

South African Banking: Competition and Access

Rural Housing Loan Fund

10th Annual Workshop

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F E A S i b i l i t y

Financial

Economic

Analysis

Strategy

Agenda

- Introduction and background to latest report
- Overview of Findings of *National Payment System and Competition in the Banking Sector* report
- TOR of Banking enquiry
- Role of Submissions

Background

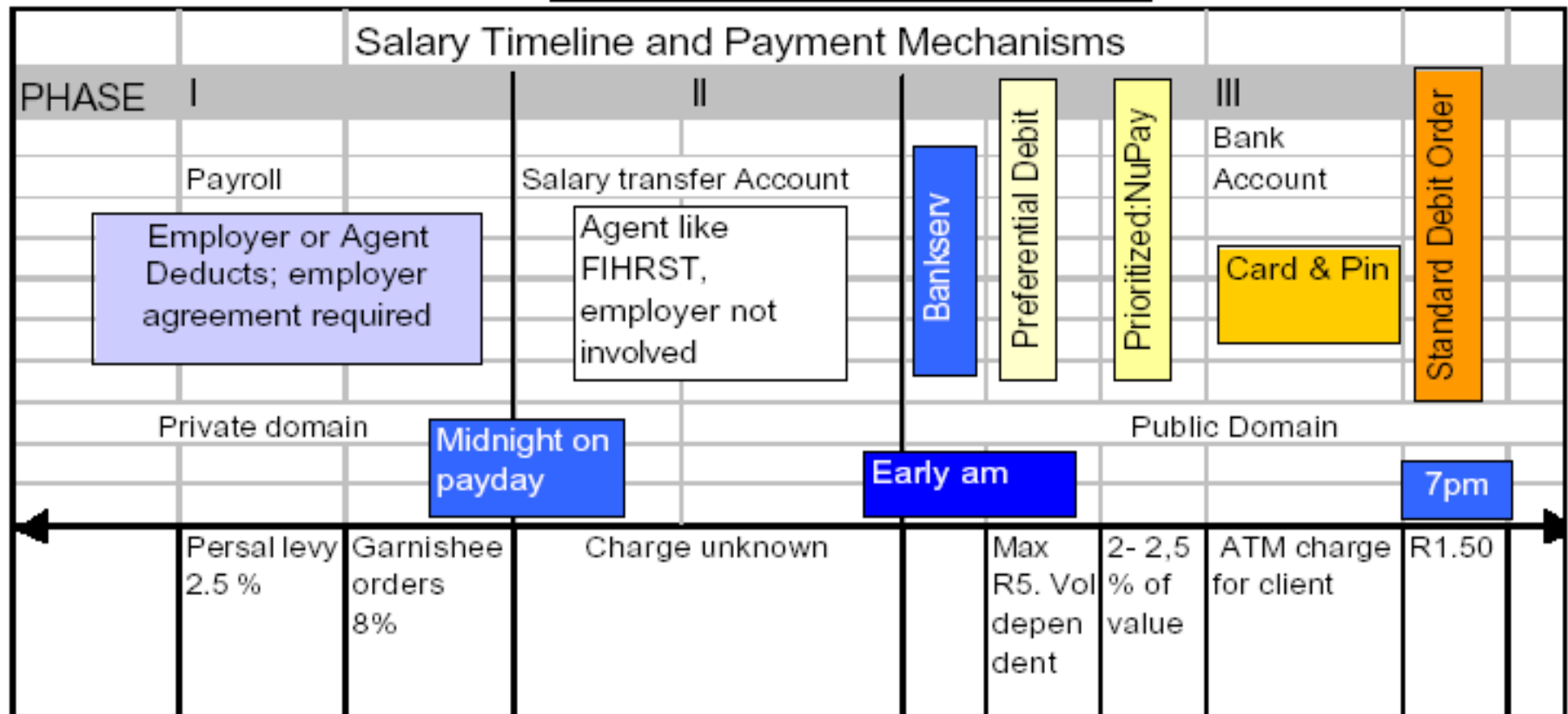
- Credit Law Review Process; including the ***Cost, Volume and Allocation of Credit (2003)***.
- National Treasury and SA Reserve Bank commissioned the Task team report ***Competition in South African Banking (2004)***.
- ***National Payment System and Competition in the Banking Sector***, for the Competition Commission ***(2006)***.

Cost, volumes and allocation of credit

- Factors that contribute to the high cost of credit:
 - Poor access to information and poor sharing of information undermines credit risk assessment
 - Difficulties associated with accessing the payments mechanism; unreliability of the debit order collection mechanism
 - Difficulties in accessing funds

Payment system preferences

Figure 7.2 Payments system timeline



Source: Interpretation of interviews with suppliers

Cost, volumes and allocation of credit

Factors that contribute to high cost of credit:

- Unequal playing fields caused by disparate consumer credit legislation
- Unintended consequences of such legislation
- Distortions created by current legislation, including the Usury Act, its exemption and the Credit Agreements Act, mean that:
 - Some categories of credit provided because of associated profitable products; Opportunities for arbitrage have been fostered; Low returns on some categories lead to limited choice for borrowers; A sense of uncertainty dominates the consumer credit market; Credit providers are encouraged to take a short-term view, leading to an increase in the cost of credit

Cost, volumes and allocation of credit

- Factors that undermine market forces, from the consumer perspective include:
 - Weak disclosure to consumers, which impairs their ability to evaluate comparative rates
 - Bundled and tied products undermine ability of unsophisticated consumer groups to assess costs
 - Inability of individuals to review personal credit records, and difficulties of redress
 - Limited choice and substitutability for some income groups

Competition in South African Banking

□ **Outcomes of Concentration in the Banking sector:**

- High profitability (especially in retail segments).
- Ability to impose increasingly higher fees.
- Incidence of cost falls on low-income customers and small businesses.

Competition in South African Banking

Recommendations:

- Access by second tier banks to the payment system on competitive terms should be facilitated
- Interoperability in the payment system and transparency of access requirements should be extended
- Penalty fees should be on a cost-plus basis and open to regulatory oversight
- Government should prohibit any preferential processing mechanism for payments
- The Commission should investigate the NPS as a complex monopoly.

National Payments System and Competition in banking

Terms of reference:

- Provide a technical description of how NPS operates, the operators and ownership structures of the payment system
- Provide an understanding of the regulation of the system and current and pending changes to the regulations
- Provide an analysis of possible anti-competitive outcomes of the system
- Focus on retail payment system

International Background

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

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

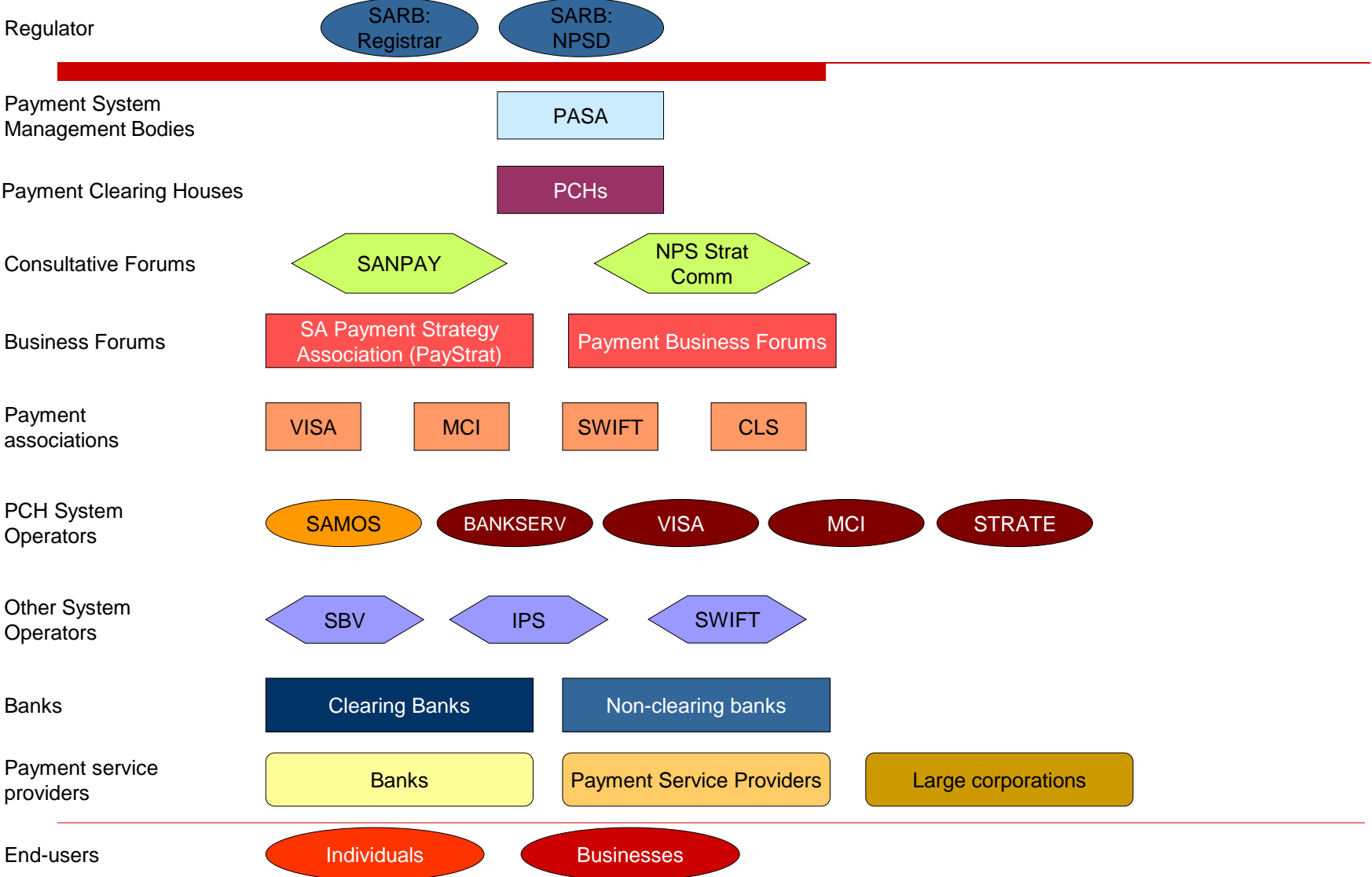
Overview of the NPS

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

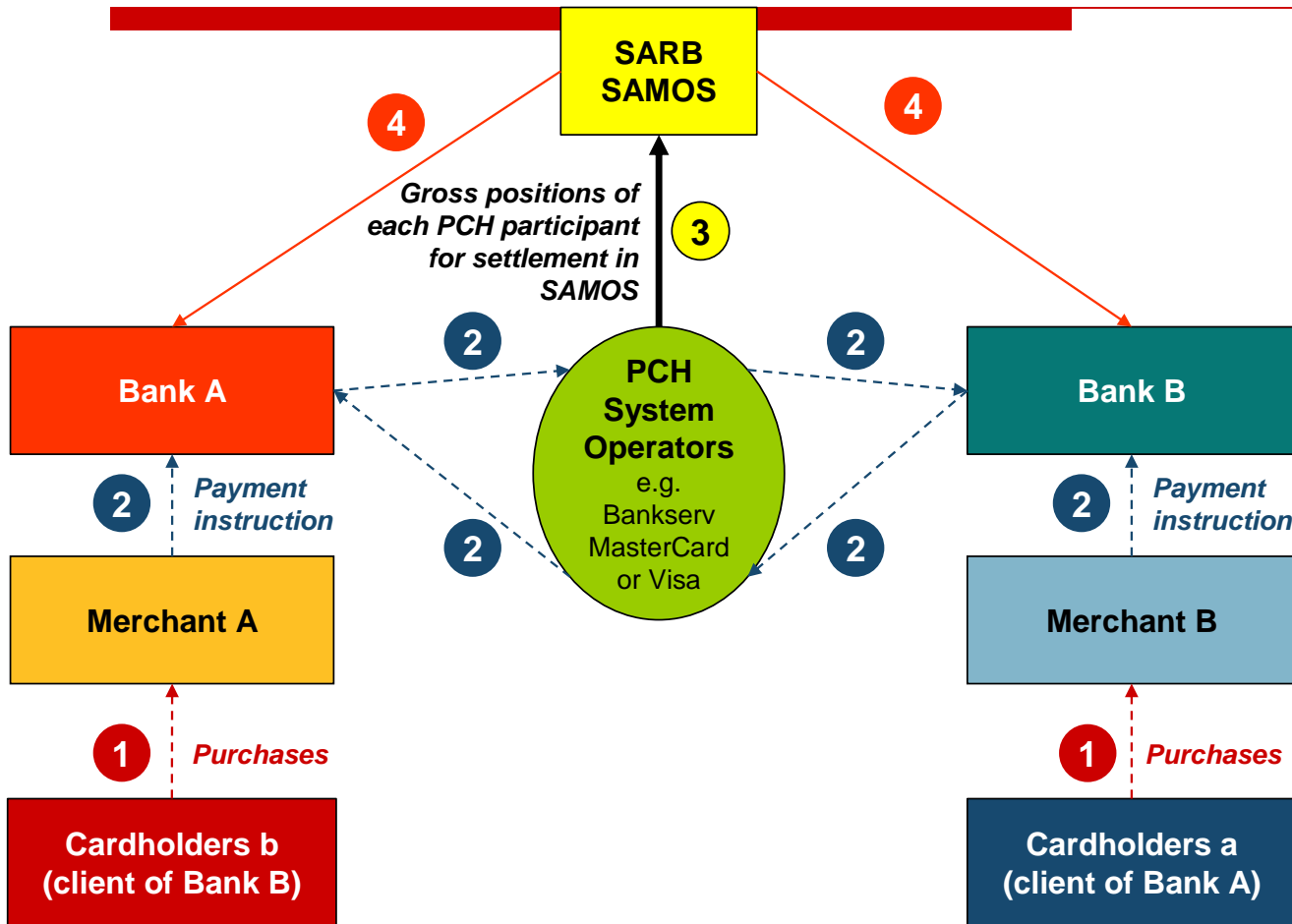
Overview of the NPS

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

SA Payment Landscape



The clearing and settling process



- 1 Cardholders **a** and **b** make purchases though
- 2 merchants **A** and **B**
- Banks **A** and **B** send matching payment instructions to the PCH system operator
- 3 The PCH system operator sends the net position of each PCH member to¹⁵ SARB
- 4

Payment Instruments

- Cash
- Cheques
- Electronic Funds Transfers (EFTs)
 - Debit orders or stop orders
- Debit Cards
- Credit Cards

Finding 1: Cost & Revenue

At present banking industry earns 38% of its revenue (some R 29 billion) from fees.

R26 billion of this is directly from transaction fees. At the same time, any apparent link between discernable operating costs associated with a transaction and bank charges is not transparent.

Number of fee categories:

- PCH System operator or switching fees (eg Bankserv fee)
 - Interchange fee (Paid by one bank for the use of another bank's infrastructure)
 - Merchant fee (Paid by merchant to acquiring bank for processing costs)
 - Customer fee (Paid by consumer to issuing bank)
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- There is little apparent link between the switching cost and the fees customers pay.
 - Bankserv earns around 2% of the revenue generated by the transaction;
 - The bulk of the fees are earned by the acquiring and issuing banks.

Off-U.S. ATM cash-withdrawal

<i>Fee / Cost (based on R100)</i>	<i>From</i>	<i>To</i>	<i>Value</i>
<i>Pin fee / transaction Charge</i>	<i>Consumer</i>	<i>Bank B</i>	<i>R10.00</i>
<i>Interchange</i>	<i>Bank B</i>	<i>Bank A</i>	<i>R3.90</i>
<i>Bankserv</i>	<i>Bank B</i>	<i>Bankserv</i>	<i>R0.13</i>
<i>Total</i>			<i>10.00</i>

<i>Institution</i>	<i>Amount earned from transaction</i>	<i>Share of revenue</i>
<i>Bank A (Acquirer)</i>	<i>R3.90</i>	<i>39%</i>
<i>Bank B (Issuer)</i>	<i>R5.97</i>	<i>60%</i>
<i>Bankserv</i>	<i>R0.13</i>	<i>1%</i>
<i>Total</i>	<i>R10.00</i>	<i>100%</i>

Assumption:

September 2006
ATM Charges: R3.25 + 65 c per R100

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Finding 1: Cost & Revenue

Key concerns:

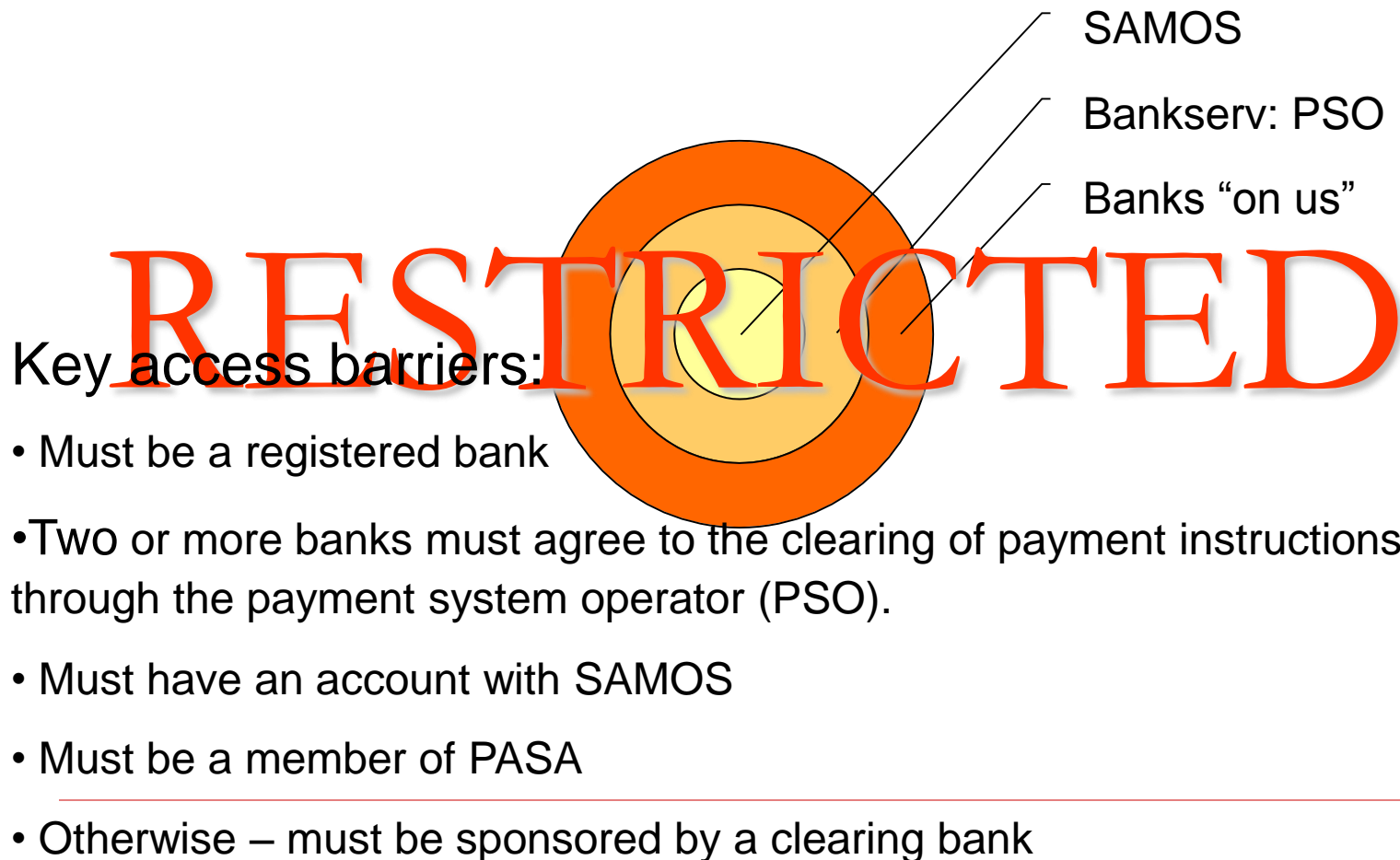
- Little apparent link between costs (such as Bankserv fee) and customer fee
 - But draw this conclusion based on information in public domain; further inquiry might reveal a more nuanced picture
 - The question of whether the level of bank charges is cost-related and competitive or whether it is a pricing consequence of the dominance of the retail banking sector through the account holding of big banks needs further investigation
 - The distribution of income from payment activities appears to be influenced by ownership of acquiring infrastructure. Further consideration is needed on whether interchange benefits large banks
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Finding 2: Access

Not only the banks, but all payment system participants appear to find payment system activity profitable – indeed this might be the motivation for the clamour to gain access. Only SAMOS appears to work on a cost recovery basis.

- Payment systems tend to be viewed as a privileged banking space – role in monetary transmission process, ability to create credit and the fact that they are regulated as deposit takers.
- What is meant by access (by non-banks and would-be banks)?
 - Access to clearing and settlement – the preserve of banks
 - Access to SAMOS system
 - Ability to enable clients to make payment against deposits
 - Access to banks accounts via their own system operator – rather than Bankserv

Payments System: Access to clearing and settlement



Finding 2: Access

□ Key concerns:

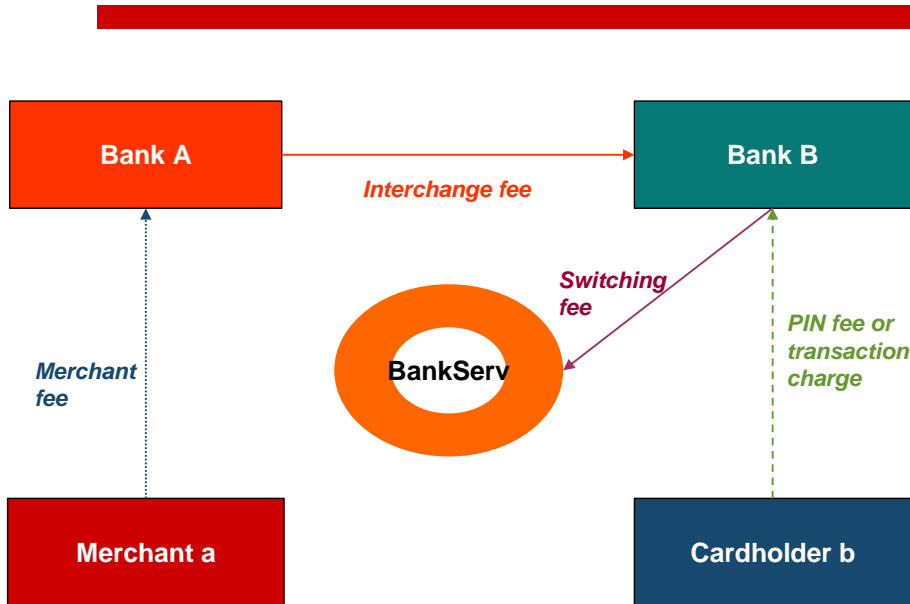
- Absence of rules for Customer Payment Service Providers (CPSPs) – in spite of *Blue book* strategy
- Regulatory gap: high barriers for banks, non-banks can do as they please, as long as that does not include playing in clearing and settlement space
- No PASA equivalent – possibility of extending membership?

Finding 3: Pricing

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

- Traditionally, the banks have set the prices by agreeing between themselves on the appropriate fee to be paid by one bank, when its customer uses another bank's ATM infrastructure, for example. Generally known as interchange, these fees are compensation for using another bank's infrastructure.
- In some jurisdictions these fees have been regarded as very high and indicative of market power rather than cost.
- Further consideration is needed as to whether interchange benefits large banks and the extent to which interchange is justified given technology.

Debit Card Transactions



Cost	From	To	Value (based on R100)
Customer or Pin fee / transaction charge	Consumer	Bank B	R2.33
Interchange	Bank A	Bank B	R0.55
Bankserv/Operator	Bank B	Bankserv	R0.09
Merchant Fee	Merchant	Bank A	R2.50
Total			R4.83

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

Finding 3: Pricing

Key concerns:

- Key to the existing debates around pricing is the role of interchange and merchant fees and how they are determined through negotiation. The relationship between bilateral price negotiation and multilateral price setting needs to be probed.

Finding 4: Control and ownership

Current control and ownership of Bankserv by banks raises the possibility of broader representation on the Board of Bankserv

- Essential infrastructure allows interoperability – key to trust in the system. In SA, both public and private control and ownership:
 - SAMOS – capital expenditure by SARB, cost recovery of operational costs from users
 - Bankserv – Capital expenditure by banks – owned 92,7% by big banks, rest by smaller banks (Dandishelf)
- There are concerns regarding the control of infrastructure giving banks advantages in other market segments
 - International precedent regarding governance of privately owned infrastructure (allowing for greater transparency and oversight)

Finding 4: Control and ownership

□ Key concerns

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

Finding 5: Market conduct

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

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

Charges based on Average Transaction Values

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

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

Finding 5: Market conduct

Key concerns:

- Lack of an independently-funded banking adjudicator to which consumer complaints can be directed has contributed to the apparent consumer resistance to high banking fees.
- In a country where there is evident need to improve the access of under-served consumers to financial services, the absence of these features is likely to be particularly keenly felt.

Finding 6: Non-banks

- NPS legislation and regulation have focused on banks
 - Technology has allowed non-bank providers to offer payment services all over the world, but their ability to do so is affected by the rules for membership in their respective countries as well as the general approach of their regulators.
 - In most countries, non-banks have neither a voice nor a vote in terms of the rules of their participation.
 - The increasing involvement on non-banks may potentially increase risks which could undermine confidence in the system. In some countries, non-bank players have been allowed into the system as a different class of participant
 - In South Africa, there is a wide area of payment activity beyond the clearing and settlement space which remains unregulated. The regulatory gaps remain in spite of the proposed rules in the *Blue book*.
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Findings of the report 6: Non-banks

□ Key concerns:

- Lack of rules governing non-bank participation
- Absence of clear regulatory framework
- Uneven playing fields
- The SA NPS is a highly efficient and sound system and is more advanced than similar networks in more economically developed countries. Patchy opening of the system without appropriate strategy may achieve short term consumer satisfaction, but may not be beneficial to efficiency or welfare in the long run

Terms of Reference

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

The objects of the enquiry

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

Panel and Submissions

- The enquiry is to be conducted for the Commission by a panel, appointed by the Competition Commissioner, consisting of Mr Thabani Jali (Chairperson), Mr Oupa Bodibe, Mrs Hixonia Nyasulu and Mr Rob Petersen SC.
- Closing dates for submissions:
27 October 2006

The End

Thank you!