency of the clearing and settlement type services it provides.

CHAIRPERSON: I may be wrong but it was my understanding that the talk was about appointing people who have ... payments knowledge.

MR LE SAR: Mr Chairman I stand [to be] corrected [but], as far as I remember from the presentation, banks who make up more than 5 per cent of the volume will be assigned each a chair, up to a maximum of five; the remaining five board members will be independents which necessary talks to where would you find those type of...

CHAIRPERSON: It does not necessarily mean that they do not have payments knowledge if they are independent.

MR LE SAR: No, no that is why I said they may have little or ...

CHAIRPERSON: That is why I am raising the concerns that it was not my understanding that it would be people without any payments knowledge.

MR LE SAR: Correct, but what we are saying is that, hypothetically, where you are sitting is that you could be appointing anybody to that Board which would not necessarily bring in payments knowledge, you are driving for profit maximum and hence that could take you down a different route.

CHAIRPERSON: OK, there is also reference, in Slide 12, ... that the commercial profit maximum motive may drive behaviour that potentially introduces more risk into the system. Can you maybe expand on that?

MR LE SAR: Mr Chair I think the short answer to that is if you are now starting to drive services potentially utilising the same infrastructure that you used for clearing and settlement ..., but your focus is on driving profit type related services which now start expanding your services which may not even necessarily be constrained to anything to do with payments, you start running the risk that the lack of focus which we have had to date on ensuring clearing and settlement and sound systems, could come apart.¹⁶⁰

The discussion above, while not exhaustive, provides a flavour of the pressure Bankserv is currently under in terms of satisfying its shareholders.

7.6.4 Development path for 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. A non-clearing bank may not provide payment services to its clients as defined in the NPSD position paper, may not clear domestic payment instructions to or from other banks, may not be a signatory to any payment clearing agreement, may not operate a SAMOS account and may not enjoy membership of PASA.

As noted earlier in this chapter, 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, 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.

¹⁶⁰ Transcript 29 May 2007, p 86-88.

The development path in moving from being a non-clearing bank to a clearing bank, is not set out as, strictly speaking, mentoring and sponsorship are only open to those who are already in effect clearing banks.¹⁶¹ The difficulty for a new player remains transparency and familiarisation with the entry requirements of PASA, the PCHs and the SARB.

One bank, Grindrod, which is the most recent bank to become a clearing bank, has made a submission to the effect that obtaining access to clearing and settlement activity and PASA took it 153 working days (between February and September 2007) to complete. This is in spite of a full-time team working on the project, so that where possible, tasks were performed concurrently. The listing of activities, together with the length of time it took, is in itself instructive and includes such tasks as information gathering, preparing application forms, meeting with Bankserv, testing with the other banks in the relevant PCH's, testing with SAMOS, etc. The list is included as an appendix to the report.

How the current structure enables new entrants into clearing and settlement and facilitates the transition from non-clearing to clearing banks was tested at the hearings (Messrs Pienaar and Coetzee were appearing for PASA):

ADV PETERSEN: ... So to get into mentoring you have to first get into the category of a clearing bank.

MR PIENAAR: Yes.

ADV PETERSEN: Right that was what I was getting at.

MR PIENAAR: Yes.

ADV PETERSEN: So there is no... At least as far as this Position Paper is concerned, there appears to be no provision for the education of a non-clearing bank to prepare it for that entry into the clearing bank category. Now is that correct?

MR PIENAAR: No you are quite right, but there are obviously informal relationships between banks. I mean most of the banks that [are] not clearing banks has[ve] got a corporate client relationship with another clearing bank. [The non-clearing bank] has got to have it, so the relationship is already there with a clearing bank so should he want to...pick up knowledge, he [will] probably discuss it with his bank on the how to what to et cetera, et cetera. So the informal relationships certainly will be there.

MR COETZEE: ...if there is the perception that there was first clearing then mentoring that is not correct. It is at the moment when clearing starts; you start out as a mentored clearing bank.

ADV PETERSEN: The point is however that there is no mentoring before clearing.

MR COETZEE: Well before joining PASA then as a member, yes.¹⁶²

Given that there is much discussion about the entry of other tiers of banks (both dedicated banks and co-operative banks), the setting out of a development path for new entrants may become more pressing. The Co-operative Banks Act 40 of 2007 was signed into law on 22

¹⁶¹ Of course, we have noted the exceptions to this throughout the chapter.

¹⁶² Transcript 29 May 2007, p 66-67.

February 2008. Consequential amendments to the NPS Act of 1998 make provision for co-operative banks to participate in the clearing and settlement arena. However, the way in which access to the clearing and settlement system will be facilitated for these entities is not clear. Clarity on the position of co-operative banks needs to be obtained, given that they will not be regulated by the Registrar of Banks, will not fall under the Banks Act and its regulations and hence will not necessarily fulfil the liquid asset requirements that are statutory for a clearing bank to obtain a settlement account at the SARB. It is also likely that even secondary co-operative banks may not have the technological infrastructure or technical skills to be a direct participant.

And while greater clarity on this is necessary, it may not be sufficient to lower barriers into what PASA itself calls the “complex clearing arena”.¹⁶³ Surely there is a need for expanded membership to the clearing and settlement space – going together with a more active mentoring process?

What we are raising for consideration here would be for at least some of the risk and responsibility in the smaller low-value payment streams to be borne directly by the sponsored bank (or non-bank). Hence they would have settlement accounts, but perhaps only in certain low-value PCHs. This should avoid the problem raised by Standard Bank in which (within the relationship between the sponsor and the sponsored entity) the sponsoring bank is liable for settlement.

7.6.5 Discrimination between clearing banks

In the discussion below, the submissions related to the relative unevenness of the playing fields between large and small clearing banks are presented. The discussion is related to relative prices faced by big and small players and the terms and conditions under which they operate. Although this discussion is part of the section relating to concerns around access to the payments system, it is one of the more vexing areas, as different parties have frequently argued that the discrimination is simply a part of rational business arrangements involving firms and activities of different scale. Hence solutions may not be easy to identify. From the submissions it is clear that pricing and risk in the NPS are associated, with the basic principle that if an entity introduces risk to the system and to other participants, there is a price to pay. While there is the principle that lower fees are charged for higher volume (as certain costs are reduced), higher volumes may actually increase risks (in terms of insurance costs, for example).

¹⁶³ In the PASA Position paper on Banking models within the NPS – Rules for participation in clearing (01/2001).

Hence even once a registered bank becomes a clearing bank, there are disparities of pricing and activity – associated with volume – that may hamper the success of new bank entrants and their ability to compete effectively with the incumbents.

Bankserv's pricing differentials came under attention in this regard. As a commercial operation, Bankserv sets prices for participants, typically on a volume basis. Hence larger banks, with larger volumes, pay lower fees on a per transaction basis than smaller banks. The matter of pricing was raised with Mr Cilliers of Bankserv at the hearings:

MR BODIBE: If there was a decision or if you have to shift to say to a flat rate...

MR CILLIERS: Yes?

MR BODIBE: What will be the impact on the company?

MR CILLIERS: In other words there is no differentiation per customer?

MR BODIBE: Yes.

MR CILLIERS: Well we will certainly, we will make [sure] that flat rate equates to our current revenue if that is..., so it will be an interesting calculation to start with.

MR BODIBE: As a normal business practice?

MR CILLIERS: Yes but I think the effect on us may not be so obvious financially speaking at least to start with. The effect long term is this word "unforeseen consequences" comes to mind, you know obviously there will be questions asked. I think the effect on the industry is more relevant and that is that 94 per cent of our volumes come from the large banks in South Africa. So effectively you will have 94 per cent of the fees paid by the large banks in South Africa and that does not reflect our reality. Our reality is that you know... depends on your definition between 60 and 80 per cent of our costs are fixed costs and they are not all related to volumes.

So we have organised our pricing systems such that our pricing system for these core services are stripped between a fixed fee and transaction fees and the fixed fees are trying to recover some of this fixed cost that are equal or more or less equal between the participants whereas the transaction fee is really tiered at the volume element of our pricing.... On the volume side specifically you know we believe or we have proven that our cost per transaction declines as volumes increase. So we passed that into the transaction fees pricing mechanism that we have. On the fixed fee we are unable to recover what we consider adequate compens[ation] from the smaller players in the industry, so we have a rising fixed fee per client where the bigger players also pay you know up to four times what the small payer pays, the small bank, for example.

...[B]ut at least we still have some semblance of ... us being able to recover some of our fixed cost from every participant. If you just go to a purely flat pricing mechanism that flexibility disappears ... I think we had a bank last year with 30 transactions a month. So whatever your price is ... they will be a participant in the NPS at R30 a month maybe, you know, whatever you can charge.¹⁶⁴

Several of the big banks pointed out that they could shift their custom from Bankserv, or switch to direct clearing between themselves, if Bankserv pricing did not serve them:

Given the commercialisation of Bankserv and therefore the option of competing switching systems to establish themselves in the market, the fee structure and levels of Bankserv need to be set in a manner that retains their customers and volumes. This is especially true for the

¹⁶⁴ Transcript, 28 May 2007, pp 92-94.

larger banks that bring in substantial volumes to Bankserv and which therefore lower the cost of service for all participants.¹⁶⁵

... [I]f the fee structure ...did not pass on some of the volume benefits brought by large banks, then the fee structure might create incentives for larger banks to take volumes out of Bankserv...¹⁶⁶

[B]anks have the option of making direct bilateral clearing arrangements with each other should they so wish and this possibility remains a threat for Bankserv.¹⁶⁷

As a small clearing bank, Mercantile raised concerns regarding the pricing differential for big and small banks. Although Bankserv had recently provided Mercantile with a new pricing proposal (which had met Mercantile's concerns somewhat), Mercantile proposed a flat pricing mechanism for all players. In the hearings however, Mercantile's Mr Bloem conceded that this would not necessarily provide an ideal solution. The transcript picks up with Mercantile's discussion of a new pricing proposal from Bankserv:¹⁶⁸

MR BLOEM: ...Well it is a pricing proposal from their side and what it basically says is that they are willing to revise the original set of prices proposed for the next year with the new set of prices...The proposal is that they are prepared to revise the pricing. They did not change anything as far as the floating component, the variable component is concerned. They basically revised the fixed component to actually streamline the pricing so that if we sit on a one million Rand pricing tier now, it will make sense for us to rather move to three or four million Rand because there is an advantage, overall advantage in doing that. The proposal is subject to a three-year contract then. So we need to give them a commitment that we will continue with this service for a three-year period.

ADV PETERSEN: Fine, so far as the anomaly was concerned that you mentioned in your submission, which I understand to refer to the distance between the lowest tier and next tier.

MR BLOEM: Yes

ADV PETERSEN: Has that anomaly been satisfactorily ironed out as far as you are concerned?

MR BLOEM: Yes, if we accept the new proposal, absolutely sir...

ADV PETERSEN: Now you went on to say today that it is nevertheless still an uneven playing field...

MR BLOEM: Yes sir.

ADV PETERSEN: And your answer, your proposed solution to that, if I understood you correctly, was a uniform per transaction price for all participants?

MR BLOEM: Yes sir.

ADV PETERSEN: Do you recognise that there may be problems in the application of a uniform transaction price?

MR BLOEM: Yes, I do agree.

ADV PETERSEN: What would you say those problems are?

¹⁶⁵ SBSA, April 2007, Second Submission, Access and interoperability, p 11.

¹⁶⁶ *Id.*, p 12.

¹⁶⁷ Absa, March 2007, Second Submission, Access and interoperability, p 2.

¹⁶⁸ Transcript 28 May 2007, pp 158-162.

MR BLOEM: I think the challenge sits in the fact that Bankserv is a service provider. It is trying to remove a lot of risks out of the local settlement system and therefore one must also look at the fixed component that they need to fund out of their pricing model. There is a certain set of costs that they cannot move away from. So they must guarantee in any pricing proposal that they at least cover that in order to make sure that they can continue operating as an efficient service provider and at the same time obviously continue with this job or the roles that they are fulfilling.

So I think the challenge sits in how to balance the requirement to keep everybody happy with the fact that they need to obviously ensure that they do not introduce a risk into the system and the way to do that is to make sure that in the pricing, they make sure that they get in sufficient funds to cover at least their operating cost. So yes we are aware of those facts and therefore it is..., I think it will be quite a challenge to find suitable solution at the end of the day but we still feel that the current pricing is not keeping us warm.

ADV PETERSEN: You recognised that the large volume players might find other switching operators more attractive?

MR BLOEM: Yes sir.

ADV PETERSEN: If there was uniform transaction pricing at Bankserv.

MR BLOEM: Yes.

ADV PETERSEN: And would you recognised that the loss of volume, if a large player was to withdraw from using Bankserv, would in turn impact upon the ...uniform transaction price for the remaining participants?

MR BLOEM: Absolutely, you are absolutely correct but nothing would prevent the smaller players then to join the one big player that moved away and also join the new service provider. I can maybe just mention ...that Mercantile for example is using Visa as our service provider on credit card transactions. We [are] not currently switching through Bankserv, just to prove the point that you are making. So it will be possible for some of the players to move away.

ADV PETERSEN: So you are not suggesting that the uniform per transaction price is necessarily a solution.

MR BLOEM: I think it could pose its own challenges, definitely. It can introduce a risk to the system in that one or two of the bigger players can decide to move away, which will obviously put a whole new perspective on the way that the market is going to operate ...

It appears that Bankserv is currently in a dominant position¹⁶⁹ – which clearly should not be abused in terms of section 8 or 9 of the Competition Act. From the evidence presented to the Enquiry, we are unable to conclude that the differential pricing treatment of its customers actually falls foul of the Competition Act, whether as prohibited price discrimination or prohibited exclusionary conduct. Nevertheless, it is recommended that the Competition Commission keeps Bankserv's pricing practices under observation.

Discrimination between large and small banks is also a feature of access to such payment services as acquiring credit and debit card transactions. In South Africa, the issuing of scheme cards has always been the domain of banks. In the case of acquiring of participating merchants, this has traditionally been the domain of large banks. Both Visa and MasterCard have very strict rules and regulations regarding the eligibility and participation of prospective

¹⁶⁹ This is not assured going into the future, with new and existing players competing for its switching business.

and incumbent members. There are also practices of the schemes which have created unnecessary barriers to acquiring by smaller players. This is dealt with in detail in the chapter on Payment Cards and Interchange.

In Australia, the authorities intervened in the card market by creating an access regime where the card associations are no longer permitted to deny access to acquiring on the basis of an institution not having established an adequate issuing base or programme first.

On the regulatory side, two changes have allowed non-financial institutions to participate more fully in payment systems. The first was the establishment of an Access Regime for the Bankcard, MasterCard and Visa credit card schemes in 2003. The creation of a new class of authorised deposit-taking institution, known as Specialist Credit Card Institutions (SCCIs), has provided an avenue for firms that are not traditional deposit takers to enter the credit card system as either an issuer or an acquirer or both.¹⁷⁰

In the chapter of this report dealing with Payment Cards and Interchange we have recommended that, if the card schemes do not voluntarily – both formally and in practice – abandon restrictions which limit acquiring to issuers, then the matter should be addressed either by the initiation of formal complaints and investigations by the Competition Commission, or by regulatory intervention, or by both. In the event of a regulatory remedy being embarked upon, the Australian precedent would merit further study.

7.6.6 Non-banks and the recent directives

A key concern raised above is the lack of a regulatory framework for non-banks, in spite of the 1995 Blue book referring to non-banks and the rules for their participation.

Some rules – in the form of directives from the NPSD – were published in September 2007. These have appeared as the Directive for Conduct within the NPS: Payments to third persons and the Directive for Conduct within the NPS: System operators respectively.

In these documents, the NPSD acknowledges

that the provision of services relating to payment instructions to two or more persons by persons other than banks, in certain circumstances, adds value to the users of the NPS in a broader market, provided that risk in the NPS is controlled.

In the case of the *Payments to third persons* directive, both many-to-one (such as bill payments for a utility by customers) and one-to-many (such as salary payments) are mentioned. Those entities undertaking such services must:

- Be appointed as an agent of each beneficiary
- Keep records of such payments for five years

¹⁷⁰ RBA, 2006. Payments System Board Annual Report, p 9.

- Keep separate and distinct the business divisions associated with payments
- Ensure its systems are safe and efficient so as not to introduce risk, including reputational risk, into the NPS
- Inform its banker of its involvement in payments to third persons, and the banker in turn must inform PASA.

PASA should keep a record of such entities and inform NPSD upon request.

In the case of the *System Operator* directive, a system operator provides services to any two or more persons in respect of payment instructions, including the delivery to and/or receipt of payment instructions from a bank and/or a PCH system operator. The persons to whom such service may be provided include: banks; beneficiary service providers, payer service providers; institutions exempted or excluded from the Banks Act and clients of banks.

The directive excludes those who perform such services on their own behalf, however they are expected to meet the operational and technical requirements set out in the Criteria for System operators (Annexure to the directive).

A system operator shall:

- Meet the criteria as recommended by PASA
- Have a written agreement with each person to whom services are rendered
- Keep the information in respect of the services rendered confidential and separate
- In respect of the bank accounts from which funds are to be paid or to which funds are to be transferred, only act in accordance with instructions issued by the person to whom the service is rendered, and not pay such funds from or transfer such funds to its own account. (Note: This is presumably intended to prevent such operators from holding a "float".)
- Keep separate the business divisions providing system operator services
- Refrain from providing services which allow the offsetting of mutual obligations by trading partners or persons for whom they are processing payment instructions. (This prevents netting of obligations.)
- Keep records of all (each and every) payment instructions for five years.

These directives hence provide a framework for regulation for these two categories of non-banks. It is notable that system operators appear to be precluded from keeping a float of funds to which others are entitled; however bureaux, which would be involved in third party payments, do not appear to be so constrained.

There are a few points that are worth noting regarding the Directives.

- The Directives give authority to PASA to authorise, determine the criteria for authorisation, and provide the NPSD with information regarding the registration of third party payment providers and system operators. In their comment on the System operator directive in October 2006, the Association of System Operators raised concerns that:

PASA is traditionally an organisation acting in the interests of the banks, which in turn control process payments. The banks being competitors of the system operators have traditionally and generally been opposed to the involvement of system operators in the processing and services relating to payment instructions. Accordingly, it is submitted that a conflict of interest would exist should PASA oversee the management and control of system operators.¹⁷¹

While the NPSD has ultimate authority to approve the rules set by PASA, PASA remains the operation manager of the directives and the author of any rules. At the same time that system operators are managed by PASA, they are denied access to membership of the organisation, which is exclusively for clearing banks.

- These directives are created in the context of non-banks not being permitted direct participation in the clearing and settlement arena. In and of themselves it is difficult to interpret the extent to which the directives truly bring order to the “outer core” – even the *Criteria for authorisation to act as a system operator* (published as an annexure to the System Operator directive) leaves room for interpretation and decision making by the PASA council and one cannot conclude that they provide a holistic framework for the regulation of non-banks in the payments system. The latter would be necessary to ensure quality-of-access.
- Concerns regarding governance in the payments system date back to the Task Group report on *Competition in South African Banking*¹⁷² and the subsequent report for the Competition Commission on *Competition in South African banking and National Payments System*¹⁷³ and have been expressed at the public hearings of the Banking Enquiry itself. Hence PASA has been aware for some time of the concerns around its structures and governance. It is currently going through a process of restructuring – of both the organisation and its decision making body, the PASA council. While the restructuring is not yet complete, it is clear that the council will continue only to allow participation by its clearing bank members and although each member will have a

¹⁷¹ ASO, 2006. Comments on the Directive issued by the South African Reserve Bank in respect of System Operators. October, p 1.

¹⁷² Falkena et al, 2004. Competition in SA Banking. A report for the National Treasury and the SARB.

¹⁷³ FEASibility, 2006. Competition in Banking and the National Payments System. A report for the Competition Commission. Note this report is specifically listed as the cause for the change in the Bankserv governance structures by SBSA, April 2007, Second Submission, Access and Interoperability, p 7.

fiduciary duty to PASA, it is difficult to see how the new structure brings advancement in terms of non-bank participation.

Concerns relating to the continued reliance on PASA as a payment system management body with vested interests, coupled with restrictions on its membership to clearing banks only, are thus exacerbated by the publication of the NPSD's two directives for non-banks.

7.6.7 Innovation

In principle, the possibility that innovators may be rewarded with increased access is likely to enhance innovation and efficiency. To restrict access means to rely on only a small cohort of incumbent firms to introduce efficiencies and innovations that may cut across existing sub-markets.

A number of current arrangements in the NPS undermine innovation, namely:

- The restriction of participation in clearing and settlement to clearing banks only, except in the case of technical outsourcing under the auspices of a clearing bank. The pricing of such participation by the existing incumbents, or by means of bilateral negotiations with unequal power relations may also be a barrier to the sustainability of new entrants.
- The arrangement whereby introduction of change or innovation must be agreed by incumbent competitors, who may play a gate keeping role.
- Undue restrictions on participation in low-value payments activity. Only clearing banks may participate here.

These will be discussed briefly in turn.

Participation under the auspices of a clearing bank

The restriction of participation to clearing banks means that participation by a non-clearing bank or a non-bank must be under auspices of a clearing bank.

This implies that to gain acceptance, the innovative idea must first be adopted by a clearing bank that in turn will take the innovation to the PCH. This may involve a number of hurdles, including that to gain acceptance, the clearing bank will need to be convinced that such an innovation will not undermine revenues from its existing business lines. The successful innovator is tied to the terms and conditions of the clearing bank concerned and typically gets locked into an arrangement from which there are high risks of switching.

The current arrangement may stifle or delay innovation as incumbent clearing banks are likely to adopt a very conservative approach to innovation and hence may reject viable innovations out of hand or take an unduly long time to approve any change. The current arrangement may also introduce a hazard where the regulated entities or clearing banks do not themselves have the mechanisms or motivation to monitor the transactions introduced by those acting under their auspices. Currently it is the clearing banks that have lender of last resort assurance. But business arrangements with non-clearing banks may potentially introduce risk.¹⁷⁴ The principle that the entity that introduces the transaction should be responsible for any associated risk, is sound. But this fails when the bank introducing the transaction does so only in name and is neither equipped to regulate the introduced entity nor interested in doing so.

In general, non-bank participation in the payment system is associated with innovation. At a recent conference in the US, this was affirmed by the President and CEO of the Federal Reserve Bank of Kansas City:

The retail payments system is certainly undergoing fundamental change. It is dynamic, coming from a variety of sources, and it is significant. It is also no coincidence that nonbank firms are a significant part of this change and have become increasingly prevalent throughout the world's payment system

... [N]onbank companies have had a positive influence in the areas of efficiency and access around payments. By helping to introduce new technologies and products, entering new markets, and tapping into the economies of scale and scope, nonbanks are enhancing the efficiency in the payments system. By offering payments services that frequently transcend geographic restrictions, for example, by facilitating online payment options, nonbanks are enhancing, on balance, consumer access.¹⁷⁵

Of course, non-banks are not the sole – nor always the prime – source of innovation, but since they can improve efficiency and access for consumers, their access to infrastructure needs to be taken seriously. Hence, enhancing the (regulated) access of non-banks or non-clearing banks into the clearing space, and even the settlement arena, would improve innovation and efficiencies. The risks associated with such access are greatly reduced if such entities are appropriately and explicitly regulated. Such access – which we can refer to as quality-access – is superior to the current approach where they are regulated on the basis of transactions under the name of a clearing bank.

¹⁷⁴ Transcript, 25 May 2007, p 151.

¹⁷⁵ Hoenig, T, 2007. *Central bank perspectives*, Federal Reserve Bank of Kansas City, President and CEO, at the 2007 Payments Conference entitled *Non-banks in the Payment System: innovation, competition and risk*. May. Santa Fe. <http://www.kansascityfed.org/EconRes/psr/PSRConferences/2007/PDF/HoenigRemarks.pdf>

Obtaining agreement from incumbent competitors

In this instance, we refer to the introduction of an innovation (potentially from a non-bank) by a member of an existing PCH. Here, there are two hurdles for the would-be innovator: obtaining permission from the incumbents to introduce the innovation and establishing a sustainable interbank pricing arrangement.

The case of mini-ATMS gives us some insight into these issues. While the relevant submissions received have been set out in some detail in the ATM chapter and will not be repeated here, the example shows that it is difficult to introduce an innovation into an existing PCH as competitors may feel threatened and hence unduly cautious in accepting the innovation into the PCH. There is also an intellectual property issue here as the innovator is required to unveil the innovation to competitors.

In addition, as the arrangements currently stand, the would-be innovator has to accept the classification of the type of interbank price that should apply to the innovation. In the case of the mini-ATM transactions, these were reclassified as Non-ATM Devices (NADs) after having originally been accepted as ATM transactions, with the associated carriage fee. The carriage fee applicable to NADs is considerably lower than that for ATM transactions, and was concluded on a bilateral basis between acquiring and issuing members of the PCH. Moreover, although there is a lower interbank fee applicable, the benefit of the lower cost does not pass through to the customer as the issuing banks cannot discern the difference between an ATM and mini-ATM transaction, and so the standard ATM fee is charged.¹⁷⁶

The alternative to introducing an innovation to an existing PCH is to establish a new PCH. PASA rules allow for any two members to establish a new PCH and appoint their own PCH system operators. This process is not without its own difficulties as for any PCH to warrant the necessary investment, it must have general acceptance through a critical mass of acquirers and issuers. The new PCHs established in recent years – such as EDO (AEDO and NAEDO) and Mzansi money transfer – have been established in response to external stimuli – such as pending regulation or the Financial Sector Charter, rather than in order to accommodate innovation. This suggests establishment of new PCHs is not an easy way of introducing an innovation into the payment system.

Regulatory restrictions on participation in low value streams

One of the areas where non-bank participation has generated dynamism in payment services worldwide has been in low value payments through smart cards and cell-phones

¹⁷⁶ SBSA, April 2007, Second Submission, ATM transactions, p 25.

and other technology, broadly referred to as e-money. The Financial Services Authority (FSA) in the UK set out in 2001 what electronic money is and how it works:

Electronic money is proposed to be defined ... as:

'... monetary value as represented by a claim on the issuer which is:

- (i) stored on an electronic device; and
- (ii) accepted as a means of payment by persons other than the issuer.'

E-money may be carried on a number of electronic devices and may be downloaded from an ATM, a shop-based terminal or the Internet. It can perform the same functions as physical cash: it can be used to buy different goods and services; can be redeemed for physical cash; and may be exchanged person to person. It may be used in the physical world by inserting a card into a terminal or by using contactless wireless technology; and, in the virtual world, over the Internet from a PC or mobile phone. Electronic purses are likely to feature on transport ticketing smartcards (as in Hong Kong and Singapore).¹⁷⁷

In a number of jurisdictions, such as the EU, including the UK, e-money can be issued by both banks and non-banks, subject to a purse limit. In the UK, the purse limit is GBP 250.¹⁷⁸ Issuers of electronic money are required to register with the Financial Service Authority (FSA) and are subject to money laundering regulations (and other associated regulations). The legislation aims to be fair and equal in that it permits both banks and non-banks to issue electronic money.

In South Africa, the NPSD's Position paper on electronic money¹⁷⁹ states that:

Only [clearing] banks will be permitted to issue electronic money. Electronic money will therefore be subject to regulation and supervision by the Bank.¹⁸⁰

The South African regulatory approach to e-money is problematic as it continues to retain the exclusivity of the clearing banks in this arena, and in so doing, may well be setting the country back in terms of a range of innovative payment mechanisms that could benefit low-income consumers. Once again, there are workable and operationally secure international examples which suggest that the local approach is unnecessarily closed-minded and protectionist in nature.

There need to be clear and objective criteria for the submission, evaluation and acceptance of innovations, along with changes to the access regime.

¹⁷⁷ FSA, 2001. The regulation of electronic money issuers, p 5.

¹⁷⁸ This is likely to change in the light of the new EU payments Directive and is currently under consultation. See FSA, January 2008, E-Money directive.

¹⁷⁹ NPS, April 2006. Position paper – electronic money. (NPS 01/2006).

¹⁸⁰ *Id*, p 4.

7.7 Multiple acquiring and sorting at source

The concepts of “multiple acquiring” and “sorting at source” have been introduced by non-bank participants (particularly retailers) in the Enquiry as a possible mechanism to improve access to the payment system, and also reduce layers of pricing.¹⁸¹ Consequently, the concepts have been explored at the hearings and in written submissions.

7.7.1 Multiple acquiring vs sorting at source

The concepts of multiple acquiring and sorting at source are frequently used synonymously, except that the term “multiple acquiring” is usually reserved for the payment card arena and “sorting at source” extends to other payment streams, most notably, EFTs, or even ATMs. However, as we shall see, they are not identical. Their similarity arises in their challenge to “single acquiring”, a term used to indicate that in most payment streams, a non-bank – be it a retailer, or insurance company, or bureau – typically has a relationship with a single bank to acquire or introduce its transactions into the payments system.

The single acquiring model predominates in the payment system. An example would be where an insurance company, say, with a client base that banks at different banks, sends all the payment instructions for its monthly premiums to a single bank, also known as the single acquirer, Bank A. Bank A will process all the transactions for its own bank customers – the on-us transactions. The result of this intra-bank processing will mean that for each payment instruction, the account of the insurance company will be credited with the value of the premium and the paying customer’s account will be debited. The remainder of the transactions – typically the majority¹⁸² – will then be relayed for collection via a system operator, such as Bankserv, to the other banks (Banks B, C, D, etc) where the clients of the insurance company have their accounts. The process results in interbank clearing and settlement, where the other banks debit their customers’ accounts in favour of Bank A (and the insurance company). While strictly speaking it is only this latter group of off-us transactions that will attract an interchange fee (as described in the chapter on interchange) we have no reason to believe that Bank A charges the insurance company a different rate for processing on-us and off-us transactions, but instead uses a standard rate.

In the sorting at source model, the insurance company in the example above would have multiple bank accounts with a number of different banks (typically those that suit its clients’ banking profile). The insurance company would sort the payment instructions per bank and

¹⁸¹ See, e.g. The letter from Shoprite to the Banking Enquiry, July 2006, pp 2-6.

¹⁸² On-us volumes are estimated to account for 25-30 per cent of the SA payment volumes. This number was confirmed by Mr. Pienaar of PASA at the hearing of 19 June, Transcript p 155.

relay them to each respective bank – which would in turn process them as “on-us” transactions. If there were clients with accounts at banks where the insurance company did not itself have an account, these transactions would be processed via a system operator. In this example, it is likely that the *minority* of transactions would be off-us.

In the case of multiple acquiring, a retailer is able to process different brands of payment cards through different acquiring banks. However the four-party model (described further in the chapter on interchange) appears to remain intact, so that each acquiring bank still processes the on-us transaction and then relays the rest via a system operator or payment processor such as Bankserv, MasterCard or VISA. The current rules of the game are that merchants are permitted to appoint an acquirer for each of the card brands and types, namely Visa, MasterCard, Visa Electron, Maestro, Diners Club and American Express.¹⁸³ Information supplied to the Enquiry suggests that the largest retailers, such as Pick n Pay, have two acquirers for payment cards.¹⁸⁴ In this example, it is likely that the majority of the transactions will still be off-us, and either way, the same merchant service charge will apply to all transactions of the same type processed through the acquirer concerned.

MasterCard suggests that the key difference between multiple acquiring and sorting at source lies in the relationships involved:

Multiple acquiring should be distinguished from sorting at source. Multiple acquiring requires the acquirer [the acquiring bank in each case] (not merchant) to have a relationship with the payment processor (i.e. Bankserv, MasterCard and VISA). Sorting at source, as MasterCard understands the model, contemplates that there is no role for the acquirer. The merchant transacts directly with one or more issuers [issuing banks].¹⁸⁵

Whether in the last mentioned case, the merchant has an acquiring relationship with each issuing bank, is a moot point. What is clear is that taken to its extreme, in sorting at source, the system operator (or payment processor) as MasterCard calls it, is largely by-passed. Instead the non-bank, or its back office operator, links directly through to each issuing bank. From an access perspective, the implication is that the restrictions associated with clearing (and hence access to Bankserv) could be avoided. Whether this method of pursuing this objective results in a positive outcome for the system as a whole is questionable, however.

Where a non-bank is able to send instructions to more than one bank, the non-bank will have less processing risk. This appears to be the essence of the Shoprite Checkers submission, which points out that if the systems of its single acquirer fail, it cannot process any debit card (and only credit cards below the prevailing off-line threshold).¹⁸⁶ However,

¹⁸³ Pick n Pay, October 2006, Submission of Information, p 6.

¹⁸⁴ *Id.*

¹⁸⁵ MasterCard, March 2007. Supplementary Submission to the Banking Enquiry, p 12-13.

¹⁸⁶ Shoprite Checkers, Letter to the Banking Enquiry, July 2006, p 7. At the time of submission, Shoprite had only a single

since multiple acquiring is permitted, as explained above, and enables the additional acquirer to serve as a backup in handling all transactions in the case of technical failure by the other, this would seem largely to dispose of Shoprite Checker's technical concern.

The key benefit of the widespread adoption of sorting at source set out by its proponents appears to be potential cost reduction. For example, the sorting at source model will allow non-banks greater negotiating power with regard to bank processing fees – as there will be an ability to play one acquiring bank off against another.¹⁸⁷ In addition, allowing non-banks to transmit transactions directly to each bank, rather than via Bankserv, would potentially allow for the reduction in one layer of cost.

It has been suggested further, that the interchange fee could be “avoided”.¹⁸⁸ The Enquiry has confirmed however, that while the interchange fee would not be paid away by the acquiring bank, in the case of on-us transactions, both issuing and acquiring costs are still being incurred, necessitating a transfer of intrachange between the different departments of the bank.¹⁸⁹

To the extent that levels of interchange (which enter into merchant service charges), may be set too high, and thus be open to abuse, we have addressed this problem in the chapter on interchange by proposing an independent objective and transparent process for regulating interchange. We consider that sorting at source is neither necessary nor adequate as a remedy.

acquirer for payment cards.

¹⁸⁷ A strategy mentioned by both Shoprite Checkers *id.*, p 5, and Pick n Pay, October 2006, p 6.

¹⁸⁸ Shoprite Checkers, Letter to the Banking Enquiry, July 2006, p 7.

¹⁸⁹ See Chapter on interchange.

7.7.2 The regulatory position

As has been stated above, multiple acquiring is permitted in the payment cards arena, along the lines of different branded cards. The status of sorting at source remains unclear, however. In a letter to PASA, dated 1 December 2003, the NPSD declared a moratorium on all new sorting at source arrangements¹⁹⁰. The chief reason given for the decision by the NPSD was that such activity reduced interbank clearing, which in turn meant that exposures were not transparent to the SARB. It appears that as a consequence of this decision by the NPSD, some existing sorting at source arrangements were retracted.¹⁹¹

In a subsequent letter to PASA, dated 3 January 2006, the NPSD withdrew its moratorium on the grounds that it had no legislative grounds to continue its stance.¹⁹² As stated in its letter, this was based on a legal opinion from the SARB's own Legal Services Department (LSD) that sorting at source is not clearing – and therefore the SARB has no legislative grounds to outlaw sorting at source, except if the practice should lead to a form of systemic risk. The letter goes on:

Furthermore, LSD are of the opinion that a claim that sorting at source will hide exposures from the NPSD does not hold water as the NPSD may call for any information it may require relating to a payment system, in terms of section 10 of the NPS Act.¹⁹³

The NPSD goes on to say:

...please take note that the NPSD remains averse to arrangements that allow for the bypassing of the clearing system. Other than for reasons previously mentioned (our letter of 2004-09-23) we are concerned that the proliferation of such arrangements could lead to a distortion in the pricing of interbank clearing and seriously affect the ability of smaller banks to participate in the process.¹⁹⁴

7.7.3 The standpoint of the banks and Bankserv

The resulting situation appears to be one where the banks, aware of the NPSD's misgivings on the matter, have generally refrained from allowing sorting at source arrangements since the lifting of the moratorium. Shoprite Checker's submission for example, shows that in

¹⁹⁰ Historically, sorting at source was associated with preferential payments. As Mr. Shunmugam of Standard Bank put it at the hearings: "It is where the corporate [beneficiary] would get first hit of the funds. With the introduction of the AEDO system and the NEADO system and consequently the National Credit Act ... all preference from systems has been removed and replaced with randomization." Transcript 29 May 2007, p 79.

¹⁹¹ Pick n Pay, for example, had direct acquiring relationships with each issuing bank for cash-back at point of sale arrangements associated with debit card purchases in place from 1989. From 2005, it was "compelled to appoint a single acquirer for each card brand". Pick n Pay, October 2006. *Submission of information*, p 6.

¹⁹² NPSD, January 2006. Confidential letter to PASA. Submitted as part of the Shoprite Checkers Submission, October 2006. Response to the Competition Commission's Request for the Submissions regarding the Report by Feasibility on charges within the banking sector. Annexure "S3".

¹⁹³ *Id.* p1.

¹⁹⁴ *Id.* p2.

response to its request to discuss sorting at source with ABSA in early 2006, it was rebuffed.¹⁹⁵ The reluctance was also apparent in the submissions and hearings.

ABSA for example, (represented here by Mr von Zeuner) stated that sorting at source would not result in the efficient use of the payment system, and moreover that the supposed cost savings were not likely to emerge:

MR VON ZEUNER: Sorting-at-source leads to payment transactions being less efficient than the current system. The processing that arises currently still has to arise under the sorting-at-source. Sorting-at-source does not reduce or remove the different steps that need to be taken and so there is no efficiency of processing that arises from it. It does not reduce any cost. Sorting-at-source brings, we believe, duplication in investment, all merchants with their different switches needs different links into all of the issuers.

If transactions go through, these different switches then there will be far more switches with far fewer transactions through each compared to today when most of the transactions go through one switch, referring to Bankserv. If transactions are taken away from Bankserv then it will not be able to exploit these scales of economy and the unit cost of transactions will obviously go up.

Since it would mainly be the large retailers who would source at source, this means that the small retailers will be left facing higher costs than before.¹⁹⁶

Standard Bank also submits that the reduction of volumes through Bankserv would raise unit costs and force smaller banks to have costly direct links with each of the larger banks, or bear these costs. Ultimately, they foresee interoperability being jeopardised.¹⁹⁷

Bankserv confirmed that should sorting at source be taken to its extreme, it would effectively leave no role for Bankserv in the system:

MR. CILLIERS: ... look sorting at source in its ultimate form will make Bankserv obsolete overnight. There will be no off-us transactions to process so Bankserv would not have an NPS role per se and it is a risk you know, I appreciate the comments made that there is no real international precedent for that happening at a big scale but it certainly is happening. I mean it is happening on a small scale already.

We see that in the volumes, we see little differences in volumes from time to time. We know about corporates that are sorting at source and so forth but ... I think that is a very obvious scenario. We process off-us transactions, if everything is sorted at source there are no off-us transactions, so that is quite simple.¹⁹⁸

¹⁹⁵ Shoprite Checkers. Letter to the Banking enquiry. July 2006 Annexure "S1".

¹⁹⁶ Transcript 25 May 2007, p 72.

¹⁹⁷ Standard Bank, April 2007, Second submission, Access and Interoperability, p 30.

¹⁹⁸ Transcript, 28 May 2007, p 115.

7.7.4 Benefits and costs

Who will benefit from the sorting at source model became a theme at the hearings – with the emphasis on the differential outcomes for big and small players. (Mr Jordaan appears here for FRB):

MR. JORDAAN: ...Sorting at source benefits bigger players. In the case of merchants, it would really only make sense to the larger merchants to do so and we feel that could be that the expense of smaller merchants. But I think ... size would also play out in the banking sphere. In other words if sorting at source were to happen that would completely marginalize small banks for the benefit of the larger banks, because they would have more on-us transactions by virtue of having a larger customer base. So sorting at source helps big merchants and the bigger banks.¹⁹⁹

The matter was probed with a smaller clearing bank that is able to offer its services as an acquirer in a number of payment streams. Mr Coacker was asked to indicate Mercantile's attitude to sorting at source:

MR. COACKER: This again is a double-edged sword for a small player ... If you were to fully allow sorting at source I think it would dilute our ability as a small player to compete in the switching process particularly because what would the need be to switch through us if you have a direct relationship with an ABSA, Standard, FNB and a Nedbank for submitting your transactions directly through to them? Then it removes any usefulness that we might provide to the payments market and we would therefore in our capacity as a small bank not support sorting at source over and above any other reasons.²⁰⁰

Shoprite Checkers, through the intervention of Mr Nilson, confirmed the insignificance of the number of transactions through any bank, other than the big four:

MR NILSON: ... There is a huge, huge gap between the big four and the rest, massive, it is not even in the same ball park. I mean, I will give you an example, we run an internal card, a Shoprite staff card, that staff can use, we are doing about 170 000 transactions a month or something. If I take the big four banks and I put them down, Bank A, B, C, D, in order of number of cards and value that are processed, the next highest volume card that I process is my staff card.

So down below that big four line is really rats, I call them rats and mice quite honestly... the volumes are really minuscule, compared to the big four.²⁰¹

There seemed to be little benefit to smaller merchants. Mr Cope of Pick n Pay suggested here that sorting at source will bring little change to the circumstances of smaller merchants:

ADV PETERSEN: Moving on then from that, Mr Cope, can we just consider for a minute, where multiple acquiring, sorting at source, would leave the small merchant, whose volume of transactions might not justify having a multiplicity of acquirers, have you considered what the likely effect of the change that you are proposing would be upon small merchants?

¹⁹⁹ Transcript 28 May 2007, p 24.

²⁰⁰ Transcript, 28 May 2007, p 188.

²⁰¹ Transcript 25 November 2006, p 88.

MR COPE: I think there will always be a situation where you will need a single acquirer for certain transactions. If a card is issued by a bank offshore on a different continent and there will be cards issued by hundreds of thousands of banks globally, clearly in that situation you would need to have an arrangement of single acquiring in those situations. So it will always be there. Similarly in the case of a small merchant, they may be obliged to use a single acquirer, if they are not in a position to develop their own switching situation or negotiate bilateral arrangements with the major domestic banks.²⁰²

The Panel have come to the conclusion that there is little merit in promoting sorting at source (as distinct from multiple acquiring). While it may well provide short-lived benefit to powerful non-bank users of the payment system in their own negotiations with banks, this benefit will not necessarily accrue to all non-banks and may well undermine the benefits of interoperability of the system.

For this reason, the Panel can find no reason, from a competition perspective, to recommend sorting at source. The Panel favours instead the participation and regulation of non-banks, who wish to engage in payment processing and clearing, along the lines described in this chapter. This avoids introducing a “backdoor” approach – of which sorting at source – smacks.

7.8 Conclusion and recommendations

The analysis in this chapter has challenged the notion that the existing regulatory regime for the National Payment System is meeting the needs of South African consumers for competitive and technically innovative payment services. The approach of largely ignoring non-bank activities has begun to shift. But persistence in the view that only clearing banks may participate in clearing and settlement is not an approach that will best serve South Africa’s interest. We are convinced of the need for a revision of the regulatory approach and the development of an appropriate regulatory regime for payment system activity which is functionally-based, rather than institutionally-based, so as to ensure quality of access. Those participating in payment activity should be adequately regulated, regardless of whether they are clearing banks or not.

The recommended approach requires an explicit access policy for banks and non-banks alike. Bank access is based primarily on banks being regulated by the Registrar. Further, the self-regulator, PASA, has confined its membership to clearing banks, leaving NPSD with an “oversight role”.

While the use of the term oversight is internationally adopted vis-à-vis supervision, its use is somewhat ironic, given that it may simultaneously mean one thing and its opposite. The regulatory regime in the payments system, which has relied essentially on the SARB’s

²⁰² Transcript 25 November 2006, p 18.

supervision of clearing banks, has lacked in terms of its inadvertence towards other legitimate contenders.

Our recommendations regarding the regulation of the National Payment System are as follows:

- An access regime that includes non-bank providers of payment services should be developed so as to allow for their participation, under effective regulation and supervision, in both clearing and settlement activities in appropriate low-value or retail payment streams
- The National Payment System Act and the associated position papers of the NPSD should be revised accordingly
- The membership and governance of PASA should be revised so as to include non-bank participants. Governance revision should also allow for objective application of entry criteria and formalisation of reporting to the NPSD
- A Payment System Ombud should be established that would assess whether or not applications have been fairly dealt with and whether or not participants have been fairly treated in terms of access and the pricing of such access.

7.8.1 Development of an access regime that includes non-banks

There is currently no access regime for payment system participants other than one in which, once a bank is registered as a deposit-taker, it can potentially become a member of PASA. Thereafter the PASA rules and regulations apply. If South Africa is to have a holistic access regime for the payments system, it makes sense to define criteria that relate specifically to payments activity, rather than piggy-back on the prudential requirements of the Registrar of Banks.

The Australian approach is instructive here. Some years ago, the RBA relied on the prudentially specified Liquid Asset Requirement as the basis for collateral in the settlement system. When the authority to regulate banks was shifted to the Australian Prudential Regulatory Authority (APRA), the Payment policy department of the Reserve Bank of Australia was obliged to set out an access policy that was not based on prudential regulations for banks, but instead was based on payment system activity. Hence capital and other requirements are based on volumes and values through the payments system, rather than values of assets or liabilities as set out by the prudential authority. This separation of requirements makes it easier to allow non-banks to enter the system – as these requirements can be applied on a functional, rather than institutional basis, if properly formulated.

In its Vision 2010, the NPSD sets out that:

The oversight domain of the NPS entails the entire process of making payment. In other words, it entails the process (including but not limited to) that enables the payer to make a payment (that is issuance of payment instruments), the payer to issue a payment instruction via a payment instrument or other infrastructure, the institution to receive the payment instruction via clearing or otherwise, the process of clearing and settlement (where applicable), the beneficiary to accept the payment instruction, the beneficiary to deliver the payment instruction to an institution for collection, the institution to receive and deliver the payment instruction for collection into clearing and settlement, and the beneficiary to receive the benefit of the payment. Within the described process, banks, third-person payment providers, system operators, PCH system operators and agents of payers and/or beneficiaries are included.²⁰³

Hence the oversight domain can be seen to embrace the entire payment value chain and it includes non-banks. However, as has been described in some detail above, the *Blue Book* and *Vision 2010* approach to supervision of non-banks has been piecemeal and incomplete and does not provide satisfactory access to clearing and settlement.

The current approach, which identifies the inner core as the exclusive domain of clearing banks (apart from the anomalies mentioned), and distinguishes it from the outer core, means that those that are in the outer core remain excluded, in spite of the words extracted from the Vision 2010 document above.

The underlying belief that only clearing banks ought to be permitted in the clearing and settlement arena has perpetuated the situation where only banks are permitted to be members of the payment system management body, PASA.

All registered banks are allowed to take deposits but only those banks qualifying in terms of the Bank's [i.e. SARB's] payment criteria are eligible to clear in their own name and settle in the books of the Bank in their own name.

The payment system management body (the Payments Association of South Africa (PASA)) manages the conduct of its members [defined as the Bank, a bank, mutual bank or branch of a foreign institution (or any other class of bank)] in relation to all matters affecting payment instructions.²⁰⁴

This is in spite of the provision made in the NPS Act Section 4 (2) c (i) to allow for a limited membership of PASA for exceptional entities, such as Postbank and Ithala. Hence although strictly speaking the NPS Act potentially allows for limited membership of some non-banks, this is nowhere further defined. In the PASA constitution there is no provision for limited membership, and only bank membership of PCHs is allowed. Postbank and Ithala are not members of PCHs and this leaves the concept of limited membership obscure.

²⁰³ SARB, 2006. Vision 2010 NPS Framework and Strategy, Para 3.4.1.

²⁰⁴ SARB, 2006. Vision 2010, para 3.5.4 and 3.5.5. Co-operative banks have now been added to the list.

Because non-banks are not catered for as members of PASA, they are excluded from having an effective voice. Moreover, they are excluded from the rigour of participating in policy and regulatory debate and contributing to a greater understanding of what takes place in the outer core.

An access regime that includes non-bank providers of payment services should be developed so as to allow for their participation, under effective regulation and supervision, in both clearing and settlement activities in appropriate low-value payment streams. As has been discussed earlier, there are international precedents that suggest that an access regime of this sort can be designed that does not threaten the systemic stability of the existing system.

In our view, the new structures proposed – such as the new NPS framework and the directives – discussed above do not adequately address these concerns.

7.8.2 Revision of the NPS Act and associated position papers and directives

The discussion of the chapter leads to the conclusion that the NPS Act needs to be substantially redrafted with a new access framework in mind. This would allow for non-banks to be clearing and (even) settlement participants, and hence members of PASA. It would allow for different types of participants and membership of PCHs.

This is especially so, given the omission acknowledged by PASA in the piecemeal approach of the 2004 amendments. For example, the 2004 amendments to the NPS Act introduced a number of changes that potentially expanded access to the payment system. For example, they introduced the concept of system operator – a person, other than a designated settlement system operator, authorised in terms of section 4 (2) (c) to provide services to any two or more persons in respect of payment instructions.²⁰⁵ It also introduced the concept of payments to third persons, made or accepted in accordance with directives to be issued by the SARB.

However, it failed to allow such participants access to the clearing arena or to allow a defined membership of PASA.

Once the NPS Act has been redrafted, the associated position papers and directives would also have to be revised. Obvious examples are the Bank models position paper to accommodate the realities of Postbank and Ithala and the e-money position paper, as well as the directives on system operators and third party providers.

²⁰⁵ NPSA Act, as amended, Section 1 Definitions.

7.8.3 PASA membership and governance

PASA is the delegated self-regulatory authority of the payments system. In our opinion this position, together with the professed view of the NPSD that their remit and that of the payment system management body extends throughout payment system activity, means that PASA membership should be extended to non-banks.

However, this does not necessarily require all members to be on an equal footing. Again the Australian example is instructive, where three types of membership in the Australian Payments Clearing Association (APCA) are catered for:

- Owner membership (members are also shareholders)
- Participating membership (members of the PCHs)
- Associated membership (members who would like to remain informed).²⁰⁶

The governance structure includes owner and participating member overlaps. These categories are open to banks and non-banks alike. These members are clearing members as they are members of a clearing house (of which there are five in Australia). The requirements for membership are that a participant must:

- Be a body corporate which carries on business at or through a permanent establishment in Australia
- Be able to comply with any applicable laws and APCA's constitution, regulations and procedures and related technical and operational standards
- Agree to pay all applicable fees, costs charges and expenses.²⁰⁷

Moreover, the participating members are divided into Tier 1 and Tier 2 members, with only the former settling their own obligations and those of any Tier 2 participants that appoint them as clearing agents. While Tier 1 members are subject to supervision and are likely to be financial institutions of some type, this requirement does not apply to Tier 2 members.²⁰⁸

A more nuanced membership of PASA will lead the way to improved governance, as the current (and proposed) governance structures are dominated by the biggest banks which have the greatest volume and values through the system. In an environment where both bank and non-bank members of PCHs can be members of PASA's highest authority – its Council – governance concerns associated with clearing banks regulating non-bank competitors will tend to fall away.

²⁰⁶ www.apca.com.au Accessed 4 March 2008.

²⁰⁷ *Id*, Participating membership webpage.

²⁰⁸ Correspondence from Mr Nick Roberts, Senior Manager Payment Policy, RBA.

Other governance concerns that also need to be addressed are those associated with permission for entry into a PCH and formalisation of reporting mechanisms to the SARB.

In South Africa, each existing PCH member has to provide written permission for a new entrant to operate in a payment stream. However, in the UK, for example, in the LINK ATM network, the Chief Executive applies the criteria for entry into the payment stream without referring the decision to existing members. In the view of the Panel, such an approach would benefit the entry of new participants into existing PCHs. We recommend that such an approach is adopted by PASA.

During the course of the Enquiry, it became apparent that the self-regulatory approach of PASA gives it considerable authority in the NPS, and that there is a need for a more regular and formal reporting requirement to its overseer, NPSD. We recommend that such a formalised reporting mechanism be put in place.

7.8.4 Creation of a payment system Ombud

This entity would play the role of an Ombud to payment system participants, or prospective participants. The Ombud could assess whether or not applications have been fairly dealt with and whether or not they have been fairly treated in terms of access and the pricing of such access. Included in the remit of such an Ombud would be the entire ambit of the payment arena, and it would include access to the infrastructure of Bankserv, or the relevant PCH operator, access to settlement accounts, processing of membership of PASA, as well as the processing of PCH applications.

The Enquiry recommends that the Competition Commission, together with the Payment System Ombud, keeps Bankserv's pricing practices under observation – given its current dominant position in the industry.