The profile of retail payment services and models in South Africa

FINMARK TRUST

Making financial markets work for the poor

Focus note 3: The regulatory framework for retail payment services in South Africa

About the focus note series

This is the third in a series of six focus notes based on the full FinMark Trust report titled **The Profile of Retail Payment Services and Models in South Africa: Assessing the potential to increase financial inclusion and market participation,** by Insightworx (Colin Donian; Maire Eltringham). The full report can be downloaded from: **www.finmark.org.za**.

The study aimed to sketch the landscape of retail payment services in South Africa that have a positive impact on financial inclusion and market participation. It also aimed to start to develop a typology of models based on shared characteristics witnessed across various services. The prime inputs to the study were a series of interviews with market participants, desktop research, mystery shopping excursions, as well as feedback received during a stakeholder workshop in March 2011[1]. The models are not *"final"* or cast in stone; rather, they are intended to form the basis for discussion and to identify issues and trends in this market segment.

The focus note series draws out the key findings on a thematic basis. The full list of focus notes are:

- Focus note 1: The SA retail payment services landscape: key findings and issues
- Focus note 2: Towards a common understanding of terms
- Focus note 3: The regulatory framework for retail payment services in South Africa
- Focus note 4: Retail payment system market participation framework
- Focus note 5: The landscape of retail payment services in South Africa
- Focus note 6: Towards retail payment services models in South Africa

This focus note gives an overview of the regulatory regime that governs payment services and the associated rules for market participation, in order to provide a context for the market space in which retail payment services are supplied and used.

The regulatory framework for retail payment services is defined as the laws, regulations, directives and associated rules created by governing authorities and industry bodies that establish the parameters in which payment services take place at any particular time. As experienced in recent years, the rules are not immutable and may change as circumstances such as technology, new business models and global dynamics change.

There are five layers of statutes and associated directives and position papers that cover the well-regulated field of payments, through the national payments system.

1 Please note that the information contained in the notes was current at the time of research, namely February to March 2011, and therefore does not necessarily account for all recent developments in this rapidly changing market

Tier 1: The Constitution of the Republic of South Africa, 1996

At the highest order of the regulatory regime is *The Constitution of the Republic of South Africa, 1996* (Act 108 of 1996) that establishes the Central Bank (the South African Reserve Bank [SARB]) via Section 223, and provides for the South African Reserve Bank's mandate or objective. Its primary object is set out in Section 224(1), which is "...to protect the value of the currency in the interest of balanced and sustainable growth...". Furthermore it is required to perform its functions "...independently, and without fear, favour or prejudice...".[2]

Tier 2: The South African Reserve Bank Amendment Act, 1997

While the Constitution formally establishes and mandates the Central Bank, the SARB existed prior to the new Constitution as the Central Bank under the South African Reserve Bank Act (Act 90 of 1989). The South African Reserve Bank Amendment Act, 1997 (Act 39 of 1997) revised certain responsibilities including "...to further regulate the powers and duties of the said Bank with regard to the establishment, regulation and supervision of, and participation in, **payment,** clearing and settlement systems...".[3]

The Act confers on the Reserve Bank a range of powers and duties, which include those covering the payment system in which retail payment services exist. Connected with the payment system are clearing and settlement systems, without which payments cannot function.

Tier 3: The Banks Act, 1990 as amended

At the third tier of the regulatory structure is the Banks Act, 1990 (Act No. 94 of 1990). There have been a number of amendments to the Act since 1990, but as it stands, its objective is: *To provide for the regulation and supervision of the business of public companies taking deposits from the public; and to provide for matters connected therewith.*

The Act contains a number of definitions that directly impact on the character of payments and are critical to determining what institutions are deemed banks and what the business of a bank is, relative to non-banks. Most importantly, a 'deposit' is defined as follows: "when used as a noun, (it) means an amount of money paid by one person to another person subject to an agreement in terms of which – (a) an equal amount or any part thereof will be conditionally or unconditionally repaid, either by the person to whom the money has been so paid or by any other person, with or without a premium, on demand or at specified or unspecified dates or in circumstances agreed to by or on behalf of the person making the payment and the person receiving it; *et seq*."[4] In the context of payment services, a deposit is part of the business of a bank. In other words, a 'non-bank' cannot accept deposits, unless sponsored by a bank.

Guidance Note G6/08| Cellphone banking

On 7 May 2008 the Registrar of Banks, as an agent of the SARB, issued Guidance Note G6/08 in terms of section 6(5) of the Banks Act, dealing with cellphone banking. The guidance note establishes the following matters pertinent to cellphone banking:

2 http://www.info.gov.za/documents/constitution/1996/a108-96.pdf. 22 January 2011. Bold type-face added.
3 http://www.reservebank.co.za/internet/Publication.nsf/LADV/7DC59462E47AFDDF42256ED60038AE5C/$File/S+A+Reserve+Bank+Act.pdf. 22 February 2011.
4 The Banks Act, 1990. Section 1.

i. A cellphone banking service is covered by Exemption 17 of the Financial Intelligence Centre Act, 2001 (refer the section below dealing with this Act);

ii. A cellphone banking service may be originated via non-face-to-face processes (that is, a person may for example sign on from their mobile phone without in-person contact with the bank), as long as offering banks take adequate steps to verify customer identification (including cross-referencing the prospective client's particulars with third-party databases which include information on the names and identity numbers of persons sourced from the Department of Home Affairs) and provide for enhanced transactional scrutiny of such accounts' activity;

iii. Where non-face-to-face origination applies, transactions and debits from such an account may not exceed R1,000 per day;

iv. If a client's identity was confirmed through a non-face-to-face process and the client wishes to exceed the R1,000 per day limit, face-to-face confirmation of the client's identity will be required in line with the provisions of Exemption 17;

v. Full FICA compliance is required if the client wishes to exceed Exemption 17 parameters; and

vi. Only one such account may be opened per customer.

Guidance Note 6 has facilitated a number of new forms of remote banking.

Tier 4: National Payment System Act, 1998 as amended

The fourth layer in the regulatory configuration is the National Payment System Act, 1998 (No. 78 of 1998). The objective of the NPS Act (NPSA) is "To provide for the management, administration, operation, regulation and supervision of **payment,** clearing and settlement systems in the Republic of South Africa; and to provide for connected matters."

An amendment to Act 78 of 1998 was enacted as the National Payment System Amendment Act, 2004 (Act No. 22 of 2004) and a further amendment in the Financial Services Laws General Amendment Act (Act 22 of 2008). The objectives of the amended act (2004) were to essentially provide for four changes to the original Act. The changes relevant to the report are; (i) the withdrawal of recognition of a **payment system management body,** (ii) the enablement of **payments to third persons,** and (iii) provision for the issuance of directives by the South African Reserve Bank.

The NPS Amendment Act may be considered the 'operational handbook' guiding retail payment services matters. The Act sets out definitions that are important to an understanding of the key terms associated with the payment system and payment services. Section 1 of the Act defines, amongst others, system participants (see Focus Note 4 for an overview of market participants).

A payment system management body[5]

The establishment and functioning of a 'payment system management body' is set out in Section 3 of the Act. Essentially this entity, the Payment Association of South Africa (PASA), is an extension of the **administrative role and responsibilities** of the SARB. Policy and strategy are uniquely the domain of the SARB. In practice PASA existed prior to the amended Act, but it is fundamentally the same body that is re-established to manage the operational side of payment services on behalf of the SARB, and for its members. PASA, as a 'recognised payment system management body', came into being on 15 August 2006.[6]

The object of the 'payment system management body' – in this instance PASA - is to organise, manage and regulate participants (members) in the payment system. The body so established is required to be equitable in its admission of members, to represent all its members fairly and act transparently in its decisions. PASA comes into existence through the SARB, is beholden to it in its functioning and may have recognition withdrawn if it fails to act in terms of its mandate. While the NPS Department of the SARB has final oversight responsibility of the NPS, it has delegated selected powers of 'self-regulation' to PASA, who in turn have been mandated to 'organise, manage and regulate' members with regard to payment matters.

PASA membership includes the SARB, banks (both local and foreign branches) and designated entities as may be approved by PASA and the SARB. Such approved entities may be granted only limited membership. All payment service providers must either be a first-line or primary member (this is the case for all settlement or clearing banks) or must be sponsored, mentored, or an agency member supported by a first-line member (this can be the case for banks and non-banks)[7]. At the time of drafting the report, PASA listed 25 member (clearing) banks, with only the South African public sector bank, the Postbank, a non-clearing member[8].

Who may provide payment services?

The prime prerequisite for a payment service provider is that such an entity must either be a bank, or sponsored by a bank. There is one exception whereby non-banks may participate without bank sponsorship: Section 7 of the NPS Act establishes that non-banks may participate as third party payment providers in the NPS if payments are 'due' to a third party and such payments are not deposits. The only means by which a non-bank is able to engage in payments that are 'not-due' is to have bank sponsorship, as is the case with retailers and telecommunications that are enabled to conduct person-to-person money transfers. The sponsoring bank and the third party payment provider have to apply to the SARB for authorisation to conduct such business. In September 2007 SARB issued two directives (discussed below) to lay down minimum criteria that should be applied by such non-bank participants[9].

Retention of records

The NPS Act (section 13) requires participants in the payment system to retain records for a period of five years. This is a compliance requirement that incurs costs for the payment service provider. Where service providers use costly paper-based recording and storage systems, and the entity applies fully-absorbed accounting principles, the costs are likely to drive up

5 For a full explanation of the role of the Payment System Management Body (PASA) vis-à-vis the National Payment System Department within the SARB, see the June 2011 SARB paper NPS 02/2011 titled "Position paper on access to the national payment system". Available at: http://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Legal/Documents/Position%20Paper/PP2011_02.pdf
6 Refer the PASA Constitution at http://www.pasa.org.za/Documents/PASA%20Constitution.pdf.
7 South African Reserve Bank. National Payment System Department. *Position Paper – Bank Models in the National Payment System.* Position Paper number 01/2007. Date: 2007-06-01.
8 Refer Annexure 5 for an overview of PASA membership as at September 2010
9 SARB. *Oversight of the South African National Payment System.* ISBN (print): 978-0-9814465-2-3 (No date).

materially the cost-to-client of the service. For low value-high volume and concomitant low-risk transactions compliance costs can be debilitating for commercial business models.

However, Section 13(3)[10] allows electronic retention of records as envisaged under Section 16 of the Electronic Communications and Transactions Act (25 of 2002)[11]. In instances where electronic recording and retention of information are used, the operational cost-burden is likely to be lower.

Directive No. 1 of 2007

Directive for Conduct within the National Payment System in Respect of Payments to Third Persons

On 6 September 2007 the SARB published Directive No. 1 that deals with so-called third party payment providers. The Directive sets the conditions for non-banks facilitating 'payments due' as permitted under Section 7 of the NPS Act as discussed above. It allows for two types of third party payment providers, namely:

- The first is where an entity (called *a beneficiary service provider or BSP*) acts on behalf of another party, as intermediary, to collect payments from multiple payers on behalf of the service provider on the basis of some obligation that the payer has to the service provider. An example of a beneficiary service provider is a retail chain that collects payments for utility bills or traffic violation fines. The structure is 'many payers (obligators) to one beneficiary'.

- The second category of payment service providers is where an entity (called *a payer service provider or PSP*) acts on behalf of another party, as intermediary, to make payments to multiple recipients or beneficiaries on the basis of some obligation between payer and beneficiary. An example of a payer service provider would be payroll processing – a single employer pays its multiple employees through a so-called PSP. The structure is 'one payer to many beneficiaries'.

Both categories of agents are required to abide by rules similar to what applies to a bank on the keeping and retaining of payments (transaction) records. In instances where the agent also provides systems operator services, the internal business entities must be kept separate. Also, systems and processes may not 'introduce risk' into the NPS and the entities' banker must be informed of its third party payments business. The bank, in turn, must inform PASA, which must be in a position to supply such information to the SARB.

At the time of writing, there were 57 third party payment providers listed on the PASA site[12].

10 *(3) The retention of records in terms of subsection (1) may be effected as envisaged in section 16 of the Electronic Communications and Transactions Act, 2002 (Act No. 25 of 2002).*

11 Electronic Communications and Transactions Act, Section 16.
(1) Where a law requires information to be retained, that requirement is met by retaining such information in the form of a data message, if—
(a) the information contained in the data message is accessible so as to be usable for subsequent reference;
(b) the data message is in the format in which it was generated, sent or received, or in a format which can be demonstrated to represent accurately the information generated, sent or received; and
(c) the origin and destination of that data message and the date and time it was sent or received can be determined.
(2) The obligation to retain information as contemplated in subsection (1) does not extend to any information the sole purpose of which is to enable the message to be sent or received.

12 http://authorisation.pasa.org.za/Reports.aspx. 17 April 2011.

Directive No. 2 of 2007

Directive for Conduct within the National Payment System in Respect of System Operators

Directive 2, also issued by the SARB in 2007, deals with the conduct of *'system operators'* (SO) in the NPS.

A systems operator is defined in the NPS Act as an entity that 'provides payment instructions' (acts as an intermediary for the receipt and/or delivery of payment instructions) for a bank or payment clearing house (PCH) system operator. The SO acts as an intermediary on behalf of a range of institutions, including banks, beneficiary service providers, payer service providers and clients of banks. An example of a SO is Altech Card Solutions that "provides systems services across six payment streams, namely, ATM, AEDO, NAEDO, Credit Card, Debit Card and EFT Credit". Others such as Profile Software International (Pty) Limited provide a service for a single payment stream, namely, EFT Credit. There are 65 system operators listed on the PASA site[13].

As is the case for beneficiary service providers and payer service providers, systems operators need to operate within a set of rules. Systems operators are required to comply with the rules established by PASA, including the need for written agreements between the systems operator and its clients, keeping service information confidential and making payments into and out of its client's bank account/s on its instructions. The same business separation and record keeping rules apply as in Directive No. 1. An additional rule is that no offsetting of mutual obligations between multiple clients may be made.

Tier 5: The Financial Intelligence Centre Act, 2001

The first four tiers of the regulatory regime govern the supply-side. The fifth tier of the regulatory regime, namely the so-called know your client (KYC) requirements of the Financial Intelligence Centre Act, is the one perhaps most tangible to customers themselves.

The Financial Intelligence Centre Act (Act 38 of 2001) (FICA), which came into effect on 1 July 2003, requires users of payment services to provide personal information before certain services may be used. There are also supply-side requirements, such as the collection of client data and the safe-keeping thereof. The Act provides for the establishment of an anti-money laundering regulatory body and various processes aimed at preventing money laundering. It enforces compliance on institutions that might be exploited for money laundering purposes due to the nature of their business.

Accountable institutions

The Act includes Banks as 'accountable institutions'[14]. Should it make money transfers (regarded as deposits), a non-bank sponsored by a bank will also be regarded as an accountable institution.

Part 1 of the Act sets out the duty for all accountable institutions to identify clients. An accountable institution must establish and verify the identity of a prospective client before it may engage in a business relationship with the client. A number of identification obligations apply, which include:

i. Identifying all customers against some official identification document. This is to happen at the commencement of a business relationship;Part 4 of FICA requires accountable institutions to implement internal measures to promote compliance with the need to identify and verify clients' identity, record keeping and reporting procedures;
ii. Seeking to ascertain the permanent residential address of the customer, via some formal document that validates such address;

13 *Ibid.*
14 In most cases where legal references are made to 'banks' such references generally include 'mutual banks' and the state-owned Postbank and any other exempt entity.

iii. Verifying all information gathered in the identification process;

The compliance requirement exists even for a 'single', non-account based transaction. This impacts directly on, for instance, a cash-to-cash transfer.

Recordkeeping requirements

Part 2 of the Act goes hand in hand with the first requirement in that the information obtained in terms of Part 1 and any other business information relating to the transaction (payment or transfer) must be retained and kept for a period of five years from the date of transaction. Such records may be kept by third parties and also stored in electronic format. These compliance requirements have both direct and indirect cost implications for the service provider and customer.

Part 4 of FICA requires accountable institutions to implement internal measures to promote compliance with the need to identify and verify clients' identity, recordkeeping and reporting procedures.

FICA was amended by the *Financial Intelligence Centre Amendment Act, 2008*. There appears to be no material change to the key elements that have a bearing on retail payment services matters as set out in the original Act.

FICA: Exemption 17

On 1 November 2004 the Minister of Finance promulgated an exemption in terms of FICA that repealed the original exemption 17 of the Act and replaced it with an amended Exemption 17, which currently applies.

The essential thrust of Exemption 17 is to adjust the intensity of compliance for both service provider and consumer in instances where risks are deemed to be lower (associated with lower transaction sizes and volumes). A second tier of compliance is created that aligns compliance requirements with lower risk.

The primary driver for the amendment came via the banking industry that was involved in the design of the 'national bank account'[15], in compliance with the emerging Financial Sector Charter (FSC). One of the material drivers of costs on the supply-side was banks' compliance with 'full' FICA requirements. The banking industry argued that by amending compliance requirements for entry-level banking products, the cost-to-customer would be lower and thus more affordable. In addition, millions of aspirant customers in practice simply cannot verify formal addresses and would therefore be excluded from the financial sector. A core objective of the FSC was to improve access to formal retail financial services. Thus, Exemption 17 was a step in this direction.

Exemption 17 exempts accountable institutions from the requirement for verifying the identity of customers against proof of address. A person's identity still needs to be established via a green bar-coded South African identity book and recordkeeping is still required, but no proof of residence is required as verification of identity. This concession is subject to certain **transaction parameters** being met on a qualifying service or product (defined as a single or ongoing arrangement between service provider and customer):

- A withdrawal, transfer or payment may not exceed R5,000 per day or R25,000 per monthly cycle;
- No cross-border payments or transfers may be made from South Africa, unless it is a point of sale purchase or withdrawal in the Rand Common Monetary Area (CMA);

15 The Mzansi bank account was intended as a collaborative offering in which the Big Four commercial banks – Absa, Standard Bank, Nedbank and FNB – and the Postbank would share risk, costs and infrastructure. Mzansi is a low cost, easy to use transactional account. Additional defining features are free debit cards, no monthly administration fees, minimum opening and on-going balances, a flat fee for withdrawals from the client's bank or any other participating bank, the option to make withdrawals and deposits at Post Office counters. Source: http://www.finmark.org.za/search/search.aspx?SearchTerm=mzansi

- If the service includes an account structure (e.g., a deposit account), the balance may not exceed R25, 000 at any time; and
- Only one such service (account) per person may be held at any one institution at a time.

As discussed in the Tier 3 discussion above, Guidance Note G06/08 (as a supplement to the Banks Act), further enhances the lower regulatory requirement of Exemption 17 in cases where non face-to-face services are established and transactions conducted on mobile phones.

Government Regulation No. R. 454 – Exemption in Terms of FICA, 2001 (pre-paid instrument exemption)

On 28 May 2010, a further exemption in terms of FICA was issued by the Minister of Finance. It deals with a 'prepaid instrument', which is defined as "an instrument that functions as an electronic surrogate for coins and banknotes, representing a claim on the issuer, which is stored on an electronic device such as a chip card or computer memory and which is accepted as a means of payment by persons other than the issuer". This could for example include prepaid cards used as payment for public transport.

The definition of a prepaid instrument contained in Regulation 454 entails electronic money or 'e-money', as defined by the SARB[16]. The exemption has the following parameters:

i. Banks are the focus of the exemption;
ii. Exempt 'accountable institutions' are exempt from (a) obtaining personal information, and (b) verification of that information; and
iii. The keeping of records as pertaining to (ii) above.

The profile of the 'instrument' must subscribe to the following parameters:

i. Individual transactions may not exceed a value of R200;
ii. The available balance of the instrument may not exceed R1,500 at any time;
iii. The turn-over or through-put of the instrument may not exceed R3,000 in a monthly cycle;
iv. It may not perform cross-border transactions;
v. Only so-called on-line systems that require PIN authentication may be used for reloading or topping up the instrument; and
vi. Remittances, cash withdrawal or cash-back (as part of a purchase) are not permitted.

Obligations are also placed on providers (issuers) of such instruments, which include:

i. The implementation of enhanced tracking measures that will effectively identify transactions that may possibly contravene the Act;
ii. The establishment and verification of the identity of any third party that issues the instrument on its behalf; and
iii. The implementation of similarly enhanced tracking measures for the third party issuer, which will effectively identify transactions that may possibly contravene the Act.

16 SARB. Position paper on e-money. Op cit. "...monetary value represented by a claim on the issuer. This money is stored electronically and issued on receipt of funds, is generally accepted as a means of payment by persons other than the issuer and is redeemable for physical cash or a deposit into a bank account from the issuer on demand".

The objective of this Exemption is to provide for a variety of electronic payment instruments, particularly mobile handset payments, but would include near field communication (NFC) devices too, whether loaded on a handset or a card.

FICA and its exemptions: Impact on payments

In the authors' view, the above tiered compliance structure finds a suitable balance between risk and compliance relative to the transaction size and volume needs of the typical entry-level customer. It enables the deployment of novel services using newly harnessed technology, such as mobile handsets, smartcards or NFC devices. In this way, the regulatory adjustments facilitate services more fitting to the needs of aspirant financial participants and allow for transaction costs to be lowered materially.

Nevertheless, there is a view in the market place that compliance is still an inhibitor to product development and meeting of customer needs. This relates particularly to the legal interpretation of certain compliance requirements, which are not interpreted in a standard manner amongst participants (for example, some deem it necessary to make paper copies of ID books; for others a photo of the ID taken by mobile phone suffices). There seems to be need for even greater clarity on exactly what is permitted and in what way.

RICA: Impact on Financial Services?

The Regulation of Interception of Communications and Provision of Communication-related Information Act, 2002 (RICA) requires SIM card registration, which entails the need for all SIM card owners to essentially provide the same information set as is needed for accessing financial services. Suppliers of cellular services are required to collect the information, store such data and be in a position to retrieve it for evidential purposes.

There is a further requirement placed on users (and owners) of mobile phones, that in the event of a loss of a cellular phone or SIM card, such loss must be reported to the South African Police Service.

It seems that the drafters of RICA took note of the FICA requirements. However, the requirements are not fully aligned and further differences are introduced by the actual RICA processes that are followed by RICA agents. These differences, coupled with questions regarding the reliability, integrity and currency of the data will make it difficult for banks that offer mobile banking services to leverage off the RICA data. The most unfortunate result of the introduction of RICA is, however, the fact that the face-to-face identification and verification requirements under RICA undermine the non-face-to-face account origination model that the South African Reserve Bank introduced for low value mobile banking (Guidance note 6/08) (De Koker, 2010)[17].

17 For a full overview of the interplay between RICA and FICA and the potential impact of RICA on mobile financial services, see De Koker, L., 2010. Will RICA's customer identification data meet anti-money laundering requirements and facilitate the development of transformational mobile banking in South Africa? An exploratory note. Available at: www.finmark.org.za. Paragraph in text quoted directly.

In summary

The regulatory regime governing the financial system is a critical element in the retail payments services market. It is the view of the authors that the South African Reserve Bank, the custodian of banking and national payments regulation, is set to maintain the appropriate level of risk management, while being sensitive to market dynamics and responding thereto over time – in a way that allows innovation and improved supply-side responses to entry-level needs. This is seen at three levels:

- **Expanding playing field.** Though the national payment system is still bank-driven, non-bank parties are allowed to participate formally in the payment system as third party payment providers. Others operate with bank sponsorship or partnerships, in practice fulfilling a leading role.
- **Risk-based KYC.** Three layers of KYC compliance requirements are allowed, depending on the weight of the risk that is likely to arise.
- **Allowing innovation.** The South African Reserve Bank's formal recognition of e-money, mobile banking (including the scope for non-face-to-face origination) and prepaid instruments are powerful signposts of the convergence between mobile phones, telecommunications infrastructure, retailer infrastructure and financial services. Such recognition tends to follow market pressure, which is the first signal that market dynamics are changing.

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