The profile of retail payment services and models in South Africa

Making financial markets work for the poor

Focus note 4: Retail payment system market participation framework

About the focus note series

This is the fourth 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:

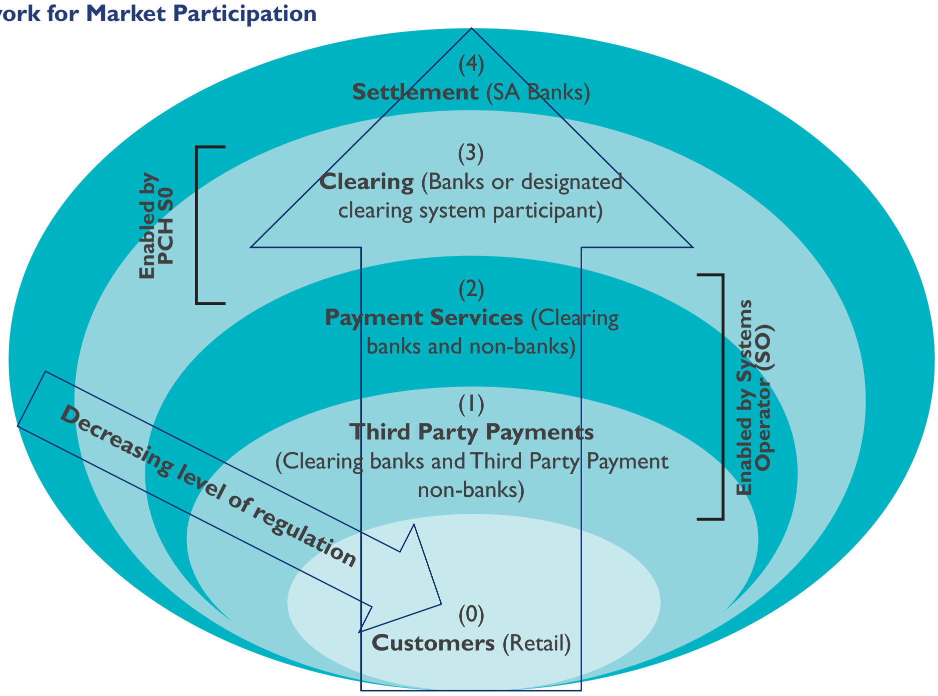
- Focus note 1: The SA retail payment services landscape: key findings and issues
- Focus note 2: Towards a common understanding of terms
- Focus note 3: The regulatory framework for retail payment services in South Africa
- Focus note 4: Retail payment system market participation framework
- Focus note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

Focus note 3 provided an overview of the regulatory framework pertaining to payment systems in South Africa. The regulatory framework also sets the framework for market participation. Essentially, the purpose of financial sector regulation is to manage the inherent risks that are contained in the nature and reach of this sector. Filtering and managing market participation in the national payment system is one element of risk mitigation.

At an aggregated level, payment system participation is established through various categories of intermediating services, defined by the National Payment System Act, and given expression by the Payment Association of South Africa (PASA). Refer to *Figure 1* overleaf that describes the four layers of market participants permitted by regulation:

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

Figure 1: Framework for Market Participation



Source. http://www.pasa.org.za/nps_key.html. Adjustments made by IX.[2]

The starting point (layer "0") is the customer. The layers have been organised in terms of how close they are to the customer experience, i.e. how directly clients deal with players. As the layers progress, regulation increases[3].

Underlying the layers, are two categories of "enabling entities", namely systems operators (SO) and payments clearing house system operators (PCH-SO):

- SO. The NPS Act defines a systems operator as an entity that 'provides payment instructions' by providing the electronic capability for the receipt and/or delivery of payment instructions between two or more entities. The SO therefore acts as an "electronic enablement intermediary" on behalf of a range of institutions across layers 1 and 2, including banks, beneficiary service providers, payer service providers and clients of banks. There are currently 65 system operators listed on the PASA membership list[4], including for example Altech Card Solutions, EasyPay (Pty) Ltd and Tutuka Software (Pty) Ltd. The Association of System Operators seeks to look after the interest of SOs. It currently has 26 members[5].

- PCH-SO. Payment clearing house system operators (PCH-SO), of which there are four, conduct clearing operations on behalf of bank and designated clearing system participants (that may be non-banks). They are therefore systems operators at the *clearing level* and facilitate electronic enablement across layers 3 and 4. Below, we give a brief description of each layer of market participants as well as the underlying enabling entities:

2 The original illustration has the five layers as set out above reversed; i.e., 'Settlement Participants (Banks)' is at the centre, as item 1 and 'Customers' as item 5. The original configuration also represents the order of regulatory intervention, the highest at the core and decreasing outwards. The amended configuration establishes the customer at the core, and the highest intensity of regulation at the outer rim.
3 http://www.pasa.org.za/more_nps_keyroleplayers.html. 16 February 2011. The following descriptive section is largely based on the material sourced from PASA.
4 http://authorisation.pasa.org.za/Reports.aspx. 9 March 2011.
5 The Association of System Operators (ASO): http://www.aso.org.za/index.php. 9 March 2011.

Layer 1: Third Party Payments (by banks and non-banks)

Layer 1 is the inner layer that most directly touches the customers and represents typical points at which a customer would initiate a payment instruction to pay a person or business (a beneficiary) for goods or services delivered. Until recently, banks were the only recognised players at Layer 1. Non-bank's participation as third party payment providers (TPPPs) was formalised via SARB Directive 1 in 2007. Non-banks may participate as third party payment providers if payments are 'due' to a third party and such payments are not deposits. As stated in Focus note 3, two types of TPPPs have been catered for, namely, (i) beneficiary service providers (BSP) and (ii) payer service providers (PSP). There are currently 57 BSPs and PSPs approved by PASA[6]:

- **Beneficiary service providers (BSP)** act 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. The vast majority of BSPs are sponsored by one of the major full service banks, such as ABSA and First Rand Bank. Examples of BSPs include Pick 'n Pay Retailers (Pty) Limited, EasyPay (Pty) Limited and Shoprite Checkers (Pty) Ltd. These are the typical 'many-to-one' payment intermediaries that collect utility bill payments for example, from many payers and transfer to one beneficiary;

- **Payer service providers (PSP)** act 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. Examples of PSPs include ACB Link (Pty) Ltd, DMC Debt Management (Pty) Ltd and Profile Software International (Pty) Ltd. These are the 'one to many' payment intermediaries that process, for example, salaries from an employer to multiple employees

In terms of regulatory requirements for the players in Layer 1, non-banks do not require a sponsoring bank to operate at this level, as they are not taking 'deposits', i.e. payments that may be returned to cash. These transactions are payments against an existing obligation from the customer.

Layer 2: Payment services (Clearing banks and non-banks)

The second layer provides for payment services, either by clearing banks or non-banks sponsored by a clearing bank, and include, amongst others, money transfer transactions, debit and credit card transactions (EFT[7] switching). These transactions can be processed either by a bank, or by a non-bank system operator that is processing the transactions under the sponsorship of a bank. The bank is required to hold the deposited funds and ensure the necessary compliance of the parties concerned in the processing of the transactions.

In summary, the difference between Layer 1 and 2 hinges on the nature and regulatory enablement of the non-bank entities – in Layer 2 non-banks are required to be sponsored by a bank as the transactions amount to deposit-taking.

6 http://authorisation.pasa.org.za/Reports.aspx. 9 March 2011.
7 Electronic funds transfer

Layer 3: Clearing (bank or designated clearing system participants)

Clearing is the second highest regulated activity in the payments system. The National Payment System defines clearing as "the physical exchange of payment instructions between the payer's bank and the payee's bank (or their agents)[8]". PASA defines clearing as "the process of transmitting, reconciling and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement."

Only clearing participants may operate in the clearing network. Traditionally, only banks were allowed here, but as the payment system developed and became more sophisticated, the Reserve Bank re-evaluated its participation criteria and more non-banks began to participate as 'designated clearing system participants'[9]. Clearing participants must be members of PASA and at least one payment clearing house. There are currently 11 PCHs[10].

Unlike the first two layers where processing of instructions or enablement can be facilitated via system operators, clearing of payment instructions amongst participants in layer 3 is achieved through PCH system operators (PCH-SOs). There are four authorised PCH-SOs, namely, BankservAfrica, STRATE Limited, and the two card associations, Visa and MasterCard.

Payment instructions are sent to the PCH-SOs via the various retail and securities payment networks. It is at the PCH-SO that the actual clearing process takes place – payment instructions are sorted and settlement obligations for the various participants are determined. These obligations are then introduced into the settlement network, where settlement can be effected by the Bank[11].

Settlement of clearing obligations is achieved either directly if the participant is also a settlement participant or via a settlement bank sponsorship (refer below for explanation of settlement).

Layer 4: Settlement (banks and non-banks)

Layer 4 represents the introduction of interbank payment obligations that arise in the individual payment streams into the settlement network[12]. The BIS describes settlement as the "act that discharges obligations in respect of funds or securities transfers between two or more parties".

Settlement system participants all have a settlement account with the Reserve Bank. Settlement participants are furthermore required to lodge collateral with the Bank, in order to provide sufficient liquidity and to ensure the smooth functioning of the settlement system.

Settlement of payment obligations between participants is achieved through the South African Multiple Option Settlement system (SAMOS), which is owned and operated by the Bank. Currently only South African registered banks can hold settlement accounts. Banks or designated participants who do not have settlement accounts may be sponsored by settlement participants.

8 South African Reserve Bank. 1995. National Payment System Framework and Strategy document.
9 South African Reserve Bank. 2008. Overview of the South African national payment system.
10 http://www.pasa.org.za/more_pchpg.html. 12 March 2011. In the PASA organisational structure there is a reference to "PCH PG's x 13", but in the list of PCHs there are 11.
11 South African Reserve Bank. 2008. *Overview of the South African national payment system.*
12 South African Reserve Bank. 2011. *Position paper on access to the national payment system.*

The settlement process works as follows: if bank A owes bank B R100 million, bank A would initiate the transaction and send a payment instruction via the messaging network to the SAMOS system. Once the bank has received the instruction and established whether bank A has sufficient funds, the money will be transferred form bank A's account to bank B's account within the books of the Bank. The SAMOS system will send a message to both bank A and bank B, respectively confirming that the transfer was successful and notifying that a payment has been made.

Market participation: In conclusion

A country's payment and settlement system is often described as the backbone of its financial system. The default by one participant can possibly have knock-on effects and may, in turn, cause the failure of other participants in the system. A robust payment and settlement system is therefore crucial for financial stability. The recent global financial crisis has reconfirmed how important it is to balance risk with more access and competition in the financial system.

The institutional profile of the payment landscape in South Africa has evolved significantly over the past few years as third party payment providers and system operators started to provide payment services. The designation of non-banks to formally participate in the clearing network has furthermore increased the scope of non-bank players in the payments space. All deposit-taking activity is still limited to a bank or an entity sponsored by a bank.

Non-banks' formal entrance into the clearing network means that they are playing an increasingly important role in the country's systemic environment. Going forward, it will be important for regulators to continuously assess the new ways of accommodating non-bank players in the payment system, but all the while cognisant of the systemic risk implications, making sure that all players are subject to an acceptable level of regulatory control.

8 Refer to the NPS Position Paper No. 02/2006 for collateral arrangements, available online at http://www.reservebank.co.za

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