The Banking Enquiry

Report to the Competition Commissioner by the Enquiry Panel

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Disclaimer:

The Technical Report of the Banking Enquiry does not reflect the views of the Competition Commission or any other Government stakeholder to the Banking Enquiry process. Furthermore, the recommendations of the Enquiry Panel have not been adopted as firm policy decisions by the Commission or Government.

A process will be established which includes the Competition Commission and other Government stakeholders, including National Treasury and Department of Trade and Industry, to form a Government response to the Enquiry recommendations.

Chapter 1

The Enquiry Process

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1.1 Introduction

This is the report of the Panel of the Banking Enquiry which was established by the Competition Commission on the 4th August 2006 in terms of Section 21 of the Competition Act No.89 of 1998 to examine certain aspects of competition in retail banking in South Africa.

In the first chapter of the report, entitled **The Enquiry Process**, an overview of the Enquiry is provided. The chapter deals with certain historical events leading up to the establishment of the Enquiry, the engagements with stakeholders, the various submissions received, the Technical Team engagements and the public hearings and exploratory meetings that were held.

Chapter 2 deals with **Market Power in the Provision of Personal Transaction Accounts.** It examines market structure, barriers to entry and expansion, regulatory requirements and product differentiation in the South African banking sector. The chapter also highlights information asymmetries, switching and search costs as well as the nature of strategic interaction among participants.

In Chapter 3, on **Costing and Pricing**, an analysis of the charging practices of South African banks is undertaken. The relationship between the prices for transactions and the costs of providing them is examined.

In Chapter 4, the Panel examines the issue of **Penalty Fees** confining its analysis to the fees charged by banks to their individual retail customers when a customer's payment order is refused, usually due to a lack of funds. These fees, commonly referred to as "dishonour fees", are charged for rejected cheques, debit orders, and stop orders. The analysis concentrates on the fees charged by the major banks for rejected debit orders, an area where there are clear indications of growing abuse. The amount of revenue of almost R1 billion (of about R11 billion non-interest revenue for personal transaction accounts) that was generated by the big four banks in 2006 from around 24 million dishonoured or rejected transactions is highlighted. In our view, the abuse of debit order dishonour fees needs to be addressed without delay.

In Chapter 5, the issue of **ATMs and Direct Charging** is considered. Issues dealt with include the history and evolution of ATMs; interoperability and the history of interbank carriage fees in South Africa; arguments for the direct charging model and the implications thereof; and revenue and pricing of the current ATM model in South Africa. International precedents and other pricing models are also examined.

Chapter 6 on **Payment Cards and Interchange**, examines payment cards in the South African market; merchant service charges and merchant acquiring; the necessity of interchange fees and the setting thereof; and the card scheme rules governing the payment

card systems. The chapter furthermore considers the potential abuse and the need for regulation of interchange. The application of this is also extended to interchange fees in other payment streams.

Chapter 7 examines **Access to the Payment System**. An historical overview is provided followed by an in-depth analysis of the payment system and the regulation thereof. Certain matters of concern in the payment system are identified. The possibilities for enhancing the access of non-banks and non-clearing banks to the national payment system (NPS) are also explored.

Chapter 8 contains the **Conclusion and Recommendations**, in which particular recommendations identified in each chapter are set out.

At the end of the report, the **Appendices**, a **List of References** and a **Glossary of Terms** is presented.

As this Enquiry has been established against the background of competition law, it is necessary to highlight some of the reasons for the enactment of the Competition Act in South Africa and its purpose as well as the functions of the South African Competition Commission where these may be relevant to this Enquiry.

1.2 The Act and the Commission

The Competition Act 89 of 1998 was enacted in order to provide all South Africans equal opportunity to participate fairly in the national economy; achieve a more effective and efficient economy in South Africa; provide for markets in which consumers have access to, and can freely select, the quality and variety of goods and services they desire; create greater capability and an environment to compete effectively in international markets; restrain particular trade practices which undermine a competitive economy; regulate the transfer of economic ownership in keeping with the public interest*;* establish independent institutions to monitor economic competition; and give effect to the international law obligations of the Republic.[1]

The purpose of the Act is to promote and maintain competition in the Republic in order –

(a) to promote efficiency, adaptability and development of the economy;
(b) to provide consumers with competitive prices and product choices;
(c) to promote employment and advance the social and economic welfare of South Africans;
(d) to expand opportunities for South African participation in world markets and recognise the role of foreign competition in the Republic;

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1 Preamble of the Competition Act.

(e) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and
(f) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons.[2]

Some of the functions of the Competition Commission (hereinafter referred to as the Commission), are:
(i) to implement measures to increase market transparency;
(ii) to implement measures to develop public awareness of the provisions of the Act;
(iii) to investigate and evaluate alleged contraventions of certain listed prohibited practices;
(iv) to refer matters to the Competition Tribunal, and to appear before the Tribunal;
(v) over time to review legislation and public regulations and to report to the Minister concerning any provision that permits uncompetitive behavior. [3]

In addition to these functions the Commission may also:
(vi) report to the Minister on any matter relating to the application of the Act;
(vii) enquire into and report to the Minister on any matter concerning the purposes of the Act;
(viii) perform any other function assigned to it in terms of this or any other Act.[4]

To obtain a better understanding of the establishment of the Enquiry, it is important to sketch some of the events leading up to its launch.

1.3 Historical perspective

1.3.1 The Task Group report

During May 2003, a Task Group[5] was established by the National Treasury to undertake a study on the competitiveness of the South African banking industry. This report entitled *Competition in South African Banking* was released in April 2004. It is not the intention of the Panel to deal in great detail with the Task Group's report save to highlight any recommendations that were made that may be relevant to the subsequent decisions made by the Commission in the establishment of this Enquiry.[6]

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2 Section 2 of the Act.

3 These functions are listed amongst others in Section 21 (1) (*a*) to (l) of the Act.

4 Section 21(2) of the Act.

5 Members of this Task Group were Dr Hans Falkena (Chairman), Mr Gabriel Davel, Dr Penelope Hawkins, Mr David Llewellyn, Mr Christo Luus, Mr Elias Masilela, Mr Geoff Parr, Mr Johnny Pienaar and Mr Henry Shaw.

6 The full recommendations of the Task Group are contained in Chapter 12 of the Task Group Report.

Some of the recommendations made by the Task Group were that:

- 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, charges for essential services or charges for services not open to competition should be on a cost-plus basis and open to regulatory oversight
- Government should prohibit any preferential processing mechanisms for payments
- The Competition Commission should investigate the possibility of a complex monopoly in the governance and operation of the payments system.

Following on these recommendations of the Task Group, the Commission reached a decision that a more comprehensive and comparative study into the issues around the payment system was essential. FEASibility (Pty) Ltd, an economic research company headed by Dr Penelope Hawkins, and Prof Olu Akinboade of UNISA were appointed to provide such a study, with distinct areas of work being specified to each of the parties.[7] This report has become known as the FEASibility Report.

1.3.2 The FEASibility report

The FEASibility Research Report titled *The National Payment System and Competition in the Banking Sector* was completed and handed to the Competition Commissioner during March 2006.

In the Commission's response to the report,[8] which will be dealt with in more detail hereinafter, the Commission stated that the FEASibility report presented a comprehensive analysis of the national payment system (NPS). The Commission went on to say that the report revealed that the South African NPS is a highly efficient and sound system and perhaps more advanced than similar networks in more economically developed countries. But an efficient and sound system may nevertheless lack features which could ensure fairness as far as consumers are concerned.

The FEASibility Report highlighted the following regarding the state of the banking industry at the time of the report:

- The banking industry earned roughly 38 per cent of its revenue from fees related to the payment system. Any link that there might be between the operating costs associated with a payment transaction and the charges made by banks for that

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7 The main body of the report presents the research efforts of FEASibility while the research annex dealing with international comparisons is the work of Prof Akinboade.

8 The Commission's official response is set out in the Press Statement release to the media on the 20 April 2006 which statement is available on the Enquiry's website www.compcom.co.za/banking.

transaction was not transparent. It thus might be the case that bank fees have less to do with the cost of the payment system and more to do with the market power of the big banks in setting fees.

- Not only the clearing banks but also those that participate under the auspices of the clearing banks in the NPS appeared to find their activities in that regard very profitable — indeed this might explain the clamour of others to gain access. Only the SAMOS system[9] within the NPS, operated by the Reserve Bank and limited to participation by registered banks, appeared to work on a cost recovery basis.
- Apart from SAMOS, the pricing arrangements for each payment stream within the NPS fell outside the remit of regulation, and it was believed that in the past these had been negotiated between participants on a multilateral basis. While some smaller players were concerned that bilateral negotiations might place them at a disadvantage as they wielded so little market power, it seemed possible that bilateral negotiations might benefit the consumer. Further inquiry regarding the pricing arrangements in each payment stream seemed to be warranted. There might well be aspects of the NPS where uniform pricing could give way to competitive pricing without compromising the soundness or efficiency of the system.
- The banks operated a switching arrangement between themselves called Bankserv. Although Bankserv costs made up only a fraction of the price of a payment transaction, the current profitability of Bankserv and the control and ownership of this essential infrastructure by the banks raises the question of broader representation on the board of Bankserv. There was international precedent for this.
- There was an absence of market conduct regulation throughout the banking industry and the NPS in particular. There was also an absence of transparency. Disclosed pricing is often difficult to evaluate because of bundled offerings. In a country where there was an obvious need to improve the access of under-served consumers to financial services, the absence of a market conduct regulator was likely to be particularly keenly felt.
- Legislation and regulation have focused on banks. This had left a regulatory gap in terms of the rules of participation for non-banks and highlighted the need for an overall strategy. To the extent that collaborative infrastructure and uniform pricing is necessary for sustaining a sound and efficient NPS for the benefit of consumers, there might also be a need for regulatory oversight.

1.3.3 The Competition Commission's response

For the Commission, the FEASibility Report raised a number of concerns, the main ones being the concerns around access to the payment system by would-be service providers

[9] See Glossary for explanation of the SAMOS system.

(banks and non-banks) and charges levied by banks for payment transactions. Both of these impacted on access to competitive banking services for South African consumers (be they businesses or individuals).[10]

The Commission was furthermore of the opinion that while the FEASibility study provided a detailed understanding of how the system works in general, it did not extend to indicating whether or not actual contraventions of the Competition Act were entailed in the current structure and operation of the national payment system.

Having regard to its responsibilities and powers, the Commission decided to conduct a public Enquiry in order to obtain further information and input about the competition concerns highlighted in the FEASibility report.

In its announcement, the Commission stated that such an Enquiry was to be held in terms of Section 21(1)(*a*) of the Competition Act which gives the Competition Commission the responsibility to implement measures to increase market transparency. Section 21(2)(*b*) empowers the Commission to enquire into and report to the Minister of Trade and Industry on any matter concerning the promotion and maintenance of competition in the Republic.

The Commission invited all interested persons and stakeholders, including the banks, to respond to the FEASibility report and voluntarily to provide detailed information and answers on relevant questions to the Enquiry.

The Commission pointed out that the Enquiry would be on the record, which would be made public subject only to the protection of genuinely confidential information as provided for in the Competition Act. The Commission envisaged that public hearings would be held and that the views of Regulators and other overseeing authorities would also be sought and considered during the course of the Enquiry. The outcome of the process would be a report with recommendations being submitted to the Commissioner.

After this announcement the Commission began to take steps to have the Enquiry established. As it was the first time that the Commission had undertaken an Enquiry of this nature, the Commission looked to other jurisdictions for guidance and assistance.

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[10] See Press Statement released by the Commission on the 20th April 2006.

1.4 Visit to the United Kingdom

In March 2006 a delegation of the Commission visited the offices of the UK Competition Commission and Office of Fair Trading (OFT). The meetings took place over three days from the 21st March 2006 to the 23rd March 2006. Two half days were spent at the OFT and one day at the UK Competition Commission.

The main purpose of the visit by the delegation was to learn more about the approach to similar inquiries that had taken place in the UK and to obtain information as to what was involved in the planning and organisation of such enquiries. The Commission delegation also sought to learn more about what the UK regulatory bodies considered to be the important competition issues in the banking sector which would need to be examined during the Enquiry.

The OFT provided useful information regarding the Payments System Task Team, which had been established following the competition issues that had been identified in the Cruickshank Report.[11] The Task Team consisted of dedicated OFT officials who interacted regularly with officials from the central bank, HM Treasury, and industry through working groups. There are valuable lessons to be learned here on how to establish a representative forum to bring about voluntary compliance with certain recommendations. This approach may prove useful in implementing some of the recommendations arising from the Enquiry Panel's report.

The delegation also held discussions with OFT officials regarding their investigations into interchange fees of four-party payment card schemes.

The meeting with the UK Competition Commission proved to be most beneficial insofar as it informed the conception, planning and organisation of the Banking Enquiry. The UK Competition Commission officials explained the regulatory framework within which the Northern Ireland Banking Inquiry came to be established and what was involved in the establishment of an expert Panel, the secretariat responsible for the administration of the inquiry, and the technical staff from the UK Competition Commission supporting the Panel and inquiry. Although the South African Banking Enquiry was established in terms of a different regulatory framework there were nevertheless many aspects of the UK inquiry that were adopted for purposes of this Enquiry, in particular, the role played by the secretariat in administering the Enquiry and the process of Technical Team engagements with industry participants and other stakeholders.

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11 Cruickshank, D. 2000. Competition in UK Banking: A report to the Chancellor of the Exchequer, UK.

1.5 Infrastructure and personnel

Armed with the information gleaned from the UK visit, the Commission began with the initial steps of establishing the Enquiry. A detailed project plan was drafted setting out the personnel and logistic resources for the Enquiry as well as timeframe targets and the financial resources necessary for the completion of the Enquiry.

Financial constraints dictated that the Enquiry had to be housed in the current Commission offices, but dedicated office space and separate infrastructure were provided for Enquiry personnel.

Although certain Commission staff were seconded to the Enquiry, the Enquiry operated independently and impartially from the Commission.

1.6 Launch of the Enquiry

On the 4th August 2006, the Commissioner officially announced the establishment of the Enquiry and released the document titled *Composition of the Enquiry and Terms of Reference.*[12] This document sets out the Enquiry's Terms of Reference and who the Panel members are. It also deals with submissions and when the Report might be expected. Details of the Enquiry's secretariat and contact details were also provided.

1.6.1 Terms of reference

The Commissioner's statement, *Composition of the Enquiry and Terms of Reference*, is contained in an appendix to this report.

The terms of reference of the Enquiry[13] were as follows:

5. 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.

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[12] For the purposes of convenience this document will be referred to in this report as "The Terms of Reference".

[13] Paragraphs 5 and 6 of the Composition of the Enquiry and Terms of Reference.

6. The objects of this Enquiry are, in connection with the subject matter stated above:

(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 payments 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.

1.7 Enquiry personnel

The Enquiry was conducted by the following Panel appointed by the Competition Commissioner:

- Mr Thabani Jali (Chairperson)
- Mrs Hixonia Nyasulu
- Mr Oupa Bodibe, and
- Adv Rob Petersen SC

The Technical staff that rendered support to the Panel during the course of the Enquiry were:

- Mr Keith Weeks – Head of the Technical Team
- Dr Penelope Hawkins – Expert Consultant
- Miss Jana Louw – Head of Technical and Data Analysis
- Mr Stephen Chisadza – Research Assistant
- Miss Vania Cardoso – Research Assistant
- Mr Vincent Motshwane – Graduate Trainee
- Prof. Chris Torr – Editorial Consultant

The Administrative staff were:

- Mr Charles Frank – Enquiry Manager
- Miss Kamogelo Seleka – Personal Assistant to the Manager

The Enquiry also received assistance from amongst others, the following consultants:

- Mr Keith Smith
- Mr Henry Shaw.

1.8 Enquiry programme

In accordance with the undertaking given at the launch on the 4th August 2006, the Enquiry's Programme of Action and its Guidelines on Submissions were made public on the 22nd August 2006 through a media release and by posting both documents on the Enquiry website.

The Programme of Action informed stakeholders and the South African public in general how the Enquiry process would unfold. The Programme set out the main activities that the Enquiry was likely to be engaged in during its various stages. Timeframes for the completion of the various stages were also included.

The initial Programme provided for five stages and set out the main activities that would take place during each stage.

After amendments, the five stages of the Enquiry programme were:

a) Stage one: August to October 2006
Submissions, analysis and research

b) Stage two: November 2006
First public hearings

c) Stage three: December 2006 to March 2007
Further analysis, engagement and research

d) Stage four: April 2007 to July 2007
Second public hearings

e) Stage five: August 2007 onwards
Analysis and report writing

1.9 Stakeholders and submissions

During Stage one, the Enquiry focused on the following activities:

- Identifying and contacting stakeholders
- Releasing the programme of action and guidelines on submissions
- Introductory meetings with stakeholders
- Receiving submissions.

Each of these areas is briefly discussed below.

1.9.1 Identifying and contacting stakeholders

Once the operating structure had been established, the Enquiry set about compiling a comprehensive stakeholder data base. Stakeholders were divided into the following categories:

(a) banks

(b) card associations

(c) regulators & supervisory authorities

(d) consumer and civil society organisations

(e) retailers

(f) additional stakeholders

After verifying the office bearers of each of such stakeholders, introductory letters were addressed to the following organisations in each of the categories:

(a) Banks

- Absa Bank
- FirstRand Bank[14]
- Nedbank
- Standard Bank
- Investec Bank
- Capitec Bank
- Mercantile Bank
- Teba Bank
- Rennies Bank
- Deutsche Bank
- HSBC Bank
- Standard Chartered Bank
- MEEG Bank
- Ithala Limited[15]

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[14] First Rand Bank includes other bank brands – such as Rand Merchant Bank, Wesbank and First National Bank. This report focuses on the latter, as one of the big four commercial banks.

[15] Even though Ithala Limited is not a registered bank in terms of the Banks Act, it has been included under the list of banks as it is conducting the deposit taking functions of a bank in terms of an exemption from the provisions of the Banks Act granted to it by the Minister of Finance.

- South African Bank of Athens
- Postbank
- Bank of Baroda
- Citibank NA
- Bank of Taiwan
- Sasfin Bank
- Societe Generale
- Imperial Bank
- Albaraka Bank
- Habib Overseas Bank
- State Bank of India
- HBZ Bank
- Commerzbank Aktiengesellschaft
- China Construction Bank
- Bank of China
- ABN AMRO Bank NV
- Marriot Corporate Bank
- Calyon Corporate & Investment Bank
- GBS Mutual Bank
- VBS Mutual Bank

(b) Card associations

- MasterCard International
- Visa International
- Diners Club South Africa
- American Express

(c) Regulators and overseeing authorities

- Ombudsman for Banking Services
- Payment Association of South Africa (PASA)
- Bankserv
- The Bank Supervision Department of the South African Reserve Bank

- The National Payment System Department of the South African Reserve Bank
- The National Treasury
- Ombudsman for Financial Services
- The National Credit Regulator
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(d) Consumer and Civil society organisations

- Financial Sector Campaign Coalition (FSCC)
- South African National Consumer Union (SANCU)
- National Consumer Forum
- Consumer Goods Council of South Africa
- Benchmark Foundation
- Congress of South African Trade Unions (COSATU)
- National Economic Development and Labour Council (NEDLAC)
- Federation of Unions of South Africa (FEDUSA)
- South African Council of Churches (SACC)
- South African Communist Party
- Black Sash
- South African National NGO Coalition (SANGOCO)

(e) Retailers

- South African Retailers Payment Issues Forum (SARPIF)
- Pick ‘n Pay
- Shoprite Checkers

(f) Other stakeholders

- Micro Finance South Africa (MFSA)
- NET 1
- Capital Software
- ATM Solutions
- Direct Transact
- Intecon
- Savings and Credit Co-Operative League of South Africa (SACCOL)

- Protea Finance
- Fundamo
- Rural Housing Loan Fund
- Credit Bureaux
- Freedom of Expression Institute
- Capital Software
- STRATE Limited
- Xpertek Group
- SA Financial Sector Forum
- Micro Enterprise Alliance (MEA)
- Eskom

In letters to each stakeholder, the Panel welcomed the opportunity of an initial meeting with them and encouraged organisations to contact the Enquiry Manager if they were desirous of such a meeting. (See Section 1.9.3). The introductory letter also explained that the main purpose of such meetings was to afford the Panel members the opportunity to introduce themselves and to explain the ambit of the Enquiry and the relevant information that the Enquiry sought from stakeholders.

1.9.2 Guidelines on submissions

Guidelines were issued to assist stakeholders in the preparation of submissions. The guidelines provided directives on length, language, claims of confidentiality, number of copies and deadlines. All first submissions made by stakeholders were to be received by the Enquiry by no later than the 27th October 2006. In the record of the Enquiry, all such submissions are referred to as First submissions, and are referenced accordingly in the report.

After the first set of hearings, the Technical Team requested additional information in the form of questionnaires. These enabled stakeholders to clarify or amplify any portion of submissions previously received (see section 1.9.4). These are referred to as the Second submissions received by the Enquiry (see section 1.11).

1.9.3 Introductory meetings with stakeholders

As soon as the responses were received from the interested stakeholders, the Enquiry commenced with the process of arranging and holding meetings between the Panel and Technical Team and those stakeholders that had requested meetings. The Enquiry also

initiated meetings with those stakeholders that had been identified by the Enquiry as being important in providing information relating to the matters relevant to the terms of reference.

During the course of the Enquiry, a total of 101 engagements and consultations were held by the Enquiry's Technical Team either at the offices of the Banking Enquiry or at the offices of the stakeholders. A complete list of such meetings is attached in the Appendix entitled *Technical Team Engagements*.

As the success of the Enquiry was largely dependent on the voluntary participation of the banks, the main aim of these initial introductory meetings was to gain the co-operation and confidence of banks and to address any concerns or perceptions that may have existed after the announcement of the Enquiry.

At these meetings, the background to the Enquiry was explained as well as the Enquiry's terms of reference. The Enquiry's intended programme of action and its preliminary proposals on the guidelines on submissions were also discussed and the likely areas of focus during the course of the Enquiry highlighted.

The initial stakeholders that the Panel visited were banks, regulators and overseeing authorities. In this regard, Panel members held introductory meetings with:

- Absa Bank
- Nedbank
- FirstRand Bank
- Standard Bank
- The Bank Supervision Department of South African Reserve Bank
- The National Payment System Department of the South African Reserve Bank
- The Banking Association of South Africa
- The Ombudsman for Banking Services
- Bankserv
- The Payments Association of South Africa (PASA)
- Capitec Bank
- Mercantile Bank
- Ithala Limited
- The Bank of Athens
- Standard Chartered Bank
- HSBC

- The Bank of Baroda.

The Enquiry was, however, unsuccessful in arranging meetings with Investec Bank and the Postbank.

Panel members also held meetings with the following card associations and retail organisations:

- MasterCard
- Visa International
- American Express
- South African Retailers Payment Issues Forum (SARPIF)
- Shoprite Checkers
- Pick ‘n Pay.

The Enquiry also attempted to increase awareness of the work of the Enquiry amongst organisations belonging to civil society and consumer groups and held briefing meetings and/or discussions with:

- Nedlac
- Financial Sector Charter Coalition
- South African National Consumer Union
- Benchmark Foundation
- Ethekwini Civic Forum.

To facilitate the interaction and exchange of views, the Enquiry invited consumer and civil society organisations to a briefing workshop which dealt with how the work of the Enquiry impacted on such organisations and their members.

1.9.4 Receiving submissions

During this early period of the Enquiry the Panel and the Technical Team focused their efforts on encouraging stakeholders to participate in the process and to furnish submissions and information to the Enquiry.

During the course of the Enquiry, submissions from the following stakeholders were received by the Enquiry Manager.

(a) Banks

- Absa

- Capitec Bank
- FirstRand Bank
- Ithala Limited
- Mercantile Bank
- Nedbank
- Standard Bank

(b) Card associations

- American Express
- MasterCard
- Visa
-

(c) Retail sector

- Pick 'n Pay
- Shoprite Checkers
- South African Retailers Payment Issues Forum (SARPIF)

(d) Consumer & civil society groups

- Benchmark Foundation
- Black Sash
- Ethekwini Civic Forum
- Financial Sector Charter Coalition
- Savings and Credit Co-Operatives (SACCO)
- South African National Consumer Union
- 1860 Pioneers' Foundation

(e) Overseeing bodies

- Banking Association
- Ombudsman for Banking Services
- The National Credit Regulator

(f) Other submissions

- ATM Solutions

- CIBA (Commercial Independent Bureaux Association)
- Eskom
- Fundamo
- Intecon
- Micro Finance South Africa (MFSA)
- Net1
- Rural Housing Fund
- Wizzit
-

(g) General public

The Enquiry has received 267 submissions or letters from members of the public. Where these raised matters that fall within the jurisdiction of the Ombudsman for Banking Services they should be referred by the Commission to that office.

Many of the submissions from business entities were made under claims of confidentiality in terms of Sections 44, 45 and 45A of the Competition Act. We did not deem it necessary to challenge the confidentiality claims, as they did not impede the Enquiry in its work. The Commission will need to ensure that no confidential information is placed in the public domain.

The submissions are not deal with in any detail in this chapter as they are discussed under the relevant subject headings in subsequent chapters.

The Commission and the Panel have from the outset maintained that the Enquiry would be public and that all submissions (unless covered by claims of confidentiality) would be made available to the public. As many of the submissions had been made under claims of confidentiality, public disclosure of the submissions presented a challenge to the Enquiry. The Enquiry was greatly assisted in surmounting this by many of the banks and card associations who provided the Enquiry with non-confidential versions of their submissions which the Enquiry was able to make available to the public on the Enquiry's website.

On receipt all submissions were briefly analysed by the Enquiry's Technical Team and where necessary the stakeholders making such submissions were asked to verify, clarify and amplify the submissions. Thereafter, in consultation with the Panel selected organisations were then invited to appear before the Panel at the first public hearings.

1.10 First public hearings

During the course of the Enquiry, the Panel held two sets of public hearings, the first being during November 2006 and the second in the period April to July 2007. In total, 21 days of public hearings were held by the Panel during the existence of the Enquiry.

The first public hearings (November 2006) afforded selected stakeholders an opportunity to make public presentations regarding their submissions and organisation. Only parties who had furnished the Enquiry with written submissions by the closing date of the 27th October 2006 (and who had been specifically requested by the Enquiry to appear) were entitled to appear to make oral presentations at these first public hearings. The Panel reserved the right to invite other persons to appear if it considered that their appearance would assist the Enquiry.

In an attempt to increase public awareness and greater participation by the stakeholders in the process, the Enquiry held these first set of public hearings in several cities and as far as was reasonably possible, the Enquiry attempted to arrange venues that were most convenient to stakeholders wishing to make presentations. The Enquiry also reserved the right to expand the hearings to other cities if the number of submission received justified such a decision.

The first hearings were held on the dates and in the cities set out hereafter:

- 1st to 3rd November 2006 - Pretoria
- 9th November 2006 - Pretoria
- 13th November 2006 - Cape Town
- 29th November 2006 - Durban
- 30th November 2006 - Pretoria

To ensure that stakeholders understood the Enquiry's adopted procedure for its first public hearings and to assist stakeholders in presenting their submissions at such hearings, the Enquiry released a further set of guidelines dealing with the first public hearings.

The Guidelines provided for the orderly conduct of the hearings to be held in public. Exceptions to this would only occur if the Panel decided to conduct any portion thereof in private – involving a subject matter in respect of which a claim of confidentiality had been made – or if the Panel considered that such a decision was necessary for the effective conduct of the Enquiry.

The nature of these presentations was such that the invited parties were to provide the Panel with an introduction to the organisation itself and then enlighten the Panel on how they had dealt with or were dealing with the issues that are the subject matter of the Enquiry.

These presentations were to be one hour of duration with parties being expected to summarise and highlight the main thrust of their submissions.

The general rule at the public hearings was that only the Panel members would be entitled to put questions directly to anyone making a submission or presentation and any deviation from this rule would only be allowed if the Panel was of the opinion that compelling reasons existed for doing so.

All proceedings at the hearings were recorded and transcribed and, subject again to the preservation of confidentiality provided for in the Terms of Reference, all transcripts of the hearings were made available on the Enquiry's website as soon as was reasonably possible by the Enquiry Manager.

At the time of these hearings the Panel had not had an opportunity to read the detailed submissions made by the banks and thus the presentations made were not probed in great detail by the Panel at these first hearings. The Panel's interaction with those appearing was mainly intended to clarify and test at a general level the significance and reliability of the presentations made. The Panel made every effort to deal with the substantial merits of the issues with a minimum of legal formalities and thus all proceedings were conducted in an informal manner.

All those appearing before the Panel were, however, entitled to assistance when they presented their submissions and although all the hearings were conducted in English, interpretation services were made available to any party desiring such service.

The first to be given the opportunity to make presentations were the banks and card associations followed by consumer groups and members of the public. As was the case with the banks, only those consumer groups and members of the public who furnished the Enquiry with written submissions were afforded the opportunity to make presentations.

Full details of all the parties that appeared and made presentations at these first public hearings are reflected in the Appendix entitled *November 2006 Hearings Schedule*.

1.11 Further analysis and engagement

After the completion of the first public hearings the focus of the Enquiry shifted from the procedural to the analytical with the Panel and the Technical Team commencing with the task of analysing the submissions made by all parties in greater detail and attempting to identify the main issues of concern from a competition law and policy perspective. A detailed schedule of technical meetings between the Technical Team and the banks, card associations and other identified stakeholders with the aim of obtaining a better understanding of the submissions received was drawn up and followed.

Where the Technical Team was of the opinion that additional information was required, questionnaires were prepared and forwarded to stakeholders to enable them to clarify or amplify any portion of submissions received or any other matter that the Technical Team considered to be in need of such clarification or amplification. Supplementary submissions were also requested.

Stakeholders were also, in one-on-one meetings, requested to clarify any aspect of their presentations and submissions. Stakeholders were also encouraged to make supplementary submissions in response to any issue raised during the course of the Enquiry.

1.12 Second public hearings

Unlike the first public hearings held in November 2006, the second set of public hearings focused mainly on specific subject matters that had been identified by the Enquiry as requiring further airing in public.

The subject matters that the Enquiry had initially identified were:

- ATM charging and related issues
- Payment cards and interchange fees
- Access to the National Payment System
- Market power and the level and structure of bank charges.

The Enquiry extended invitations to specific parties to appear before the Panel and to make brief presentations and answer questions on the specific subject matter being dealt with at the time. Only parties who had been specifically requested by the Enquiry appeared at these second and final hearings. Such parties were given the opportunity to make supplementary submissions on any relevant issue and/or in response to any allegation made by any party whether in a submission or at the first public hearings.

The hearings into each of the subject matters commenced with the Enquiry's Technical Team making a presentation that provided an overview on the subject matter. The Technical Team presentations attempted to identify the main areas of concern in respect of each of the topics and such areas of concern were cross-referenced with submissions, regulations and even academic material on the subject matter.

For the Panel, the greatest challenge surrounding these second hearings was how to deal in a public forum with all the confidential information contained in the original and supplementary submissions. The questionnaires sent out by the Technical Team had requested detailed disclosure of further data and all the major banks had indicated that they would be claiming confidentiality over a large proportion of their responses. The smooth running of the Enquiry would clearly be affected if a disruptive situation arose where the hearing room was being constantly cleared to deal with confidential information and then reconvened and perhaps only to be cleared again.

In addressing this issue, the Panel adopted the approach that the Enquiry was a public process and any stakeholder requesting a deviation from this position had to specifically request that the Panel hear them in a closed session. The Enquiry acknowledges the co-operation received from the parties appearing at these second hearings who in general agreed to the hearings being conducted in public. During the entire hearings process, the public was excluded on one occasion only.[16]

The details of the second hearings were posted on the Enquiry's website and a press statement was released. All the regulatory authorities, including the National Treasury were informed of the hearings and invited to attend. All such hearing were held at the Commission offices in Pretoria on the following days:

- 3rd April 2007 – ATMs and direct charging
- 4th April 2007 – ATMs and direct charging
- 11th April 2007 – ATMs and direct charging
- 17th April 2007 – Payment cards and interchange fees
- 18th April 2007 – Payment cards and interchange fees
- 19th April 2007 – Payment cards and interchange fees
- 25th May 2007 – The National Payment System – Access and regulation
- 28th May 2007 – The National Payment System – Access and regulation
- 29th May 2007 – The National Payment System – Access and regulation
- 5th June 2007 – Payment cards and interchange fees

16 This occurred during the Visa International presentation held on the 18th June 2007.

- 18th June 2007 – Market power and the level and structure of charges
  – Payment cards and interchange fees
- 19th June 2007 – Payment cards and interchange fees
  – The National Payment System – Access and regulation
- 9th July 2007 – Market power and the level and structure of charges
- 17th July 2007 – Market power and the level and structure of charges

Full details of the parties that appeared and made presentations at these second public hearings are reflected in the Appendix entitled *April to July 2007 Hearings Schedule*.

1.13 Exploratory process

One of the objects of the Competition Commission's Banking Enquiry, stated in paragraph 6(c) of its terms of reference, was:

> 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 payments system, there could realistically be improvements in the conditions affecting competition in the relevant markets, including increased access to the national payments infrastructure.

With this in mind, the Enquiry Panel requested the Technical Team to arrange meetings with banks and other relevant stakeholders in order to explore the feasibility and practical implications of certain possible recommendations and/or changes which were mooted in public hearings and which could come to form part of the eventual recommendations of the Panel.

These exploratory meetings focused on three distinct topics:

- A proposed change to direct charging for ATM transactions, and greater access for additional (including non-bank) ATM service providers
- The introduction of an independent, objective and transparent process for determining interchange in all payment streams in which interchange is necessary
- A combination of measures to improve the ability of bank customers not only to compare product offerings and prices, but also to switch providers with the minimum of cost and difficulty. The possible measures to be considered here included the availability of one or more basic banking product bundles.

Participation in the process did not commit any participant to support or endorse any particular change or measure which was mooted for exploration, nor was the process or its topics taken to imply definite findings or recommendations by the Enquiry Panel. It was emphasised that nothing said at those meetings would be considered as being on the record

of the Enquiry, unless specifically advanced and recorded as an on-the-record statement at the instance of, or by agreement with, the participant concerned.

A series of exploratory meetings were arranged on the 15th August, 3rd and 4th September and 30th October 2007. These were attended by representatives of banks, system operators, card schemes, consumer groups and retailers. The process contributed to further understanding of the topics, through both oral debates and working documents for discussion (that remained off the record). The understanding so gained has been drawn upon to varying degrees in this report.

The completion of the exploratory meetings generally marked the end of engagements and interactions by the Panel and Technical Team with stakeholders. The Enquiry team then focussed its attention on the writing of this report.

Having provided an overview of the Enquiry process we deal with the subject of market power in the subsequent chapter. In the Panel's opinion, banks' market power has a bearing on every facet of their operations.

In the following chapters, we make recommendations designed to address issues of market power and consumer protection in retail banking. These recommendations are gathered together in the concluding chapter.

Chapter 2

Market Power in the Provision of Personal Transaction Accounts

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2.1 Introduction and synopsis

2.1.1 Competitive banks… or banking cartel?

Banks maintain that they compete vigorously with each other.[1] Popular suspicion, on the other hand, is that banks are a cartel.[2] Where does the truth lie?

We have come to the conclusion generally that banks in South Africa operate not as a cartel but rather as oligopolists[3] that maximise their profits by avoiding outright price competition where they can[4] (although competing for customers in other ways), and by taking advantage of the degree to which customers, once recruited, become locked in to a particular bank. It is by differentiated product offerings and complicated pricing structures – rather than by combining to fix prices – that banks ensure the high profitability of their services. The cost and trouble involved in switching banks further weakens the competitive effect of price differences where those can be identified by customers, and allows supra-competitive pricing to be maintained.

At the same time, because banking is a closely-knit industry with relatively few players, and because so much of banking revolves round payment transactions, banks are constantly dealing with each other and must get together frequently at a high level to discuss and agree on issues concerning interoperability in the payment system. Banks know a great deal about each other, and are well-placed to shadow each other's business strategies as well as to set rules and conditions collectively favouring themselves. Consumers, as well as would-be competitors, are vulnerable to the effects of decisions made by the incumbent banks or their representatives behind closed doors.

We have tried during the Enquiry to gain a clear understanding of the payment system in order to identify any respects in which banks may be overstepping the bounds of legitimacy in their interbank arrangements, or in which actual or potential abuses may warrant intervention under the competition or consumer protection laws, or action by the banking and payment system regulators. While concluding generally that banks do not operate as a

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1 Standard Bank, October 2006, First Submission, p 8. FRB's CEO, Mr Nxasana said, "…We believe that competition in the financial services industry is intense and banks and other players complete vigorously…" (Transcript 9 November 2006, p 5). Nedbank's Mr Shuter said, "…So what is our perspective on the level of competition? I can certainly say I having been involved in retail banking now for two years, that our experience is that the industry is very competitive." (Transcript 2 November 2006, p 25). Absa's Mr Booysen said, "The fact that banks have been willing to facilitate entry by non-banks is an indication of the competitiveness of the banking industry." Then the CEO states, "Competition between the various players in the market becomes quite noticeable when one considers the impact of competition on innovation, performance and access." (Transcript 30 November 2006, pp 5-6 & 10).

2 Essentially, a cartel is a combination of producers that fixes prices, or otherwise deliberately restricts output and competition.

3 As distinct from a monopoly with a single supplier (the monopolist), a market dominated by a few large suppliers is characterised as an "oligopoly" and those suppliers as oligopolists. The significance of this is discussed below.

4 See Appendix on "Complex monopoly", "collective dominance" and "tacit collusion".

cartel, we have found a number of particular instances and aspects where, in our view, the conduct of banks and others in the payment system does require such action or intervention. These matters are addressed in detail in subsequent chapters of this report.

2.1.2 Personal transaction accounts (PTAs)

Our focus in the present chapter is on whether or not banks have significant market power in the provision of personal transaction accounts (PTAs) and related payment services – and, if so, what can be done to reduce it. Market power essentially means the ability of a firm to sustain its prices above the level that would prevail in a competitive market.[5] For reasons explained below, we have come to the conclusion that the major banks (at least) do indeed have significant market power in the provision of PTAs and related payment services.

By PTAs we mean the ordinary current accounts and transmission accounts (savings accounts with transactional facilities) that are used by individual consumers.[6] The terms of reference of the Enquiry are specifically concerned with the payment services aspect of retail banking and PTAs are central in this regard.

The traditional role of the bank, from a consumer's perspective, is to lend money and to invest savings. However, having a bank account also allows the consumer to plug into the national payment system and as such enables and facilitates economic activity in a number of areas. For example, consumers make use of payment services whenever they pay rates, taxes, purchase items with a credit or debit card, and otherwise receive or make payments other than in cash. For the unbanked there are considerable costs and risks associated with the handling of cash. By being able to rely on bank deposits, and draw on funds to receive cash or make payments as required, individuals can manage their money more safely and efficiently, and become financially empowered.

Without a bank account and access to payment services, it would be difficult if not impossible for an individual to participate effectively in any modern economy. Today, a bank account is usually required in the formal economy in order to receive wages and salaries, make a wide variety of routine payments, and access savings and credit facilities. There are currently no real alternatives for individuals and businesses that want to participate in the formal economy. Most employers insist on depositing salaries electronically into employees' bank accounts and many other payments are made via debit orders and other electronic payment systems. Credit facilities including home loans are generally only available to those able to service the debt via a transaction account.

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5 The concept of "market power" is discussed below.

6 The expression "transmission account" arose historically to describe an account on which the account-holder may carry out payment transactions without using a cheque. It thus refers essentially to savings accounts, as distinct from "current" (or cheque) accounts. Term deposit accounts, of course, are not transaction accounts at all.

Banking thus plays a central role in the economic life of society. A lack of effective competition in banking and payment services has far reaching consequences for consumers and the economy at large. It not only raises the cost to consumers of managing their money and making or receiving payments; it also drives a wedge into wider areas of economic activity by introducing inefficiencies and raising transaction costs for both individual consumers and businesses.

2.1.3 Structural concentration in the market for PTAs

The market for PTAs and related payment services is highly concentrated. The four largest banks – Absa, Standard Bank, FNB, and Nedbank ("the big four") – together supply more than 90 per cent of this market. Barriers to entry by additional firms, and barriers to their competitive expansion, are high.

The market for PTAs in South Africa (as well as the market for most other retail banking services) can be characterised as an oligopoly, with a fringe of smaller players. Even important fringe players, such as Capitec, have not to date posed a serious competitive threat to the big four banks in their established market. Although there is potential for greater competition from innovative firms like Capitec, as well as other banks and non-bank players in the payment system, the extent to which they can impose an effective competitive constraint on the big four banks across the retail market will depend on whether existing restrictions on competition, both on the supply side and the demand side, can be effectively addressed.

The reality remains, however, that the cost structure of retail banking – high fixed and common costs – drives concentration in banking and places certain limits on the extent of competition. Economies of scale and scope are of vital importance. To an ever increasing extent, therefore, retail banking has become a volume business in which even medium-sized enterprises find it difficult to succeed. The concentration of banks produces an oligopoly structure which facilitates strategic interaction among the participants and obstructs competitive outcomes. The individual customer becomes – and feels like – a statistic.

With the ever-growing volume and sophistication of payments in the modern economy, banks have naturally extended their traditional deposit-taking and lending functions into the provision of payment services linked to bank accounts. Banks' revenues and profits have increasingly come to reflect their activities and dominant role in the payment system. At the same time, technological innovations are creating new possibilities for smaller firms to operate successfully in providing various payment services, or components of payment services, that are not intrinsically dependent on deposit-taking. Faced with this challenge banks will naturally seek to leverage their strategic advantage as providers of PTAs which combine payment services with deposit and credit facilities. Elsewhere in this report we deal extensively with the need to open up access to the payment system, on a carefully regulated

basis, to qualified non-bank service providers.[7]

In competing with each other for PTA customers, banks recognise the underlying threat to their profits posed by the essential homogeneity of the services which they provide. The processes involved in the banks' operation of transaction accounts and payment services on a mass scale are increasingly standardised and automated, thanks to new technology. This relentless commoditisation of banking services brings with it a vulnerability of banks to intensified price competition and to the erosion of profit levels even in a highly concentrated market. To counteract this vulnerability, and to preserve market power, incumbent banks typically resort to measures which serve as buffers against price competition. By these measures, and by avoiding challenges to each other which could end up spoiling the game for all, the banking oligopolists are able to sustain supra-competitive pricing and profits, especially in segments of the consumer market judged able to bear the burden.

These measures, and the resulting dynamics, are explored in further detail in this chapter below. Here a brief outline must suffice.

2.1.4 Product differentiation and price complexity

To keep essentially homogeneous products or services differentiated so that their prices are not readily compared by consumers is a considerable art. From a consumer welfare perspective, of course, there are advantages and disadvantages arising from product differentiation. On the one hand it allows suppliers to serve a variety of consumer needs through differentiated offerings. On the other hand, however, it complicates choices for the many consumers who are really looking for something quite simple and uniform.

Our argument is not against product differentiation *per se,* for that would risk inhibiting the development of innovations that would benefit consumers. However, we find that in current banking practice much of what passes for product differentiation arises from different combinations of product features and different pricing structures and not from intrinsic differences in the product features themselves. The incumbent full-service banks all offer the same set of account-holding and transaction facilities. It is the manner in which these facilities are bundled, packaged and priced which varies from bank to bank. We find that this unnecessarily complicates choices for consumers and thus weakens price competition. We believe that there is a need for simplified offerings that can be readily compared, in both price and content, across the banks and thus be subject to more direct price competition. The information contained in the chapter on Costing and Pricing substantiates this.

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7 See the chapter on Access to the Payment System.

2.1.5 Information asymmetries

Information asymmetry describes the situation in which one party to a contract has the advantage of having more information than the other, so that the latter is effectively in the dark when weighing up the likely costs and benefits of the deal. There are considerable information asymmetries in the market for PTAs and related services which tend to benefit the banks but are detrimental to consumers. These asymmetries arise not only from the complexity already described, but also from inadequate transparency and disclosure in respect of the features and pricing of transactional banking products. Further, each bank uses its own terminology and nomenclature to describe its products and related product features and fees. This makes it very difficult for consumers to understand and assess the different offerings of the banks.

As a consequence, the great majority of consumers do not actively investigate what they are paying in bank fees, nor do they respond readily to changes in prices by seeking out an alternative provider. This is an important factor conferring on banks an appreciable degree of market power over their customers.

2.1.6 Switching and search costs

We have found that the cost to customers of switching banks (including the search costs in finding an alternative) are generally enough to create a significant degree of customer captivity and so confer on banks an appreciable degree of market power.

We were able to quantify the minimum objective costs likely to be incurred by customers when switching a typical transactional account from one bank to another. According to our calculations, total switching costs as a percentage of the net present value of average annual banking costs over three years are likely, on a conservative estimate, to be well in excess of 5 per cent.[8] We have concluded that, on the basis of these switching costs alone, the market power of each bank is appreciable, as each bank is in a position to impose a small but significant non-transitory increase in price without losing its customers. Customers would have to find an alternative bank which is substantially cheaper than their own and likely to remain so, in order to justify the expenditure of time and money in switching.

To switching costs must be added the search costs of finding a suitable substitute. In addition to problems of transparency and disclosure, the greatest obstacle faced by consumers in the search process lies in the difficulty of making meaningful comparisons across the product offerings of the banks. We found that there is no uniformity in the manner in which the packaged offerings are structured and priced. It is therefore impossible to make direct price comparisons between the offerings without having to input detailed information about the transactional behaviour of the prospective customer and then perform fairly

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[8] See discussion below on switching and switching costs.

lengthy calculations based on the different pricing formulas of the banks.

In their submissions the banks themselves have argued that price is not the most important factor influencing consumer choice and that consumers are driven by other considerations in selecting a bank and product offering. While the quality of service may well differ competitively as between banks, we do not consider such differences to be dramatic or fundamental. The evidence presented here suggests that the overriding reason consumers do not make choices primarily on the basis of price is that the cost and effort required to make such a determination with any accuracy is simply prohibitive for the great majority of consumers. This reinforces customer inertia when it comes to changing banks and accentuates the degree of market power that banks have. Inertia is not difficult to account for, even though expressions of discontent are widespread. Consumers – in particular those who depend on a range of banking and payment services provided by the full-service banks – have little reason to conclude that they would be substantially better off by switching. This is certainly not because prices are at a keenly competitive level.

2.1.7 Lack of effective price competition in an oligopolistic market

We find that appreciable customer inertia – having regard to all the underlying reasons for it – tends to facilitate price shadowing behaviour between the banks, while incentives for competitive price cutting tend to be mitigated further due to the interbank arrangements which underlie the various transaction services. Generally speaking, at least within established market segments, banks tend to set their fees within a close enough range of each other such that none would be likely to impinge greatly on the market share of the other. Their conduct is in that sense rational behaviour of oligopolists who stand to gain more in the medium and longer term if they refrain from competing prices down in the short term for the sake of temporary gains in market share.

In the rapidly expanding lower-income market for basic banking services, interbank competition is keener;[9] but the incumbents have been careful not to allow this to erode the surplus accruing to them in the more established parts of the retail market, the segmentation of which they are astute to maintain. In our view, that is the main reason for their resolute resistance to the idea of a basic banking product (or products) to be offered to the entire market, in order to facilitate comparison and intensify price competition across the board.

The analysis of banks' pricing and costing data in the next chapter of this report reveals the absence of any identifiable relationship between the prices of PTAs and related services and the costs to the banks of providing them. This is not what one would expect in a market characterised by effective price competition.

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9 Given that banks seek to capture new customers through their entry level offerings.

Clear evidence that banks' prices in a major part of the market have continued rising, or have not been lowered significantly, while there has been a sustained rise in customer and transaction volumes accompanied by a sustained fall in average total costs (i.e. unit costs), satisfies us that the banks do not in fact subject each other to effective price competition. The fall in unit costs has simply provided the basis for increased profit, whereas in a competitive market prices would have come down markedly.

This combination of factors leads us to conclude that banks – the major or full-service banks specifically – have an appreciable degree of market power over their ordinary customers in the provision of PTAs and related services throughout the country, and that they do exercise that power in keeping prices above levels that effective competition would dictate.

2.1.8 Recommendations

To the extent that these problems are rooted in the conditions which produce banking concentration – a global as well as South African phenomenon – they are not susceptible to being resolved fundamentally by any recommendations that we can make here. However, there are a number of particular changes that can be made which would serve to improve competitive conditions. Many of them are presented and explained in the subsequent chapters of this report. In this chapter we concentrate on remedies that we believe would stimulate price competition between banks in the provision of PTAs and related services.

We recommend a combination of measures aimed at improving the ability of bank customers to compare product offerings and prices, and aimed at enhancing their ability to switch providers with a minimum of cost and difficulty. These involve codes of conduct and other measures:

- To ensure greater transparency and disclosure of product and price information by banks
- To reduce search costs and improve comparability of products and services
- To reduce switching costs and assist consumers in the process of switching.

We recommend that the role of the Ombudsman for Banking Services be expanded to include enforcement and monitoring of compliance with the proposed codes of conduct for information disclosure and switching.

2.2 The meaning of market power

In the technical sense, says the American antitrust scholar Herbert Hovenkamp, market power is:

> a firm's ability to deviate from marginal cost pricing. Further, marginal cost, or competitive, pricing is an important goal of the antitrust laws. Marginal cost is therefore a useful base from which to measure market power: the greater the ratio of a firm's profit maximizing price to its

marginal cost, the more market power the firm has.[10]

This view, based on the Lerner Index, looks at performance of the firm, rather than industry concentration levels, to assess market power.[11] One must, however, take care in applying this concept. By "marginal cost, or competitive, pricing", Prof Hovenkamp is referring to what usually takes place under perfect competition. Marginal cost is the additional cost incurred by a firm when increasing its output by one unit of the product concerned. Since a firm's fixed costs remain unchanged at that *point*, marginal cost will consist entirely of the increment in variable costs. Under perfect competition, the market price is set by the intersection of the industry demand and supply curves. For the individual firm, this is typically where MR (marginal revenue[12]) = MC (marginal cost), and will be at the minimum of the average total cost curve in the long run. Being price takers, all such firms have no ability to exercise market power over the industry price.

When seeking to apply this concept of market power under conditions of imperfect competition, or monopolistic competition, or oligopolistic competition, one looks for indications of firms' ability to price their goods and services above the level which, over the medium to longer term, would return a normal profit to an efficient producer. In short, one tries to determine whether or not competition is *effective* in the relevant market rather than whether it is "perfect" or not.

In the hypothetical perfectly competitive market characterised by marginal cost pricing, the firm faces a demand curve in the form of a horizontal line. Because of the horizontal demand curve, a firm cannot raise its price without losing *all* its customers to rivals. The demand for the firm's product is thus completely elastic. The possibility of market power arises in a market in which a firm can raise the price above marginal cost without losing all its customers to competitors. In this case, the firm's demand curve slopes downward.[13] The deviation between the price set by the firm and the marginal cost (which forms the basis of the Lerner index introduced above) can provide a measure of market power.[14] We shall be

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10 *Federal Antitrust Policy: The Law of Competition and Its Practice*, 3rd edition, p 80. The simplest formulation of this in terms of the Lerner Index is $\frac{P-MC}{P}$, where P is the firm's price at its profit-maximising level of output and MC is the firm's marginal cost at that same output. If the firm's price is equal to its marginal cost then the index reading for the firm's market power would be zero. As price rises above marginal cost, or (conversely) as marginal cost falls below price, the index reading rises above zero. If price were to reach infinity, or marginal cost were to reach zero, then an index reading of 1 for market power would be obtained. However this index is of no practical use unless the firm's marginal cost is known. As the chapter of this report on Costing and Pricing explains, it has not been possible to establish a relationship between costs and prices from the data submitted by the banks.

11 Bilas, 1971 *Microeconomic theory*, p. 267.

12 Marginal revenue is the firm's additional revenue from selling the additional unit of output.

13 Alfred Marshall, reputed to be the father of the elasticity concept, wrote: "The *elasticity (or responsiveness) of demand* in a market is great or small according as the amount demanded increases much or little for a given fall in price, and diminishes much or little for a given rise in price." (*Principles of Economics*, 8th edition, p 102).

14 Sullivan and Grimes, *The Law of Antitrust: An Integrated Handbook*, 2nd edition, p 27, provide a graphic illustration of market power. The firm whose demand curve is depicted is able to exercise significant market power over a certain range of prices – i.e., within that range its price changes will have little effect on quantity demanded (output), and so it is able to raise its price profitably above the price that would prevail if competition were really effective. At much higher or

returning to this index below.

American antitrust scholars Sullivan and Grimes deal with the implications of these realities for competition policy as follows:[15]

> Some writers draw a distinction between the term "market power" as used in economic literature and the use of that term in antitrust. In economics, any downward sloping demand curve may describe a measure of market power. In antitrust, the focus is on substantial and nontransitory market power that suggests injury to competition. Inelasticity of demand that is transitory or, although nontransitory, is sustained over a very narrow range of prices, would not be considered the type of market power that warrants antitrust intervention. Each of these points may be illustrated. If a firm markets an improved product that performs better than competing offerings, it may increase its price, lowering its output below the level that perfect competition would produce. Or, if a retailer's newly adopted warehouse mode of operations allows it to sell more efficiently, it may sell at a price that passes only part of that gain on to consumers, preserving the remainder as a higher return. Each firm faces a downward sloping demand curve consistent with market power for each has the ability to raise or maintain price above the competitive level without losing substantial sales. In each of these cases, the higher profitability, although it may be substantial, may prove transitory. High profits will encourage rivals to emulate the improved product or innovative retailing method. The high profits serve as an incentive for rivals to mimic a new competitive initiative. ...
>
> For antitrust purposes, then, market power must involve inelasticity of demand that is both nontransitory and covers more than a narrow range of prices. Such power might be exercised, for example, by a monopolist; by an oligopolist engaging in strategic behaviour; by a cartel; by a patent holder or branded product seller that has differentiated its product in a way other sellers cannot easily replicate; by a seller controlling its aftermarket; by a seller that exploits buyer information voids to extract a higher return; or by a seller or buyer in a vertical relationship with a smaller and dependent firm (as in franchising). These exercises of power are possible targets of antitrust, but are not uniformly vulnerable. Certain exercises of market power may be tolerated to obtain other social goals. A patent monopoly is tolerated (indeed fostered) to encourage innovation. Some manifestations of franchisor power over franchises may be tolerated as enhancing the efficiencies of franchising. The monopolies thought to be efficient (such as utilities providing gas, electricity, or water) may be permitted subject to public regulation of rates.

Our Competition Act[16] links the concept of “market power” to that of dominance. It requires an especially high standard of behaviour from firms deemed to be dominant. They are not allowed to abuse their dominance, whether over customers or rivals, in various ways specified in the Act.[17] There may be a number of dominant firms in the same market. This is

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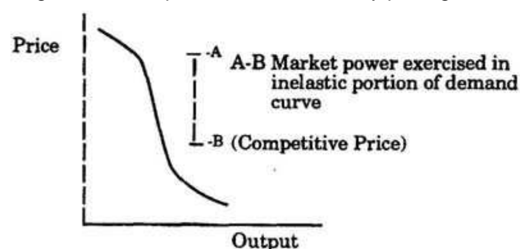
much lower prices, however, the effect of a further price change upon quantity demanded can become considerable, showing that market power would be lost by pricing outside the middle range.



15 *Op cit*, pp 27-29.

16 Act 89 of 1998, as amended.

17 This applies only to firms whose annual turnover, or assets, exceed a threshold determined by the Minister of Trade and Industry and published in the *Government Gazette.* All the firms we are considering here exceed this threshold –

because section 7 of the Act (a) conclusively presumes a firm to be dominant if it has 45 per cent or more of the market in question; (b) raises a presumption of dominance if a firm has at least 35 per cent but less than 45 per cent of the market, unless it can show that it does not have "market power"; and (c) provides for any firm to be held to be dominant if *in fact* it has "market power".

For reasons indicated below, we are unable to conclude that any bank in South Africa has crossed the threshold where its share of the market that we consider relevant for current purposes – that for PTAs and related payment services – would create a presumption of dominance.[18] Our focus is therefore on the question whether, as a matter of fact, banks should be found to have market power as contemplated by the Competition Act.[19]

Section 1(1) defines "market power" as meaning

> the power of a firm to control prices, to exclude competition or to behave *to an appreciable extent* independently of its competitors, customers or suppliers.[20]

In other words, the mere existence of some slight degree of market power in the economic sense outlined above would not amount to "market power" under the Competition Act. The extent of the firm's independence from, say, its customers would have to be more than merely capable of being perceived;[21] it would have to be considerable[22]– that is to say, notable and of consequence – in order to meet this test for dominance laid down by the Act.

A firm would be able to behave "independently" of its competitors and customers to an appreciable extent if, for instance, it could raise prices appreciably and sustain the increase for an appreciable period of time without thereby losing sales to the extent that the additional

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currently R5 million – many times over, and so qualify to be subjected to the dominance test. See section 6 of the Competition Act.

18 Statistical data showing that particular banks have a share of 35% or more of a particular transaction type, (e.g. credit cards — see data provided by Absa, October 2006, First Submission p 38) do not in themselves support a finding of market power inasmuch as the statistical categories concerned do not constitute distinct relevant markets for competition analysis.

19 Where market shares must be established in order to reach a conclusion of dominance, accurate definition of the boundaries of the relevant market in product and geographical terms is obviously necessary. If market definition were lacking, then substitute products and/or suppliers could be wrongly excluded, or wrongly included, when it came to calculating a particular firm's market share. However, where other factors including the behaviour of a firm itself provide the evidence that it possesses market power, then market definition loses its analytical importance. It is then enough to be able to describe the product and area in respect of which the power is held. As the Competition Tribunal expressed it in *Natal Wholesale Chemists (Pty) Ltd v Astra Pharmaceutical Distributors (Pty) Ltd* [2001-2002] CPLR 363 (CT) (Case No. 98/IR/Dec00), pp 376-377: "We concur with the complainant that the purpose of defining a relevant market is to identify the exercise of market power [as] defined in the Act … and that market definition is only a tool for estimating market power, not a scientific test. … If the exercise of market power, as defined, is identified — if, for example, the firm is able to raise appreciably the price of its product without occasioning a significant reduction in demand — then a market relevant for the purposes of the enquiry will have been identified."

20 Emphasis added. The Afrikaans text of the Act renders the expression "to an appreciable extent" as *"in 'n noemenswaardige mate"*.

21 Cf *Black's Law Dictionary*, 8th edition, *sv* 'appreciable'.

22 See *The Shorter Oxford English Dictionary*, 5th edition, *sv* 'appreciable'.

profit derived from making the increase in the first place would be eliminated.[23] Likewise its independence would be appreciable if, over a sustained period when unit costs throughout the market were falling appreciably, it could maintain its prices at former levels without losing its customers to rivals, and so reap greater profits.

We proceed to examine and assess a number of indicators as to whether South African banks do indeed have appreciable market power.

2.3 Profits of SA banks, and the response of prices to falling unit costs

In a thorough initial submission in October 2006, Absa included (as Annex 4) a study of competition in the South African banking industry by the international economic consultancy CRA International,[24] which the bank had retained to assist it in the Enquiry.[25] In the course of this study,[26] CRA provided a critique of the profitability analysis that had been made in the *Task Group Report for the National Treasury and the South African Reserve Bank* ("Competition in South African Banking", April 2004) – commonly known as "Falkena III".[27] Also included (as Annex 6 to the submission) were Absa's own comments on that report, repeating essentially the same points. Although misgivings were expressed in Falkena III regarding the use of profitability figures as a measure of competition, the report had nevertheless concluded that "the average return on equity of South African Banks was – with the exception of 2002 – consistently higher than the weighted average of the world's leading banks over the study period".[28]

In its critique, CRA acknowledged that high profits can be indicative of lack of competition and market power. "But high profits can also be the result of superior efficiency."[29] That may be so, but if one is confronted by a pattern of high profits across an industry, based on the returns of all the major players, the superior efficiency of a particular firm or firms can scarcely provide the explanation. Nevertheless, as both Falkena III and CRA pointed out, international comparisons of profitability are severely limited in their usefulness.

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23 We assume here that the firm is operating on the inelastic portion of its demand curve – as (for example) depicted in Footnote 14.

24 *Competition in the South African Banking Industry*, prepared by Robert Stillman, Kyla Malcolm, Rameet Sangha and Nicole Hildebrandt (Absa, First Submission, October 2006, Annex 4). References hereafter simply to the CRA study are references to this document.

25 Absa, *id.,* Chapter 1 (Introduction), p 4.

26 See p 25 ff.

27 This was in response to our general invitation to participants in the Enquiry to comment on the *Task Group Report*. (Hans Falkena was chairman of the Task Group, and there had been two earlier reports with which his name is commonly associated.)

28 P 25, read with graphs on p 26. Return on equity is the standard measure of profitability in analyses of bank profitability: see the CRA study (*supra*), p 27. "Return" here is pre-tax profit, and "equity" is average Tier One capital. (Transcript 17 July 2007, p 50.) Tier One capital is defined on p 76 of the CRA report as including common stock, non-cumulative preference stock, share premium reserve, disclosed reserves including retained earnings, minority interests, and fund for general banking risks (if stated as a separate item).

29 P 25. Falkena III had also acknowledged this (p 19).

This subject was raised at the hearing on 17 July 2007, where the following question was posed to representatives of Absa:

> ADV PETERSEN (of the Panel): Let me start by agreeing with the following, which is in your main October 2006 submission in Annex 6 (which is not confidential), page 24, paragraph 2.4.1:
>
> "… [I]n a competitive market it is the marginal firm that makes the return equal to its cost of capital. Other, more efficient, competitors make higher profits. On average therefore, firms will make more profits than the costs of their capital. Given that firms would only choose to make investments if the expected returns are above the cost of capital, this should be of no surprise."
>
> I have no trouble with that, but my question following from that … [is:] What are the indicators that we should be looking for in order to determine whether the profits of efficient firms are at a level suggesting the absence of effective competition?[30]

In response, Mr Stillman of CRA (appearing for Absa) said "the simple answer is that there is no real consensus and no clear bright lines that one can apply in this area" when using evidence of profitability to assess the intensity of competition and whether it is effective.[31] He went on to accept, however, that the level of profitability would be one of a number of factors that one would look at in making the assessment, and that it would also be of some relevance to compare banking profits locally with those in other parts of the world.[32] We recognise that the weight that can be given to such international comparisons is necessarily limited.

> ADV PETERSEN: … [L]et us take Annex 6, page 26, paragraph 2.4.4, where you point out the problems with international comparisons: (1) the markets are different; (2) the business cycles are or may be different; (3) inflation is different (although you go on to deal with that factor) and (4) the risks are different. It seems to me one could add – and this seems to me quite a fundamental point – that we do not know whether, and we do not know the degree to which, banking is truly competitive in any other country with which comparisons might be made.[33]

Mr Stillman agreed.[34]

CRA had been critical of the fact that the analysis in Falkena III did not adjust the various countries' profitability figures for inflation, and that it appeared that developing countries had not been included in the comparison study. CRA subsequently carried out its own study in which it adjusted for inflation and included certain developing countries.

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30 Transcript 17 July 2007, p 44.

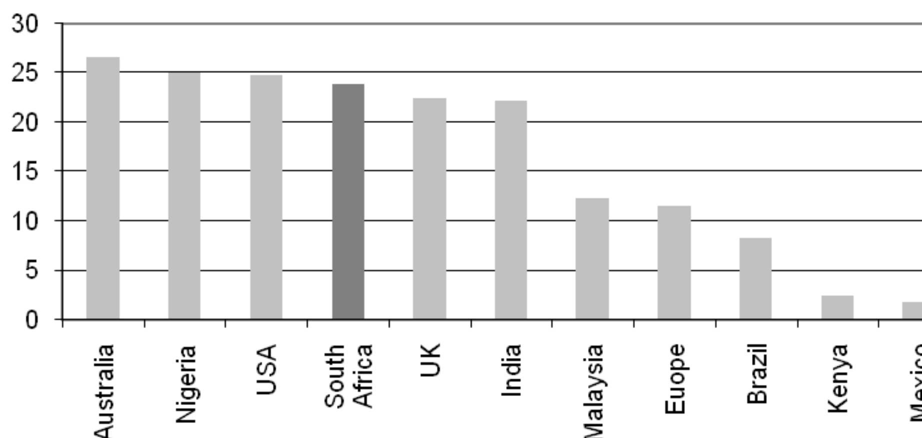
31 *Id.*, p 45.

32 *Id.*, p 46. See also p 64.

33 *Id.*

34 *Id.*, p 47.

Figure 1 Profit on average capital 1996 – 2005 (inflation adjusted)



Source: Absa, 2006, October, First Submission, Annex 4, p 30.

CRA concluded that "[t]he results of this analysis do not support the claim in the Falkena report that the profitability of South African banks has been consistently and significantly greater than the profitability of banks in other countries".[35] The CRA analysis nevertheless shows that South African banks consistently rank among the most profitable in the world.

> ADV PETERSEN: Now I want to ask you whether you would agree with the following, … that over the whole period from 1996 to 2005, South African banks have had a substantially higher rate of profit on Tier One capital [return on equity] adjusted for inflation, than banks in Europe, Kenya, Brazil and Malaysia. … That is not the whole picture, but I ask you whether you agree with that?
>
> MR STILLMAN: That is what the data…, sure, I am referring to Figure 5.4 [in the CRA study].
>
> MR VON ZEUNER: Correct…
>
> ADV PETERSEN: I have understood that correctly. [And] that South Africa essentially matches the rate of return in Australia, Nigeria, India, the UK and the USA?
>
> MR STILLMAN: Yes.
>
> ADV PETERSEN: And then, let me put this to you, would you agree that no significant country has been identified in your very thorough study, that shows a substantially higher rate of profit in banking adjusted for inflation over that ten-year period than South Africa?
>
> MR STILLMAN: Yes, and that is correct.[36]

No evidence or argument to the contrary was forthcoming during the Enquiry. Accordingly, we conclude that South African banks rank among the most profitable in the world. (See the Appendix on Updated statistics on the Task Group (Falkena III) report.) This would be consistent with the banks having market power. However, it is not conclusive.

A particular difficulty in evaluating the significance of the general level of profitability of banks is that, as CRA pointed out –

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[35] CRA study, p 27.

[36] Transcript 17 July 2007, pp 51-52.

> Banks are multi-product firms and the effectiveness of competition may vary across bank products. This means that if one were going to use profitability evidence to help assess the effectiveness of competition, one would want to examine the profitability and rates of return on the bank's activities in particular products.[37]

Mr Stillman confirmed the correctness of this at the hearing.[38] As it happens, Absa did provide information in its initial submission which, when carefully pieced together, allows a reliable evaluation to be made. We very much appreciate the contribution this has made to the Enquiry.

In assessing the profitability of banks in the provision of PTAs and related services we have reference to financial data provided by Absa for its Flexi Banking Services (FBS) and Retail Banking Services (RBS) segments.[39]

According to its submission, Absa's FBS segment provides transmission, savings and investment, and lending products to the mass market, which Absa defined as individuals earning less than R5,000 per month.[40] PTAs include transmission accounts which, as noted by Absa, "are the primary formal banking products utilized by mass market customers in South Africa".[41] Of the total number of accounts provided by FBS in 2006, approximately 85 per cent were PTAs.[42]

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Absa's RBS segment provides transmission, cheque, savings, investment, and lending products to the middle market, which Absa defined as individuals with a personal monthly income between R5,000 and R41,666.[43] PTA products (transmission and cheque accounts) also constitute a significant part of the RBS segment – approximately 71 per cent of all accounts provided in the RBS segment in 2006 were PTA products.[44] We have no reason to believe that the lending and investment components (in both FBS and RBS) are subject to less competitive constraint than transaction account services.

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Absa provided data showing profit growth in the FBS segment at a compound average growth rate (CAGR) of 24 per cent per annum over the period 2002 to 2005. Revenue (operating income) in this segment grew at a CAGR of 23 per cent per annum – i.e. at

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37 CRA study, p 25.

38 Transcript 17 July 2007, p 52. A corresponding passage from Annex 6 of Absa's First Submission, p 25 para 2.4.3.4, had been put to him.

39 In the course of the submission, the FBS and RBS "segments" are also referred to as "units" and "divisions" of the bank. See *id.,* Chapter 4, p 40ff.

40 *Id.*, p 40.

41 *Id.*, p 41. The transmission accounts are personal transaction account products.

42 The figure is calculated from the data provided in Table 5.1: Accounts and Absolute Balances for key FBS offerings, as at August 2006, *id.*, p 42.

43 *Id.*, p 59.

44 The figure is calculated from the data provided in Table 6.1: Accounts and Absolute Balances for key RBS offerings, as at August 2006, *id.*, p 60.

roughly the same rate as profit – and expenses at 22 per cent. This implies that the growth in the amount of profit in the FBS segment "was due primarily to increases in volume and not to an increase in profit margins (measured as a percentage of revenues)".[45]

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In the RBS segment, the amount of profit grew even faster – at a CAGR of 40 per cent per annum over the period 2002 to 2005. Here, however, revenue (operating income) grew at a CAGR of only 9 per cent per annum, and operating expenses at 5 per cent. Thus it is clear that profit margins did increase.[46] Given that the number of RBS customers also grew at an annual average rate of only 5 per cent over this period, higher transaction volumes at lower unit costs provide the fundamental explanation for the increased profits. Absa concluded, and we agree, that "[t]his means that the growth in profit margins at RBS between 2002 and 2005 can be attributed largely to economies of scale."[47] In short, unit costs came down sufficiently to provide the main basis for a 40 per cent compound annual growth in profits over the whole period.

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It is evident that Absa failed to pass on these unit cost savings to any significant extent to its customers by way of price reductions, choosing instead to retain most of these savings as profits. Absa was able to increase prices on its main transaction account products over the period 2002 to 2005[48] at a rate roughly in line with or slightly below inflation during those years[49] – despite benefiting from substantial unit cost reductions as a result of economies of scale.

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We were not able to conduct the same specific analysis for the other banks, primarily because they did not provide data on operating expenses going back far enough in time to be useful for this purpose. However, there can be little doubt that in the prevailing conditions of market expansion, all the major banks benefited from economies of scale.[50] As evidenced in the figures provided by Absa, there has been no real competitive pressure to reduce prices from other banks – indicating that they too have retained the greater portion of savings from unit cost reductions as profits rather than pass them on to consumers through lower prices. Indeed, effective competitive pressure on prices has generally been lacking from rivals in this market.

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If the market were characterised by effective competition, then surely competitive pressure, either from potential entrants or existing competitors, would have compelled Absa to reduce

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45 *Id.*, Annex 4 (the CRA study), p 10. Mr von Zeuner added: "And reduction in impairments." (Transcript 17 July 2007, p 66.)

46 *Id.,* Annex 4, pp 10-12.

47 *Id.*, p 12.

48 *Id.*, pp 14-15.

49 See also Transcript 17 July 2007, pp 66-67.

50 See e.g. FRB, March 2007, Second Submission Part A Data Request and FRB, October 2007, FRB Data and Info Request, p 4.

its prices in order to maintain its relative share of the market and grow its business in this segment. The fact that it did not do so suggests that banks are sheltered from effective competitive pressure when it comes to pricing of PTAs, particularly in the retail banking or middle-market segment.

This was put to Absa at the hearing on 17 July 2007.[51] After some initial wrestling which failed to get to grips with the essential point, the Absa team sought the opportunity to respond specifically in a further written submission.[52] That submission came in the form of a theoretical argument prepared by Mr Stillman.[53] He first set out the issue to be addressed:

> Absa has presented evidence showing that fees on Absa's Silver Cheque account (a cheque account designed for its Retail Banking Services or middle market segment[54]) have increased over the past several years broadly in line with inflation.[55] During Absa's 17 July 2007 hearing on "Pricing Behaviour and Market Power" the Panel raised questions about how this evidence should be interpreted, suggesting an argument along the following lines, in particular in relation to Absa's middle market segment:
>
> 1. As Absa and other banks have emphasized, a very high percentage of a bank's cost structure (perhaps as much as 80%) is accounted for by fixed costs.[56]
> 2. This means that average total costs ("unit costs") decline as volume increases, in other words that banks experience economies of scale.[57]
> 3. The South African economy has been growing strongly in recent years, and it is reasonable to assume that the demand for transactional banking services has also been growing over this period.[58]
> 4. This implies that the banks' unit costs of transactional services have also been declining.
> 5. The Panel asked whether, if the market for banking were highly competitive, then these reductions in unit costs would be passed through to consumers (at least in part) in the form of reductions in inflation-adjusted fees.
> 6. It was suggested that the fact that fees on a key product such as Absa's Silver Cheque account have not declined in real terms during this period of growing demand (but instead have moved with inflation) is possibly evidence that the industry is not as highly competitive as the banks have claimed.

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51 Transcript 17 July 2007, p 67, pp 75-76, pp 79-80, pp 84-86.

52 *Id.*, p 86.

53 CRA International, *Price changes and demand shifts*, Robert Stillman, 10 August 2007.

54 [Footnote by Mr Stillman:] This segment services customers earning between R5,000 and approximately R40,000 per month. Confidential: Absa

55 [Footnote by Mr Stillman:] See, for example, slide 19 of Absa's Competition Commission Enquiry Presentation of 17 July 2007 which shows that fees on Absa's Silver Cheque (retail market) account increased by 5.6% per annum on average during the period 2001-07 while inflation (the CPIX) increased on average by 5.8% per annum over the same period.

56 [Footnote by Mr Stillman:] Although all costs are variable in the long-term, the majority of a bank's costs (for example, staff costs and branch infrastructure costs) do not vary with the number of transactions or number of accounts. Confidential: Absa

57 [Footnote by Mr Stillman:] As noted in the 17 July hearing, Absa has submitted that the increase in profit margins in its Retail Banking Services business unit between financial years 2002-2005 "appears to have been due primarily to the realisation of economies of scale as transaction volumes increased" ("Competition in the South African Banking Industry", Annex 4 of Absa's 30 October 2005 submission, Page 12). Confidential: Absa

58 [Footnote by Mr Stillman:] Evidence submitted by Absa demonstrates that transactional account numbers have increased between March 2002 and December 2006, particularly in the Flexi Banking Services (mass market) segment (Absa's 15 March 2007 response to the Part A data request, Table 1.1 (page 1) and Table 1.2 (page 3) of the accompanying spreadsheet). Confidential: Absa

> This note explains why the final two points in the above line of reasoning are incorrect and why, more generally, the manner in which prices respond to a shift in demand does not provide any information about the degree of competition in a market.[59]

The CRA argument concluded that:

- First: it is marginal costs, not unit costs, which are relevant in determining how prices change. Accordingly, the Panel had been wrong in its intuition that, at least in competitive markets, reductions in unit costs (average total costs) should lead to reductions in prices.
- Second: the potential effects on price of a shift in demand are various, and nothing meaningful can be inferred about the competitiveness of a market from the manner in which price responds to shifts in demand.

On close examination we find that these assertions and their accompanying elaboration – while not lacking in ingenuity – do not address the case. In fact, indirectly, they reinforce the conclusion towards which the Panel had been feeling its way during the hearing.

Moreover, to a large extent, Mr Stillman's analysis ignores his point 3 above. This of course is key to the question posed by the Panel. Nonetheless, we continue to explore his argument.

Mr Stillman set out his argument in the following way: "It is a first principle of economics," he wrote, "that a firm maximizes profits by producing at the level at which marginal cost equals marginal revenue" (marginal revenue being the revenue earned from selling an additional unit of output).[60] At that quantity of output, the price which the firm can charge is determined by the demand curve which it faces, and this is true in competitive and uncompetitive markets alike. Changes in unit costs do not change either the demand curve or the point at which marginal revenue coincides with marginal cost. For a firm's price to change, there would have to be a change in marginal cost or a shift in the demand curve affecting the elasticity of demand. Marginal costs may be assumed to be constant in this analysis (the focus being on changes in fixed costs per unit of output); and there is no reason to assume a change in the elasticity of demand when the demand increases.

> Whether a shift in demand will increase the elasticity of demand has to do with the factors leading to the increase in demand (e.g. whether demand is increasing primarily because existing consumers have become wealthier or primarily because new customers have been added who may be more price sensitive); it has nothing to do with the competitiveness of the market.[61]

Let us now turn to a diagrammatic view of the argument – provided by Mr Stillman himself. It

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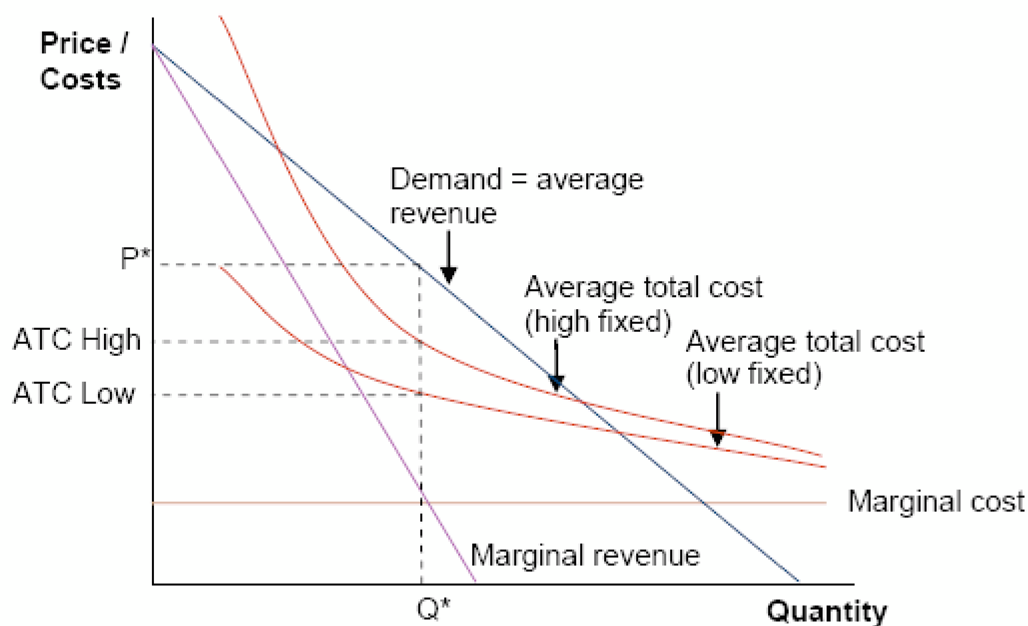
59 *Id.,* p 1.

60 *Id.,* p 2.

61 *Id.*, p 5.

appears as Figure 2. In the figure, price exceeds average total cost and whether the average total cost curve is assumed to be high or low, the firm's profit-maximising price remains unchanged.

Figure 2 Mr Stillman's diagram



Source: CRA International, Price changes and demand shifts, Robert Stillman, 10 August 2007.

What is striking about this argument, and the diagram, is that we are not told if it represents the position of the firm before or after demand has increased. The firm faces a single downward-sloping demand curve.[62] The equilibrium is where marginal cost is equal to marginal revenue and is established at a level where price is comfortably in excess of average total cost (unit cost), whether the latter is assumed to be high or low. All Mr Stillman has demonstrated is that the equilibrium price will not be affected by whether average total costs are higher or lower *after* output has settled at its new equilibrium level. If the two average total cost curves are intended to present a before-and-after picture, then one would have expected before and after demand curves to have been drawn in as well.

To say that changes in the firm's level of unit costs will *then* only affect per-unit profit, and not directly affect the firm's per-unit price, does not address the question posed. The question concerned is the process by which a new equilibrium price would be established when the output of the firm (and that of its rivals) have increased, and when average total cost (unit cost) has fallen[63] – and how the outcome would differ over a period in which further

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[62] A downward-sloping demand curve is itself indicative of the existence of market power, but is *per se* no proof that competition will be ineffective.

[63] The question related to changes in average costs with changes in output – i.e. a movement *along* some ATC curve and

adjustments may follow, depending on whether the market is competitive or not.

A firm's demand curve is affected by *the price at which its rivals offer substitute products*. Thus the supplier of butter, for example, will face two quite different demand curves (different in both position and slope), depending on whether the prevailing price of margarine is high or low,[64] and will be constrained accordingly in the price it can charge. The same must apply in any market where the substitution by the consumer of an existing product with a rival's product of the same kind would be relatively straightforward.

In his written submission, Mr Stillman does not use the term oligopoly. Prior to his written submission, he referred at the hearing on 17 July 2007 to "pricing in an *oligopoly* where you have multi-product firms and [a] lot of fixed costs"[65] and in the same sentence indicated that it would be useful to present "a short note on economics" that illustrated the concepts involved. We accordingly classify Mr Stillman's approach in his written submission (the "short note") as one that embraces oligopoly. Since he presents a picture in which excess profits are not eliminated by the entry of competitive firms, we can regard it as a closed model – in other words one in which entry is not allowed.[66] It should nevertheless be noted that the diagram is also compatible with monopoly and monopolistic competition (as long as there are barriers to entry). While Mr Stillman's employs the profit-maximising principle (marginal cost equals marginal revenue) to his model of oligopoly, it can also be applied to monopolistic competition and monopoly, and, for that matter, to perfect competition.

Let us investigate for a moment what Mr Stillman is showing in his diagram of a firm in conditions of oligopolistic competition. Such a firm has some degree of market power – and is neither a perfectly competitive firm nor an outright monopolist. Here (so Mr Stillman would have us assume), the firm is already producing at the profit maximizing level of output consistent with the marginal cost equals marginal revenue condition. This means the firm would make a loss on every additional unit of output produced, as its marginal cost would

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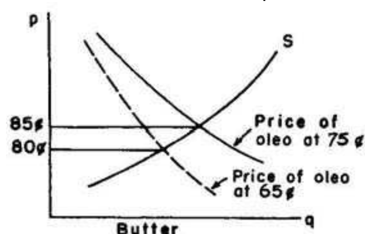
not an upwards or downwards shift of the ATC curve at a fixed level of output, as depicted in the diagram.

64 That is illustrated, for example, in Milton Friedman, *Price Theory* (Transaction Publishers edition, 2007), p 24:



Samuelson and Nordhaus, *Economics*, 12th edition, p 503 state: "The perfectly competitive firm can sell all it wants to along its horizontal [demand] curve, never depressing market price. But the imperfect competitor will find that its demand curve slopes downward as its increased *q* forces down the *P* it can get. And **unless it is a sheltered monopolist**, a cut in its rivals' *P*s will appreciably shift its own [downward-sloping demand curve] leftward…." (Emphasis added. American economic writers often use the term "monopolist" to refer to firms having significant market power, and do not confine it, as we do, to a firm having the whole market to itself.)

65 Transcript 17 July 2007, p 83, emphasis added.

66 See Koutsoyiannis, A (1987). *Modern microeconomics*, Second edition, Macmillan, p 228.

then exceed its marginal revenue. All else remaining constant, it has nothing to gain from lowering price in order to increase the quantity demanded.

In Mr Stillman's analysis, the persistence of the price above the average total cost curve also implies that there is no whittling away of profits by competitors under-cutting the price, be they incumbents or new entrants. This is consistent with the existence of barriers to entry as well as existing rivals choosing to refrain from price competition. Either the latter all have nothing to gain, *even in the short term*, from presenting such competition – a colossal assumption to make – or else they prefer to live a quite life where pricing is concerned.[67]

Aspects of Mr Stillman's analysis can be challenged both on points of theory and with reference to market conditions experienced in the banking industry in recent years.

We begin with the theoretical challenges.

Mr. Stillman presents the assumption that all firms are in fact producing output at the point where MC = MR as if it were an inviolate principle – above reproach. A brief glance at the history of economic thought indicates otherwise.

The MC = MR argument employed by Mr Stillman came to the fore around 1880, during the so-called marginal revolution. The MC = MR principle was applied in the theory of perfect competition and in the theory of monopoly. It was also subsequently applied to models of oligopoly.

By the 1920s, economists were growing increasingly skeptical of the perfect competition model. In 1933, Joan Robinson[68] (in England) and Edward Chamberlin[69] (in the USA) independently put forward models of monopolistic competition, although Robinson preferred to use the term "imperfect competition". Here firms produce products that are close substitutes, even though each firm tries to promote a differentiated product. An individual firm faces a downward sloping demand curve for its product. In the theory of monopolistic competition the profit maximising condition (MC = MR) is retained.

In the theory of monopolistic competition firms are generally assumed to have freedom of exit and entry. The existence of supra normal profits (sometimes referred to as "pure" profit[70]) lures firms into the arena and their entrance in turn puts excess profits under pressure. Firms are assumed to act independently of each other. Bilas points out that pure

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67 As Bilas (1971) points out, the Lerner analysis shows what a firm is doing rather than what it is able to do, so a firm with market power may refrain from charging the highest possible price if that helps preserve its market power: " …the greatest of all monopoly power is the quiet life". *Op cit,* p 268.

68 Robinson, J (1933*). The economics of imperfect competition*. Macmillan.

69 Chamberlin, E H (1933). *The theory of monopolistic competition.* Harvard University Press.

70 See Bilas, *op cit*, p 267.

profits can exist in monopoly and oligopoly but not in perfect competition and not in monopolistic competition.[71] This provides further evidence that Stillman's diagram depicts oligopolistic competition.

Although many oligopoly models saw the light of day from about 1940 onwards, writings on oligopoly can be traced back to 1848 when Augustin Cournot presented a duopoly model. So we can say that by the late 1930s at least four theories of the firm were in place: perfect competition, monopoly, monopolistic (imperfect) competition and oligopoly, although oligopoly had yet to come into its own. For present purposes the critical feature of all four approaches was that all four employed the assumption of profit maximisation with its associated MC = MR condition.

What we have shown is that Mr Stillman's diagrammatic approach is firmly entrenched in the marginalistic tradition that had pervaded conventional theories of the firm by the late 1930s. If there had been no further development in the theory of the firm since the 1930s, Mr Stillman's argument that "It is a first principle of economics that a firm maximises profits by producing at the level at which marginal cost equals marginal revenue" could perhaps be maintained. However, a lot has happened in economic theory since then.

Koutsoyiannis writes:

> In 1939 Hall and Hitch published some results of research undertaken at Oxford… The most startling results of the studies of 'The Oxford Economists Research Group' reported by Hall and Hitch were that firms did not attempt to maximize their profits, that they did not use the marginalist rule MC = MR, and that oligopoly was the main market structure of the business world. Up to then the theory of monopolistic or imperfect competition of Chamberlin and Joan Robinson had been generally accepted as typical or relevant. The firms were assumed to be able to act atomistically, ignoring their rivals' reactions and pursuing their short-run (and long-run) profit maximization by equating marginal cost to marginal revenue in each time period.
>
> …
>
> Hall and Hitch found that firms do not attempt to maximize short-run profits by applying marginalistic rules (MC = MR), but aim at long-run profit maximization. Firms set their price on the *average-cost principle*. That is, firms do not set their price and output at the levels determined by the intersection of the MC and MR curves, but they set a price to cover the average variable cost, the average fixed cost and a 'normal' profit margin ("usually 10%") …[72]

Koutsoyiannis adds that the Hall & Hitch study points to a number of factors:

> Firstly, short-run profit maximization was rarely stated by businessmen to be their goal. Most firms reported that they aimed at a 'fair' level of profit and that they had also other goals. … Secondly, the demand curve and its price elasticity, on which marginalism so heavily relies, are unknown in practice, because neither consumers' preferences nor competitors' reactions are known with certainty. … Thirdly, marginal costs are also unknown in multiproduct firms. … Fourthly, even if MC and MR were known, and firms aimed at the maximization of their (short-run) profits, the adherence to this equality would require continuous changes in the price in view of the continuous changes in costs and demand. Such frequent changes in prices are

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71 *Id.*

72 *Op cit*, p 263.

> not desirable, and prices have exhibited considerable stickiness despite changes in short-run costs and demand.[73]

A torrent of articles on the subject ensued, giving rise to the so-called marginalist controversy of the 1940s and 1950s. The details need not detain us here. Enough has been said to illustrate that it is misleading to present profit maximisation on the basis of MC = MR as an inviolate principle. Microeconomic texts display a staggering collection of different theories of the firm – to give a flavour of the argument we simply list three of them:

- Bain's limit-pricing theory (1949) – deals with the threat of potential entry.[74]
- The behavioural model of Cyert and March (1963) – indicates that firms have many goals, not just a single goal of profit maximisation.[75]
- Baumol's theory of sales revenue maximisation (1958) – suggests that firms attempt to maximise sales revenue rather than profits.[76]

How a firm will actually behave depends on its specific set of factual circumstances.

Mr Stillman argues that when fixed costs change, output is not affected. This follows from his MC = MR condition, with a change in fixed cost not affecting marginal cost. Because Baumol's theory makes use of the sales maximisation principle (rather than profit maximisation), Baumol can argue that firms will change output and price when overheads change.[77] Note that even in Mr Stillman's approach it is not generally true that a change in fixed cost will have no affect on output and price. If the change in fixed cost impinges upon the shut-down position, the equilibrium level of output will be affected.[78] Mr Stillman fails to address the reasons for the fall in average total costs, for example as might occur if demand shifts outwards and economies of scale are realised, and instead focuses all our attention on a change in fixed cost, which by his reasoning doesn't change price or output.

To forestall his MC = MR reasoning from degenerating into a tautology, Mr Stillman (here speaking for Absa) should have provided concrete evidence that the firms in question do, in fact, produce at a point where marginal cost is equal to marginal revenue. No evidence whatsoever was produced to show that Absa, or any of the other banks, is producing at such a point.

We now turn to the application of Mr Stillman's diagram in reality.

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73 *Id.* p 265.

74 Bain, J (1947) 'Oligopoly and entry-prevention', *American Economic Review*.

75 Cyert, RM and March, JG (1963*) A behavioural theory of the firm*. Prentice-Hall.

76 Baumol, WJ (1962) *Business behaviour, value and growth*. Harcourt & Brace.

77 See also Koutsoyiannis, *op cit*, p 330.

78 *Id.*, p 181.

The rapid expansion of account-holding and transaction volumes which the South African banking industry has experienced in recent years has nowhere been accompanied by indications that banks are reaching the limits of their profitable capacity to provide. Moreover, the advances in new technology suggest that not only average total (or unit) costs but also banks' marginal costs themselves are probably coming down. With the fall in unit costs which this implies, space would clearly have been created for prevailing prices to come down. Yet, at least in the important segment of the market for PTAs that we are analysing here, this has not occurred. The question remains: why not?

In terms of Mr Stillman's diagram, we are still in the world of excess (i.e. above normal) profits. Excess profits invite competitive challenges from rivals who could reduce their prices in order to gain market share. In an oligopolistic market, however, firms readily appreciate that by competing vigorously on price they may spoil the market and reduce their profit in the longer run.[79] In such a market, the lure of excess profits means that the possible entry of additional firms must be taken into consideration. If there is no entry of firms and excess profits persist, it is difficult to escape the conclusion that the incumbents individually have some market power and are refraining from competition that would spoil their ability to exercise it.

It does not require actual combinations or understandings among competitors to bring forth individual behaviour calculated to avoid longer-term competitive "spoiling". Sullivan and Grimes explain:

> [T]he players in an oligopolistic market can actually increase the returns that all of them receive through disciplined pricing. To achieve this discipline, the oligopolists must recognize their interdependence and act accordingly. This is distinguished from the independent behavior assumed for the theoretical models of perfect competition or pure monopoly. *But in most real markets, each market participant recognizes that its output and pricing decisions will have an impact on and will draw a response from competitors. For such players, output and pricing decisions are taken with an eye to what the competitive response will be.*[80]

As Charles E. Mueller explains further when defining "OLIGOPOLY" in his "Glossary of Antitrust Terms":[81]

> … Given a situation in which there are only a few sellers, a phenomenon called "oligopolistic interdependence" is expected. Whereas the individual firm in an atomistic industry [one characterised by many sellers] has such a small share of aggregate industry sales that nothing it can do will perceptibly influence the overall marketwide price (e.g., the withdrawal of its entire supply from the market would not affect that market price), the individual firm in an oligopolistic industry is, by definition, sufficiently large that any substantial change *in its* output volume will have a perceptible effect on the overall *market-wide* price – and hence on the volume of sales, and price received, by each of its rivals. The latter are thus expected to

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79 Marshall observed long ago that "the chief motive of all open combinations and of all informal silent and "customary" understandings whether among employers or employed is the need for preventing individuals from spoiling the common market by action that may bring them immediate gains, but at the cost of a greater aggregate loss to the trade." *Op cit*, p 498.

80 *Op. cit.*, p 39 (emphasis added).

81 *Antitrust Law & Economic Review*, Vol. 26, No. 4.

notice these changes, recognize their source, and take appropriate measures to protect their respective interests.

A price decrease, for example, will normally prove unprofitable for the price cutter. The others will promptly match his lower price, thus removing any incentive for buyers to switch suppliers. With his market share unchanged, but price now at a lower level, the price-cutter's profits are presumably lower than before. Similarly, a failure to go along with a price increase will generally prove unprofitable, since the others will quickly drop back to protect their market share if there's a holdout still selling at the lower price, the result being that the holdout gets no increase in his market share and foregoes a higher per-unit price that all could have had if he had gone along with the change. By a series of such adjustments, rational oligopolists are expected to eventually arrive at the price level that will maximize their joint profits, i.e., the *industry* profit-maximizing price level, the same price as that a single firm monopolist would charge.

The possibility of this result actually being reached is dependent on other factors, however, particularly on (1) whether the industry in question belongs to the Tight-Knit or Loose subcategory of oligopoly, that is, whether its concentration ratio is very high or only moderate, and on (2) whether its entry barriers are high enough to permit the exercise of that pricing power without inducing new entry. …

TIGHT-KNIT OLIGOPOLY – A market structure so highly concentrated that prices are expected to be significantly above, and output significantly below, the competitive norm. In general, empirical studies suggest that this result is to be expected when the four largest sellers have 50% or more of sales in a market or when the eight largest have 70% or more.[82]

With the big four banks having more than 90 per cent of the market for PTAs in South Africa, it is not difficult to conclude that a tight-knit oligopoly exists. At the same time the barriers to new entry are substantial.

Mr Stillman observes that, in the case of constant marginal costs, "the impact of a shift in demand on price depends solely on how the shift *changes* the elasticity of demand."[83]

Mr Stillman employs the Lerner Index to indicate that while an increase in demand can lead to an increase in price, nothing can be inferred about whether or not the process has rendered the market less competitive. Once again, his argument does not expand on the fact that in competitive markets, the presence of excess profits should lure other suppliers into the arena.[84]

Here we should bear in mind the rationale behind the Lerner Index (which first saw the light

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82 These passages were quoted with approval and applied by the Competition Appeal Court in *Mondi Ltd and Kohler Cores and Tubes (a division of Kohler Packaging Ltd) v Competition Tribunal* [2003] 1 CPLR 25 (CAC) par [41].

83 CRA International, *Price changes and demand shifts*, Robert Stillman, 10 August 2007, p 4. We have explained above why the assumption of constant marginal costs is unacceptable.

84 . In *Intermediate Microeconomics: A Modern Approach* 5th edition, pp 449-450 Hal R. Varian writes:

"As more and more firms enter the industry for a particular kind of product, how would we expect the demand curve of an incumbent firm to change? First, we would expect the demand curve to shift inward since we would expect that at each price, it would sell fewer units of output as more firms enter the industry. Second, we would expect that the demand curve facing a given firm would become more elastic as more firms produced more and more similar products. Thus entry into an industry by new firms with similar products will tend to shift the demand curve facing existing firms to the left and make them flatter."

The same would apply if existing firms were able to mount a greater competitive challenge – if we assume it were in their interests to do so.

of day in 1934). The index suggests that the gap between market price and marginal cost provides an indication that market power might be present. If demand increases and the gap widens, that in itself does not indicate that monopoly power has increased. If there are no barriers to entry, the size of the gap will be affected by the behaviour of competitors. If there are barriers to entry, the persistence of the gap raises the possibility that market power is playing a role.

In spite of the increased volumes, unit cost savings and sustained profitability enjoyed by Absa, over an extended period, it has not lowered its retail banking prices substantially.[85] *The fact that it has not done so is because competitive pressures have not existed or been brought to bear, compelling it to do so.* This conclusion, although drawn from an analysis of Absa's data and submissions, does not point a finger at Absa in particular. What Absa's position reveals is *the unsatisfactory state of competition in the market as a whole.*

Standard Bank[86] and FNB[87] have also enjoyed increased number of transactions, unit cost savings and increased profits, without using these as an opportunity to mount a vigorous challenge to their rivals by way of price competition. Although Nedbank has reduced its prices, we find that this has been from levels above a broad alignment with other major banks, which had caused it to lose a significant share of the market.[88] We have found no reason to conclude that Nedbank is now undercutting its rivals in the middle market to any significant extent.[89] Even in the lower-income market, Nedbank is still priced well above the lowest priced provider, Capitec. Although Capitec has managed to grow its low-income

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85 Volume growth has continued at a rapid rate. Absa's published financial results state that, in the year ended 31 December 2006, retail banking continued to show "strong growth" in transaction volumes "which emanated from the increased activities of existing and new customers", resulting in a non-interest income growth of 22%. In the year ended 31 December 2007, transaction volumes in retail banking "increased by 8.2% emanating from an increase in the customer base, improved product use and improved accessibility." Operating expenses in the segment increased by 13% while attributable earnings were up by 20%.

86 Standard Bank's published results for the year ended 31 December 2006 state: "Average operating margin improved to 8,5% (2005: 7,0%). The Group continues to benefit from enhanced efficiencies throughout the supply chain, capacity utilisation as a result of improved economies of scale and the favourable terms of supply of finished products for resale." The Bank's results for the year ended 31 December 2007 state: "Net fee and commission revenue grew by 23%. The largest category, account transaction fees, grew 10% despite sub-inflation price increases in South Africa." Standard Bank audited results, 2007.

87 See FRB, March 2007, Part A Data Request and FRB, October 2007, FRB Data and Info Request, p 4. In its interim results for the six months ended 31 December 2006, FRB stated that FNB's Consumer segment had performed well with profits before taxation increasing by 15 per cent. "This was achieved in an operating environment of rising interest rates, but continued good growth in both client and transaction volumes." FRB's Annual Report for the year ended 31 December 2007 states that the FNB mass (i.e. "Smart" account) segment which focuses on individuals earning less than R81,000 per annum "performed well during the year, with profits increasing significantly and customer numbers growing from 2.9 million to 3.3 million. The main driver of this performance was the strong growth in non interest income which increased 27%. This increase in turn, was driven by 22% growth in income generating transactions, including debit card transactions which grew 63%." Note: FNB is the commercial bank brand of FirstRand Bank. It is the latter which holds the bank licence.

88 See Nedbank, May 2007, Second Submission, Data Request Part A, p 5. See also: Nedbank's preliminary financial results for 2006, published in February 2007 for the year ended 31 December 2006. They state that volume growth in Nedbank Corporate and Nedbank Retail had resulted in an increase of 13,3 per cent in commissions and fees despite the "more competitive pricing structure adopted in Nedbank Retail", where, in July 2006, transactional fees were reduced by an average of 13 per cent. Published preliminary results for the year ended 31 December 2007 (on the Nedbank website) show a further increase of 19 per cent in operating income in Nedbank Retail.

89 See pricing brochures and Infochoice data.

customer base considerably by offering lower priced transaction accounts it has, as yet, not posed a significant competitive threat to the big four banks in their traditional areas of dominance.[90]

Our conclusion is that for Absa, and for the other major banks, the sustained fall in unit costs – with no real fall in unit price – indicates that competition has not been effective in constraining the banks from keeping prices above competitive levels over a significant period of time. We consider this to be strong evidence that there is appreciable market power on the part of these banks in the provision of PTAs and related services to the retail segment of the market.

In the subsequent sections in this chapter we examine the various structural and behavioural factors influencing the effectiveness of competition in constraining the ability of the banks to behave to an appreciable extent independently of their customers and competitors in the provision of PTAs and related services generally.

2.4 Market structure

The Task Group (Falkena III) report found that the concentration levels of the South African banking industry are high in terms of market share of assets, but not out of line with other emerging markets.[91] However, it is in the market segments rather than at firm level that concentration is even more marked. For example, while the big four banks accounted for 83 per cent of the total deposits of the public in June 2003, they accounted for 92 per cent of mortgage loans and 89 per cent of bank financed installment sales.[92]

Although there was some variation in the banks' estimates of their market shares, and in the manner of calculating market shares, an examination of the figures submitted to the Enquiry shows that the market for personal transaction services is highly concentrated, both at the broad level, and within the income segments.

Table 1 shows market shares in the provision of personal transaction services by monetary value of month end balances as of July 2006.[93]

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90 We deal with this issue in greater detail in the discussion on barriers to entry and expansion.

91 *Op cit.*, p 29.

92 *Id.* p 34.

93 Personal transaction services here include cheque and transmission accounts, demand deposits and short-term savings.

Table 1 Market shares, personal transaction services: value of month-end balances

	Standard Bank	Absa	FNB	Nedbank	Other
Value (R million)	36 485	36 300	29 632	36 962	6 552
Market Share[94]	25%	25%	20%	25%	4%

Source: Genesis report for Standard Bank, 08/11/2006, p18.

Therefore the top four banks collectively constitute roughly 95 per cent of the market for personal transaction services.

High levels of concentration appear to be characteristic of banking markets around the world.[95] This suggests that the cost structure of banking is such that there is a limit to the number of full-service banks that can be sustained over time in any particular market. In their submissions most of the banks have noted that approximately 80 per cent of their costs are fixed.[96]

FNB argued that with a high-fixed cost structure it "is unsurprising to find that the number of large banks is somewhat limited. A high fixed cost structure requires that firms price in excess of their variable cost in order to survive in the industry".[97] A high fixed cost structure will limit the number of firms in a market because (if we assume all other factors remain constant) with each additional firm there will be a proportional increase in fixed costs that must be recovered from net revenues in the sector.[98]

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Mr Stillman, speaking for Absa, noted:

> It is clear that there are very large fixed costs in the banking industry. It is one of the themes that I think has been emphasised by all the banks in their presentations and I think rightly so. I think that in the order of 70%, 80% of the cost structure can be regarded as a fixed cost and that those costs in turn are common costs that are very difficult to allocate to particular products or even in some cases, business units. So as a consequence, what you necessarily are going to have in our world … [are] very large economies of scale. … So, in this kind of industry, you are going to have prices that are in excess of and indeed considerably in excess of the marginal cost of providing any particular service that is necessary to be able to cover all those fixed costs and provide a return to shareholders.[99]

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94 Totals do not add up to 100 per cent due to rounding.

95 FNB presented information showing that there is no evident relationship between GDP and the structure of banking markets. Countries like Indonesia, Australia, Mexico, and the United Kingdom have larger economies than South Africa but are similarly concentrated – with each country (including South Africa) having only four banks holding more than 75 per cent of assets. Therefore, it does not necessarily follow that at greater levels of demand, banking markets will be less concentrated. (FNB, November 2006, Exhibit M, slide 9).

96 See e.g. Transcript 9 November 2006, p 8 (FRB); Standard Bank, 11 April 2007. Exhibit GG, Appendix 3, slide 32.

97 FRB, October 2006, First Submission, p 12. It should be noted that a low fixed cost structure also requires that firms price in excess of their variable cost in order to survive in the industry.

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98 See Panzar, J.C. (1998), "Technological Determinants of Firm and Industry Structure", In: Schmalensee, R and Willig, R.D., *Handbook of Industrial Organisation,* Chapter 1, Volume 1, pp 3-59. Firms need to cover their variable costs in order to survive. Normal profits are an important component of fixed cost. Hence even when a firm is making normal profits (zero excess profits) it is still earning enough to want to stay in the industry.

99 Transcript 17 July 2007, pp 37-38.

This particular cost structure (i.e. high fixed and common costs) drives concentration in banking and places certain limits on the extent of competition. The concentration of banks produces an oligopoly structure which facilitates strategic interaction among the participants and confers on each of the banks a degree of market power at least sufficient to cover fixed costs.

The potential for banks to exploit this market power to earn excessive returns will depend on the extent to which entry and expansion by new and existing firms effectively constrains the incumbent banks. In this regard we examine barriers to entry and expansion in retail banking in South Africa.

2.5 Barriers to entry and expansion

We find that barriers to entry and expansion are high in retail banking generally, including the provision of PTAs. The high proportion of fixed and common costs (including the cost of branch networks, other infrastructure and ensuring interoperability), and the consequent importance of economies of scale and scope, are themselves major barriers to the entry, survival and competitive expansion of new firms. The multi-product nature of retail banking also creates opportunities for cross-subsidisation by incumbents, which potentially increases the handicap facing new firms. Other barriers include the regulatory requirements for entry and participation in the banking industry, the costs faced by customers of incumbent banks in switching to new providers, and the effects of brand loyalty.

2.5.1 Regulatory requirements

> We have seen a number of players in our industry who handed back their banking licences, because of the high cost of holding banking licences.
>
> Mr Sizwe Nxasana, CEO of FirstRand Bank [100]

The Banks Act[101] requires a banking license and registration with the South African Reserve Bank (SARB) Office for Banks as a pre-requisite to operate as a bank. A banking license is required in order to offer deposit-taking services such as cheque and transmission accounts offering deposits, savings and payment facilities. The Banks Act, supplemented by regulations, sets out certain prudential requirements that must be met upon application for a banking license and prior to registration.

Prudential requirements are primarily concerned with the protection of depositors' funds and reducing the risk of bank crises. The primary prudential requirement is to maintain a

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[100] Transcript 9 November 2006, p 7.

[101] Act 94 of 1990 (as amended).

minimum level of capital and unimpaired reserves in the Republic to absorb potential losses in the event of risks materialising and to safeguard against the risk of insolvency. Currently, the general requirement is for banks to maintain a minimum capital and reserve balance of R250 million.

The regulatory and prudential requirements set out in the Banks Act are intended to protect the public. The fact that they are in place also provides regulators with a means of controlling financial conditions. They nevertheless pose a considerable barrier to entry by new firms and are an objective factor in any analysis of the degree of market power enjoyed by incumbents.

It is notable that since 2002, no new bank licenses have been granted, although there have been some purchases of existing bank licenses. The number of registered banks[102] has fallen from 41 in 2002 to 17 in 2006.

Our focus here is on conditions affecting competition in the market for the provision of PTAs and related services. As deposit-taking is involved, this is the preserve of banks. Issues of access to and participation in the payment system – historically but not necessarily in itself the preserve of banks – are dealt with comprehensively in the chapter of this report on Access to the Payment System. Nevertheless, insofar as the provision of PTAs necessarily involves banks in the payment system, the cost of that involvement must be taken into account when assessing barriers to entry for banks themselves.

In South Africa, registered banks may become clearing banks by obtaining a SAMOS settlement account with the SARB and membership of the Payment Association of South Africa (PASA) and the Banking Association.[103] There are membership and usage fees to be paid in this regard, and ultimately fees to Bankserv or any other operator or association (like MasterCard and Visa) in which the bank participates or whose services it uses. All of these are explicit costs that would mount up as a new entrant expands its participation in more payment streams[104]. Here too, the volume of business that a firm can expect in entering and remaining in the market must play a crucial part in any decision to do so.

2.5.2 Switching costs and customer inertia

Any new entrant faces the difficult challenge of having to attract new customers. In retail banking this is made particularly difficult by the inherent inertia of customers in this complex industry, and the established reputation of incumbents' brands. As will be demonstrated in

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102 Apart from 15 local branches of foreign banks, which are not full service banks, and 2 mutual banks.

103 It was indicated during the Enquiry that the last-mentioned requirement was in the process of being dropped.

104 These matters are expanded in both the Chapters on the Payment Cards and Interchange and Access to the Payment System.

detail further in this chapter, switching costs are high and consumers are not very responsive to price. This means that any new entrant would face considerable difficulties attempting to attract customers on the basis of competitive pricing. It would have to be able to offer a significantly lower price and satisfy consumers that it would sustain that price difference, in order to attract customers from the incumbents. This factor adds considerably to barriers to entry, and so reinforces the incumbents' market power.

Every time a customer transfers funds from his or her account to somebody who banks at another bank, the bank from which funds are transferred will lose reserves. During the course of the trading day, there will, of course, be funds flowing in the opposite direction. With stable market shares, the banks have a good idea of how much to keep in the form of excess reserves (to alleviate risk). One of the problems facing a new bank is that until it has achieved a reasonable market share, it will have to keep enough excess reserves to deal with such a drain on its reserves.

2.5.3 Reputation and brand loyalty

Consumers tend to place a high premium on the reputation of incumbents' brands. This is particularly true in the case of banking where consumers perceive an established brand as being representative of the stability of the bank and thus the security of their deposits.

The consumer survey conducted for the Enquiry by KLA found that consumers perceived larger banks to be more secure and stable. It was noted that "advertising is more strongly associated with bigger banks which in turn emphasises their stronger sense of establishment."[105] Trust and security were among the themes typically invoked. Further, in differentiating between small banks and large banks, the majority of participants in the survey associated greater stability and financial security with "big banks" as opposed to "small banks".[106] Consumers appear to have bought into the notion of some banks being "too big to fail".

Already inert customers will not easily choose a new bank that does not have an established brand. It is thus not surprising that the banks spend substantial amounts of money on brand awareness and "top-of-mind" advertising.[107] FNB note that "building the brand" takes the form of advertising as well as sponsorships. "Brand building via advertising takes place

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105 Kaufman, Levin, Associates "Qualitative research to understand what the main factors are that drive consumer choice when choosing a bank for the first time and when considering whether to switch to another bank", July 2007, Exhibit GGG, slide 13.

106 *Id.*, slide 14.

107 Hal R. Varian observes (*op cit*, p 453) that if firms can succeed in convincing the consumers that their product has no close substitutes, they will be able to charge a higher price for it than they would otherwise be able to do. "This leads each producer to invest heavily in creating a distinctive brand identity. Laundry soap, for example, is a pretty standardized commodity. Yet manufacturers invest huge amounts of money in advertisements that claim cleaner clothes, better smell, and a generally happier existence if you choose their brand rather than a competitor's. This 'product positioning' is much like the ice cream vendors locating far away from each other in order to avoid head-to-head competition."

across the market; however extra efforts are made in market segments where FNB is focused on improving market perception."[108] FNB spent more than R15 million on sponsorships in 2006.[109] Brand-building is linked to product positioning and product differentiation (discussed further below). Our impression is that differential colour-branding and general image-building have tended to be emphasised in the major banks' advertising rather than hard-edged messages advancing competitive prices. This poses a significant barrier for new entrants who must incur substantial sunk costs from spending on advertising and brand awareness.

2.5.4 Extensive branch networks and infrastructure requirements

Although there are alternative distribution channels for the delivery of personal transaction services, physical branches have played, and are likely to continue to play, an important role in the channel strategy of retail banks. The costs of establishing and maintaining physical branch networks are substantial and pose a significant barrier for new entrants who do not have established branch infrastructure.

The importance of physical branches is evident in the banks' response to the requirements of the Financial Sector Charter to provide banking to low-income individuals. Absa submitted to the Enquiry that it plans to increase its branch network over the coming years and noted that "network expansion will follow from the requirements of the Financial Sector Charter related to providing access to low-income individuals, and will also flow from Absa's long-term growth across all customer segments".[110]

2.5.5 Limited expansion by firms in the competitive fringe

"Oligopoly", write Lipsey, Courant and Ragan, "is consistent with a large number of small sellers, called a 'competitive fringe', as long as a 'big few' dominate the industry's production."[111] With appropriate caveats, the South African banking market for PTAs, while clearly an oligopoly, may be characterised as having a "competitive fringe".[112]

In this regard it is important to assess whether competition from firms on the fringe effectively constrains the market power of the big banks. The combined share held by smaller banks in the market under consideration is very small, constituting altogether less

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108 FRB, October 2006, First Submission, p A1.64.

109 *Id.* Note that FNB is one of the brands of FirstRand Bank. See Transcript, 9 November 2006, p 5.

110 Absa, First Submission, October 2006, p 7. Branch construction in order to meet FSC proposed densification objectives is estimated to be R27 million per year for each of the big four banks (*Id.*, p 20).

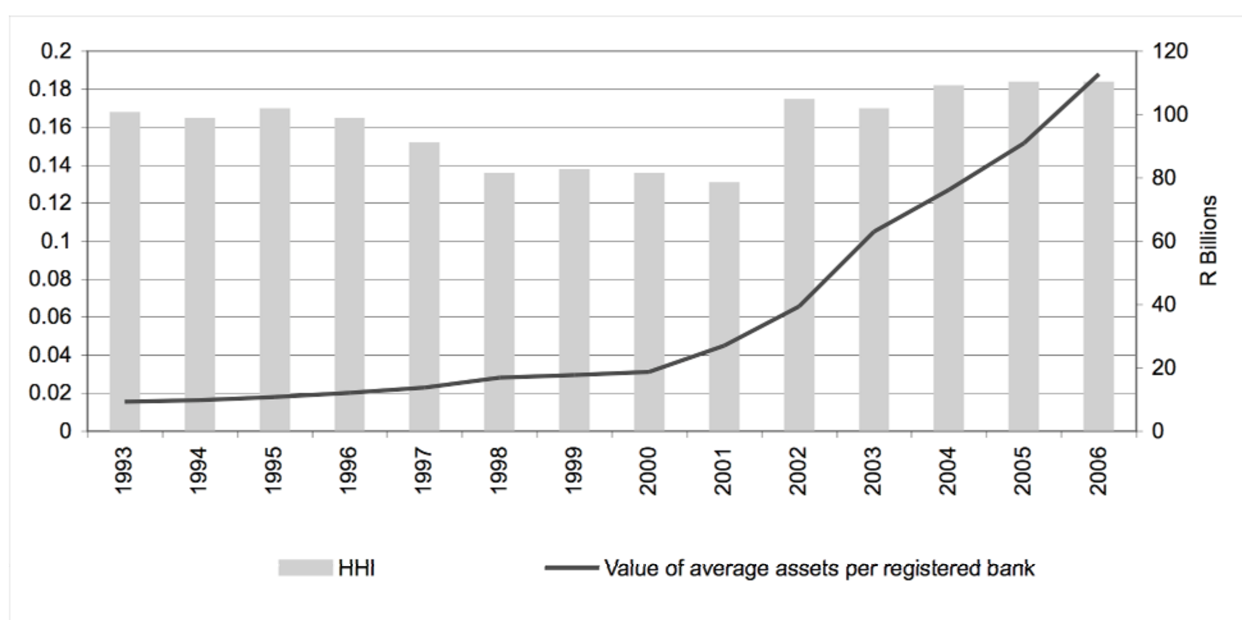
111 *Economics*, 12th edition, p 260.

112 When describing a fringe as "competitive", it must be borne in mind that players on the fringe may in fact use the supra-competitive prices of the oligopolists as a benchmark when setting their own prices, thus diminishing effective competition with incumbent firms.

than 10 per cent. As noted above, the cost structure of banking drives concentration. The volumes needed to achieve the kind of scale economies enjoyed by the major banks are substantial and have, as yet, not even been approximated by other firms. Although there have been some success stories these have largely been in niche areas either at the high end or the low end of the market.[113] The dominance of the major full-service banks in the wider middle market has gone largely unchallenged.

In the past the scope for a smaller bank to develop into a serious contender has been stifled as a consequence of a fairly stagnant market. This situation has changed somewhat over the last few years, which has seen substantial growth in the market. Nevertheless, retail banking has become more rather than less concentrated since 2001. Figure 3 shows the HHI[114] (a measure of concentration), and the value of assets of registered banks (a proxy for market growth).[115]

Figure 3 HHI and average value of assets per registered bank for South Africa



Source: Bank Supervision Department, SARB.

A number of factors have contributed to increased levels of concentration since 2002. Prior to that, and after 1995, a number of new entrants reduced concentration in the industry, but the failure of Saambou and BOE (the seventh and sixth biggest banks, respectively, at the time) in 2001/2002 resulted in a number of smaller banks leaving the market. However, two

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113 In this regard we have reference to Investec – a bank providing PTAs and related services to high net worth individuals; and Capitec – a bank specializing in microfinance which has had success providing transaction accounts to low income consumers.

114 HHI is the Herfindahl-Hirschman Index, a measure of concentration devised in the United States. It is calculated as the sum of the squares of the market shares of every firm in the relevant market. See Herbert Hovenkamp, *op cit,* p 518. We are not concerned here with the significance of particular HHI levels, the significance of which is debatable, but rather with the *trend* towards greater concentration which the index reveals.

115 These and other data were originally part of the Falkena III report, and have been updated and presented in the Appendix at the end of this chapter.

features of the market have been consistent since 1993. The first is that the market has been dominated by the four largest banks. The second is that no new full-service bank has emerged to challenge the dominance of the big four.

There is currently no indication of a foreign bank intending to enter the market on a green fields basis. Even the recent entry into South Africa of Barclays Plc – one of the largest banks in the world – was by way of acquisition of control of Absa, one of the existing big four. Given the barriers to entry discussed above, as well as the particular challenges faced by smaller banks, there is little prospect for banks on the fringe to expand and pose a serious challenge to the dominant positions of the incumbent full-service banks.

The fringe consists of a number of smaller banks. These include Investec, Capitec, Postbank,[116] South African Bank of Athens/Wizzit, Mercantile Bank, Teba Bank, and Ithala.[117] In this section we discuss some of the key fringe competitors and evaluate the scope for their expansion and whether or not they are likely to pose a competitive constraint.

Investec

Investec did not make a submission to the Enquiry. It is predominantly an investment bank focusing on "serving the needs of select market niches where the group can compete effectively".[118] This approach also applies in the case of transactional banking where Investec targets high-net worth individuals only. It has shown no sign of deviating from this business model and thus cannot be considered as an existing or potential competitive constraint in the broader low and middle market for personal transaction accounts, although it does compete with the big four for high net worth individuals.

Capitec

Of all the smaller banks, Capitec may have the greatest potential to introduce serious competition for the currently dominant banks. In its submission to the Enquiry in 2006, Capitec stated an ambitious "vision to be the dominant mass market bank".[119] This goal could be achieved, it submitted, by offering affordable services to the low income market.

Capitec has had success in this regard. Fees for transaction services on its products are significantly lower than those of the other banks and it has increased the number of account holders from 399,000 in 2004 to 1,010,000 in 2007.[120]

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116 The Postbank is excluded from the application of the Banks Act.

117 Ithala Limited is not a registered bank. It has an exemption from the provisions of the Banks Act. (See further the chapter on Access to the Payment System.)

118 http://www.investec.com/GroupLinks/AboutInvestec/CoreActivities.

119 Capitec, First Submission, October 2006, p 18.

120 Capitec, Annual Report, 2007, p 7.

Capitec's core business is in making loans to low-income consumers. Its transactional products are similarly targeted at low-income consumers. Capitec's offerings are thus limited to a particular segment of the market. Its business model is thus one of niche banking targeted at a specific segment. As noted in its submission, "small banks have the ability to compete with large banks, not directly with all the products, but they can specialise in a niche."[121] This suggests that Capitec do not see much scope for development into a full-service bank that would compete with the dominant banks in the broader middle market.[122]

In its submission, Capitec highlighted a number of factors that restrict small banks' ability to expand and compete head-on with the larger banks:

- The requirement to be interoperable with the incumbent banks limits the scope for smaller banks like Capitec to expand and innovate. Capitec noted in its submission that:

  > ..due to the concentration of clients in the large banks it would be almost impossible to implement new innovative payment services unless all the large banks buy into the concept and see a business case. Smaller banks can implement payment instruments on their own but the success and volumes will only come when there is interoperability with the clients of the large banks. The market is therefore dependant on the ability of the large banks to move with new ideas.[123]

- Public perceptions that smaller banks are risky present a challenge to small banks attempting to attract depositors away from larger banks. As noted by Capitec:

  > Individuals therefore tend to place their deposits with large banks that are "too big to fail". This creates the challenge to small banks to attract depositors, normally paying higher interest rates as a risk premium, from large banks in order to grow their client base.[124]

South African Bank of Athens / WIZZIT

The South African Bank of Athens focuses on lending to small and medium sized businesses generally owned by members of the Greek community.[125] Although it accepts deposits and offers transactional products, this is a limited part of its business and thus it cannot be considered a significant competitor in the market for personal transaction services.

However, the South African Bank of Athens recently (March 2005) launched a division called

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121 Capitec, First Submission, October 2006, p 9

122 As Mr Stassen, CEO of Capitec stated at the hearings, "We are a very focussed bank, we are not everything to everybody..." Transcript, 4 April 2007, p 121.

123 Capitec, First Submission, October 2006, p 9

124 *Id.*, p 5.

125 https://www.bankofathens.co.za/home

WIZZIT, which provides transaction services on a low-cost basis to un-banked and under-banked consumers.[126] WIZZIT offers various transaction services through a combination of mobile phone technology, ATMs, and branches of Absa and the Post Office.[127]

The experience of WIZZIT shows the great potential that exists for technology to be used to overcome costs of establishing a branch infrastructure in order to provide low cost transactional services. However, WIZZIT's experience also illustrates the difficulties that non-bank innovators face in entering the market. It is noteworthy that WIZZIT originally arose as a business model developed by entrepreneurs who were not affiliated with registered banks. As a consequence of the bank-led model of regulation in South Africa, WIZZIT were compelled to partner with a licensed bank in order to able to bring their product to market. As noted by CGAP,[128]

> Technology firms and mobile operators that want to develop e-money based branchless banking have to partner with a licensed bank, thus increasing their costs and delaying time to market. The result is technically a bank-led model that is only marginally "branchless", in that the bank's infrastructure and personnel are used for all cash transactions except where services are rendered through post offices.[129]

The restrictive approach of South African authorities towards e-money, relative to international comparative standards, is discussed in the chapter on Access to the Payment System.

Mercantile Bank

Mercantile Bank, is a subsidiary of Caixa Geral de Depósitos, a company registered in Portugal. While providing "a full range of domestic and international banking services", Mercantile operates in selected retail, commercial, corporate and alliance banking niches.[130] Apart from Portuguese customers, its focus is on small and mid-sized businesses.

Mercantile's relatively small scale and niche market focus does not pose a major challenge to the dominant position of the big four.

Postbank

Postbank did not make a submission to, or engage with, the Enquiry in any way. As a result we have been unable to explore the important question of its potential for expansion as a

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[126] Wizzit, Submission, 2006, pp 4-5.

[127] Transcript, 9 November 2006, pp 140 and 150.

[128] A World Bank entity focussing on financial inclusion.

[129] CGAP Focus Note, No.38, October 2006, p 12, *Use of agents in branchless banking for the poor: rewards, risks, and regulations*.

[130] http://www.mercantile.co.za/au/cp/cp_overview.asp. Alliance banking refers here to cooperative arrangements with other entities which facilitates access to the payment system.

provider of deposit-taking and payment services in competition with the major banks, using for the purpose the extensive nationwide post office branch infrastructure.

In our view, concerted attention by the government to the role, regulation and development of Postbank is required. For purposes of the present chapter, we can only observe that we have no basis on which we could now conclude that Postbank will subject the major banks to any significant competitive pressure in the retail market segments of full-service banking where their market power is most pronounced.

Others

There are a number of other small banks and firms who offer transactional services in selected market segments. These include Ithala Limited, Teba Bank and MEEG Bank. However, they constitute a very small share of the total market and pose no significant competitive constraint to the major banks. Moreover, Absa has been in the process of acquiring MEEG, so that it may simply become another brand of Absa. The banking activity associated with retailers, which is frequently cited as evidence of banking competition, in reality, manifests joint ventures between retailers and major banks. These include Pick 'n Pay Go Banking (with Nedbank), Virgin credit card (with Absa), etc. These reflect brand proliferation rather than any fundamental change in the competitive landscape.

2.6 Product differentiation

Antitrust economists Viscusi, Harrington and Vernon write:

> No discussion of oligopoly theory would be complete without mentioning product differentiation. One of the most significant ways in which firms compete is by trying to make their product unique relative to the other products in the market. The reason is that the more differentiated one's product is, the more one is able to act like a monopolist. That is, a firm can set a higher price without inducing large numbers of consumers to switch to buying competitors' products.[131]

In their submissions and presentations during the hearings the major banks stressed that they compete on the basis of a number of factors, of which price is not the most important.[132] Although product differentiation is limited in the low income segment – particularly in the case of Mzansi – in the middle and high income segments the product offerings of the banks (i.e. transmission and current accounts) are characterised by a high degree of differentiation.

Each bank has emphasised the importance of being able to differentiate its offerings in order to meet the increasing variety of consumer preferences. Transaction services are delivered through a number of different channels, and consumers differ with regard to their usage of and preference for these different channels. Banks develop different product packages

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131 *Economics of Regulation and Antitrust*, 4th edition, pp 113-114. See also Transcript 17 July 2007, pp 92-98.

132 See further the chapter on Costing and Pricing.

based on unique channel combinations and pricing structures to be able to service as wide a variety of customer preferences as possible. Further, based on their strengths in particular channels and other strategic considerations, banks will differentiate their offerings to target different customer segments. In a report prepared for Standard Bank, Genesis Analytics (Pty) Ltd (Genesis) noted that comparisons between banks on the basis of a common profile of customer behaviour is rendered meaningless by the fact that banks differentiate their offerings to target different customer segments.

Standard Bank submitted that:

> Banks have, over time, evolved their products and service offering in line with increased understanding of their customers and their behaviours. As the ability to manage data and evaluate customers' preferences on channels has improved, customers have in turn displayed their preferences in unique combinations which allow them to optimise their lifestyle choices with increased diversity of channel access.[133]

Evidence of this can be found in the fact that while certain customers prefer to do their banking through electronic means such as the Internet and payment cards, other customers (who perhaps do not have access to the Internet) make greater use of branches and ATMs. Customer usage of different channels is also influenced by differences in income. For example, access to and frequency of use of payment cards will vary depending on the level of income of the customer.[134]

Banks therefore compete to develop products which best match the behavioural characteristics of customers. The closer the fit between the features of the product and the behaviour and preferences of the customer, the more willing the customer will be to pay a higher price. Of course, consumers' willingness to pay is greatly influenced by income levels – with higher levels of income being associated with a greater willingness to pay. This explains why there is greater product differentiation and product variety in the middle and higher income segments than there is in the low income segments.

The consequence of this form of product differentiation is greater product variety and, given the presence of alternative channels of distribution, greater product complexity. It is important to note, however, that differentiation arises from different *combinations* of product features and different pricing structures and not from intrinsic differences in the product features themselves. The full-service banks all offer the same set of transaction facilities. It is the manner in which these facilities are packaged and priced which varies from bank to bank.

The consequence of the prevailing practice of product differentiation by the banks in South Africa is that it is a *fait accompli* that each of the major banks will have a degree of market

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133 SBSA, July 2007, Comparison Shopping for Banking Services, p 4.

134 *Id.*

power over its customers. What is disputed, however, is whether this market power is *appreciable*. In the following section we explore the extent to which the market power of each of the banks (which is inherent in a model of product differentiation) is enhanced as a result of the information asymmetries and costs of searching and switching which are prevalent in the market for personal transaction accounts.

2.7 Information asymmetries

When customers have sufficient information they are able to use this information to make efficient and rational choices. Firms thus have an incentive to provide products that best meet the needs of customers and are forced to compete with one another as consumers are sufficiently informed to be able to differentiate between the offerings of the different firms. Competition tends to result in prices that reflect the value to the consumer of the particular product or service, rather than the ability of the firm to exercise market power.

However, when firms have more information than their customers about the attributes of their products, this information asymmetry confers on these suppliers a degree of market power over their customers. In such circumstances it may be difficult for consumers to assess the attributes of the products or to differentiate between the different offerings of the firms. This may be because of the complexity of these products or because they are purchased infrequently. Where customers are not adequately informed, and suppliers do not adequately disclose relevant information, competition on price, quality, and other factors is likely to be diminished.

There are a number of factors which contribute to and exacerbate information asymmetries in the market for personal transaction services. These are discussed below.

2.7.1 Limited knowledge and understanding of fees paid by consumers

There are several products in the market for PTAs and related services where pricing is not transparent. These include the pay-as-you transact and packaged cheque and current account services of the banks. The actual cost to consumers of purchasing these products depends on the interest rates and fees applied to the accounts, as well as the various fees for payment services. The combination of these elements makes it very difficult for consumers to determine exactly what they will pay for particular products, and thus also makes it difficult to compare products.

The KLA study for the Enquiry showed that most of the focus group participants had limited knowledge about what they were being charged for transaction account services. In particular, the study reported that “the sheer variation with respect to fees (different for

different banks and different applications) is experienced as very confusing"[135] and difficult to calculate.[136] As a result, participants felt disempowered and were forced to rely on and trust the experts, namely the banks. It was reported that there was an element of blind faith among consumers entering into relationships with the banks, and that consumers are not able to "interrogate, confront, and challenge these experts due to a lack of knowledge, experience and confidence".[137] These problems are exacerbated where many consumers suffer the additional disadvantage of low levels of formal education.

A focus group study done by the Monitor Group for the Banking Association produced similar results.[138] In particular Monitor found that:

- Customer awareness of fees and fee levels is limited
- Many customers do not use the cheapest channels, although price is a driver of behaviour
- Customers find it difficult to understand fee information and tables in bank statements and other bank documents.

At the hearing on 9 July 2007, Mr Shuter of Nedbank discussed some of the findings of Nedbank's own research indicating that consumers have little knowledge of and do not really interrogate what they pay in bank fees:

> One of the challenges with bank fees is, we still do not see a huge trend of clients actively inquiring on what their fees are inasmuch as all of the information is available in the branch space and the things are printed out and all of that. The research we have done on people opening current accounts in our branch system is that they are not actively inquiring on fees as to one of the challenges we have had because we have to…, must explain to our stakeholders [shareholders] why it is important that we are competing so strongly on the price element when some of our own internal research says that much as there is a sort of general view that banking is expensive and people are being charged too much, there is not a great deal of inquiring at an individual level on the cost of banking and you only have got to do, you know pop surveys just amongst just our own peers, very few people had actually interrogated what they are paying. So I would not accept the argument that clients are trying very hard to compare but it is so difficult that they are actually now focusing on service and product.[139]

Mr Shuter appeared to conclude that perceptions of a lack of transparency are unfounded, and that consumers' ignorance arises from apathy and consequent failure to question what they pay for bank fees rather than inadequate disclosure of information on the part of the banks.[140] In this regard he referred to anecdotal evidence as well as research conducted by

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135 Exhibit GGG, *s*lide 38. See also slide 35.

136 Transcript 17 July 2007, pp 175-177 (Ms Matterson).

137 Exhibit GGG, Slide 38.

138 Monitor Group, Competitiveness Report, 20 October 2006.

139 Transcript 9 July 2007, p 74.

140 Consumers would challenge this however. Mr. N Kholisile of the FSCC noted how fees are charged without adequate explanation: " I …did some of the research and…even went to my own bank statements and got reminded of some of the …charges that appeared there…You will get a R10 …"fee", a R4.90 …"fee" and a R2.00…"fee"…" Transcript, 3

Nedbank (not supplied). The KLA and Monitor studies also support the finding that consumers generally do not actively question what they pay in bank fees. However, this is not because the level of fees is unimportant to them. Lower bank fees would be a key factor when choosing a bank.[141]

We find that consumers' failure to question fees is symptomatic of a number of factors. Consumer apathy certainly plays a role, but it is not surprising that consumers are apathetic given the difficulties they face when trying to decode complex product features and pricing structures (see further below). Pro-active measures need to be taken to improve transparency and disclosure so that consumers are able to actively interrogate their bank fees.[142] This will stimulate competition. As the situation currently stands, consumers' failure to question fees means that, in general, consumers are not responsive to changes in price. This is a constraint on effective competition as it makes demand more inelastic and is thus a source of market power for the banks.

2.7.2 Price and product complexity

As noted in the discussion of product differentiation above, there are a number of alternative channels available for the distribution and delivery of various transaction services. Transactional products are complicated because they consist of combinations of channels with differing pricing structures for each. While it is possible to simplify pricing structures, transactional products are likely to remain inherently complex.

In addition to problems of transparency and disclosure, the greatest difficulty faced by consumers in the searching process lies in the ability to make meaningful comparisons across the product offerings of the banks.

At the request of the Panel, the Enquiry's Technical Team compiled a table containing the product features and pricing of the basic packaged offerings of Absa, Standard Bank, FNB and Nedbank.

It is evident from the comparison table that there is no uniformity in the manner in which the packaged offerings are structured and priced. It is therefore impossible to make direct price comparisons between the offerings without having to input detailed information about the transactional behaviour of the prospective customer and then perform fairly lengthy calculations based on the different pricing formulas of the banks.[143]

November 2006, p 85.

141 Transcript 17 July 2007, p 165.

142 Note that consumer groups called for improved (and even mandatory) education of consumers. Transcript, 2 November 2006, p 10.

143 An added difficulty for the customer would be to factor in different interest rates, if any, on credit balances and their ultimate net effect on the likely real fee. We have not found it feasible to perform such an exercise.

Table 2 Comparison of bundled current account options (2007) [144]

	Absa	Standard Bank	FNB	Nedbank
Name of bundle	Absa Silver Package	Classic Current account pricing option	Personal Cheque Account - Fee Manager	Every-day current Account
Pricing	R99.00	R76.00	Option 1: R45 Option 2: R85 Option 3: R135 Plus Option:[145] R140	R85.00 This fee can be rebated to R55 per month if the client holds a Nedbank homeloan and credit card.
Number of transactions	25 of the features discussed below	Bundle of specified transactions (53 transactions)	Option 1: 6 Option 2: 12 Option 3: 20 Plus Option: 12	Bundle of specified transactions (some unlimited and number of some specified)
Per item thereafter	R10 for transactions in the bundle, and all other transactions not included in the bundle are charged at the Silver current account standard fee rates.	Pay as you transact will apply	Option 1: R9.00 Option 2: R8.00 Option 3: R7.00	Special current account rates apply
Eligibility	Income between R5,000 and R9,999	Earn at least R3000	Earn at least R24,000 a year and are over 21 years of age	Over 21 years of age Have a credit history Earn > R3,000 per month
Features in all	Cash withdrawals (Absa ATM) Electronic fund transfers Account Payments Prepaid top-ups Cheque or debit card purchases Debit orders and Stop orders Internet, Cellphone and Telephone banking	8 Cash withdrawals (Auto bank) (The Standard Bank portion of other bank ATM withdrawals is also included in the 8 cash withdrawals) 15 Electronic fund transfers and Account Payments and Debit orders and Stop orders Unlimited Prepaid purchases 15 Cheque Debit card Purchases Internet, Cellphone and Telephone banking	Cash withdrawals (FNB ATM) Linked Account Transfers Account Payments Prepaid purchases Cheque Debit card Purchases Debit orders and Stop orders Internet, Cellphone and Telephone banking	4 Cash withdrawals (NEDBANK ATM) Unlimited Electronic fund transfers Account Payments Prepaid purchases Unlimited Cheque Debit card Purchases Unlimited Debit orders and Stop orders. Internet, Cellphone and Telephone banking

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[144] The information contained in this table has been verified and confirmed by each of the relevant banks.

[145] According to the FNB pricing Brochure 1 June 2007 – 30 June 2008, p 12, “this option is available to Smart Cheque Account customers only. If you earn R2000 or more per month you may qualify for the Smart Cheque Account Plus Option. For only a monthly fee of R140 you will receive a) 12 included transactions (as per the included fee manager transactions…) and b) A funeral policy of R10,000 for you, your spouse and up to five children.”

	Absa	Standard Bank	FNB	Nedbank
Special features	No monthly fees for NotifyMe, An interest free overdraft up to R500 Free life cover to the value of R10,000 Silver credit card with no annual fees Access to a Budget tool for financial planning Access to savings and investment options Overdraft ledger fee Electronic Balance enquiries and mini statements Absa ATM cash deposit (max 2 per month) Cash back on Vehicle finance and Home Loan deals	10 Cheques 2 Auto bank cash deposits Unlimited Electronic balance enquiries, mini-statements Annual cheque card fees (includes secondary card and lost card protection) 3 Branch cash withdrawals (includes withdrawal fee portion of cheque encashment)	Scheduled Payments and transfers Mini-ATM cash withdrawals Branch cash withdrawals Cheques Cashback at Point of Sale Petrol Card Purchases Free ATM, Internet, IVR Telephone, Cellphone Balance Enquiries Free ATM Cash Deposits Free Internet Statements 1 Free Printed & Posted Statement Per Month Free Cheque Books Free Internet Free InContact Statements The Plus Options is available	Garage debit card fuel transactions Annual cheque card and garage debit card fees Chequebooks Unlimited Balance enquiries at Nedbank and Nedbank Group ATMs and self-service terminals (SSTs) Unlimited Statement requests All statements 1 Cash deposit in branch or ATM 1 over the counter branch withdrawal The overdraft facility has been included since 1 June 2007.
Features charged for separately in all (outside the bundle)	Saswitch transactions	Saswitch fee component (R6.70) of agent bank cash withdrawals	Saswitch transactions	Saswitch ATM transactions
Other features charged for separately (outside bundle)	Branch transactions Any other transactions	All other transactions get paid for	Branch Cash Deposits Balance enquiries at branch Cash handling fees on branch cash withdrawals Special instructions Penalty fees Cash deposits at branch ATM mini-statements Any other	International ATM withdrawals Cheque payments Unpaid items Stop-payment instructions Any other

Source: 2007 Pricing Brochures.[146]

In our assessment, the difficulties involved in making direct price comparisons are prohibitive for most consumers. The reality is that most consumers do not make product choices on the basis of price because they cannot do so readily and effectively.

146 Verified by the appropriate banks in July 2007.

In their submission FNB note that:

> banking services are inherently complex products, and the structure of pricing must reflect that. … In particular, most banking products are compound goods, combining a number of elements and services.[147]

During the hearings Mr Shuter of Nedbank said:

> We have got a complex geography, complex array of clients. *We segment the market and we try very hard to differentiate and a lot of the complexity comes from that.* Now there is one school of thought that says that is a bad thing, no one can compare. There is another school of thought that says the complexities arise from the fact that there is a competitive environment where people interpret clients' needs differently, and one bank adds in this [while] another takes it out.[148]

It is clear that product complexity is an inherent property of product differentiation across multiple channels. What has not been demonstrated is that such differentiation has been successful in maximising consumer welfare by delivering affordable banking that meets the needs of consumers. As has been discussed above and is pursued subsequently in this chapter, there is inadequate transparency and disclosure in respect of the features and pricing of transactional banking products. The inherently complex nature of composite transactional banking products serves to aggravate this problem and further highlights the need to introduce proactive measures to improve transparency and disclosure.

2.7.3 Confusing terminology

In differentiating their product offerings, each bank uses its own terminology to describe its products and related product features. This makes it all the more difficult for consumers to understand and assess the different offerings of the banks.

Nedbank, for example – while arguing that product differentiation is part of healthy competition – agreed that "where you have exactly the same fee but it is called a different name, we do not think that is particularly helpful. We … think some standardisation on the vocabulary would be helpful."[149]

Currently, there are no codes providing for a standardisation of terminology in respect of personal transaction services. This hinders comparability and is thus likely to soften considerably the degree of effective price competition. The need to standardise terminology runs together with the need for industry standards generally to facilitate price comparisons.

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147 FRB, October 2006, First Submission, p 23.

148 Transcript 9 July 2007, pp 71-72. (Emphasis added.)

149 See *id.*, pp 45-46.

2.8 Switching and search costs

Competition tends to be more robust when consumers are able to easily switch from one supplier to another in response to a competitive price or some other factor that offers the customer better value for money.

However, when consumers are restricted from switching – whether deliberately (by the banks) or otherwise[150] – competition is inhibited. In particular, when consumers face switching costs they become captives of their suppliers, thus conferring on the latter a degree of market power. In particular, higher switching costs mean that consumers will be less responsive to changes in price and thus the demand for firms' products will be relatively price inelastic.

Banks assured the Enquiry of their willingness to assist customers in switching. As Mr Jordaan of FNB puts it, "What we try and do is from our side, make it as easy as possible for customers to switch to us."[151] We believe that all banks do assist customers in switching their accounts *to them*. Assisting customers who want to switch their accounts to another bank is not something that can appeal to an incumbent. As FNB frankly acknowledged, it is imperative for the bank that each account opened remain active for as long as possible.[152]

A useful way to determine whether the banks have an appreciable degree of market power is to test whether each bank would be able to implement a "SSNIP" – a small but significant non-transitory increase in price – without losing so much business to rival suppliers that the increase would not be worthwhile.[153] Ordinarily, a sustained price increase of 5 per cent or more would be sufficient in this regard to enable a significant degree of market power to be identified.[154]

The European Commission guidelines on market analysis and the assessment of significant

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150 The difficulty for customers in switching banks derives to a large extent from the complexity and combination of services they receive from full service banks, which tend to discourage them from switching banks unless they are intensely driven to do so. For most bank customers, switching banks will also entail re-arrangements with service providers, employers, etc all of which will add to the hassle factor of switching.

151 Transcript 9 July 2007, p 196.

152 FRB, Response to the Request for Information from the Competition Commission Banking Enquiry: Switching Costs, August 2007, p 2. See also Transcript 9 July, 2007, p 143 and p 151.

153 The "SSNIP" test, first devised in the United States as a tool for defining relevant markets in merger evaluations, has been applied more generally where the existence of market power needs to be determined and has gained general acceptance internationally. Here it has been specifically approved by the Competition Appeal Court in *Patensie Sitrus Beherend Bpk v Competition Commission* [2003] 2 CPLR 247 (CAC) at 257*h-i*. See also *Medicross Healthcare and another v Competition Commission* [2006] 1 CPLR 1 (CAC) at 9*d*-10*c*.

154 In the usual application of the "SSNIP" test, the assumption would be that the existing price charged is at no more than an effectively competitive level. However, the existing price may in fact be higher. The real test is therefore whether a price 5 per cent or more *above the competitive level* could be charged without losing the customers. The "SSNIP" test provides a possible means of establishing that. Where, say, a monopolist is already charging customers a supra-competitive price at the limit they can bear, even the smallest further increase could cause the loss of customers, who simply fall out of the market. Where, however, a sustained increase of 5 per cent or more could be imposed without the loss of customers, one can (without having to pin down the notional competitive price) safely conclude that significant market power prevails.

market power under the Community regulatory framework for electronic communications networks and services state:

> The possibility for consumers to substitute a product or a service for another because of a small, but significant lasting price increase may … be hindered by considerable switching costs. … Accordingly, in a situation where end users face significant switching costs in order to substitute product A for product B, these two products should not be included in the same relevant market. [155]

By parity of reasoning, if customers would be deterred from switching banks by the cost of doing so even if the price charged by their existing supplier were to rise by 5 per cent or more above that charged by its rivals (and kept there), it must follow that that supplier enjoys appreciable market power. Likewise, such a conclusion would follow if a rival would have to offer a price that is lower by more than 5 per cent over a significant period (all else being equal) in order to induce the other's customers to switch. For this reason a calculation of the switching costs faced by bank customers provides the basis for applying a variant of the "SSNIP" test in order to assess the degree of customer *captivity*, and thus of banks' market power.[156] Before proceeding to that calculation, we must deal with a preliminary issue.

In their submissions the banks have argued that switching costs faced by their customers are not significant. In this regard they refer to "churn" figures which they say indicate substantial customer mobility and thus relative ease of switching.

The following table, presented by Standard Bank at the hearing on 13 November 2006,[157] shows annual churn figures for Standard Bank for a number of different market segments in personal banking:[158]

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155 (2002/C 165/03), 11.7.2002, para 50.

156 Of course, a sure way for customers to escape captivity in the hands of their suppliers is to drop out of the market altogether and simply go without. In the case of retail banking services, such a course would imply such adverse consequences for the great majority of customers that we can safely assume that a small but significant non-transitory increase in price from current levels would not generally induce so drastic a step. Customer would generally remain available for exploitation by their "captors".

157 Exhibit V, slide 9.

158 These "churn" figures are more or less consistent with the Enquiry Technical Team's calculations based on confidential data submitted by all the major banks.

Table 3 Churn figures calculated by Standard Bank for market segments

Market	Churn
Cash management / transactions	20%
Low income ("Convenience")	21%
Middle income	11%
Term/notice deposits	46%
Home loans	18 - 31%
Overdrafts	11%
Credit card	38%
Personal loans	24%

Source: Standard Bank Presentation, Exhibit V, slide 9.

We do not accept that these churn figures reflect *switching*. Churn has been calculated as:

$$\frac{\text{(No. of accounts opened + No. of accounts closed)}}{\text{2 x Total No. of accounts at the beginning of the year}}$$

The figures thus include all forms of account closure and opening and do not isolate those instances where individuals close their account at one bank and open an account at another bank. First, churn figures based on the above formula will reflect the large increase in the number of accounts opened by people who have not previously been banked. Second, churn figures will include accounts opened in error and subsequently closed; accounts closed as a result of death; facilities being repaid (i.e. home loans and personal loans where relevant); and accounts closed as a result of abandonment as customers exit the banking system or leave the country. Third, included in churn would be those accounts opened and closed by customers who change products but stay with the same bank. The following exchange took place during the hearings (Mr Pintusewitz for FNB):

> MRS NYASULU (of the Panel): … I am trying to understand, on the issue of the switching to a rival bank, whether you are able to isolate specifically those figures, as opposed to someone just saying "I do not like this product because you are overcharging me on it, I am still your customer but I do not want your cheque account anymore." Are you able to isolate the specific number of people who just pack up in toto and move to another bank?
>
> MR PINTUSEWITZ: The numbers we have got include both, so we cannot show you the one piece and the other.
>
> MRS NYASULU: You cannot isolate?
>
> MR PINTUSEWITZ: So we cannot isolate it at this time and, as I say, we do those customer surveys to try and understand that as well as possible. [159]

Therefore churn cannot be said to quantify switching in any sense of the word.

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[159] Transcript 9 November 2006, pp 37-38..See also *id.*, pp 46-48. No bank was able to supply the Enquiry with figures for actual switching.

However, even accepting that there must be some level of actual switching, this says nothing about the level of switching costs or whether or not firms have market power. In a very competitive market, with zero switching costs, switching rates may in fact be very low – because the satisfied customers of competitive firms would have little incentive to switch to equally competitive rivals.[160] However, a firm with significant market power may raise price to a level where other (perhaps less optimal) substitutes become viable for the customer.[161]

In the market for personal transaction services, prevailing prices would already reflect the market power conferred on the banks as a result of search and switching costs. Even if churn reflected switching, the fact that we observe churn at prevailing prices says nothing about the degree of pricing power conferred on the banks due to search and switching costs. Nor does it say anything about whether this market power is appreciable or not. The degree of pricing power conferred on the banks as a result of search or switching costs can only be determined by calculating directly the actual costs of searching and switching as a percentage of the competitive price.

In its report referred to above, Genesis, economic consultants assisting Standard Bank, estimated actual switching costs for personal transaction accounts by costing the steps required to switch from one provider to another.[162] Genesis assumed that consumers would typically be likely to keep the same banking account for a period of three years and calculated the base price as the net present value of three years of bank fees. For products in the middle income segment, switching costs (calculated as a percentage of this base price), were estimated to be less than 3 per cent.[163]

Genesis argued that, at this level, switching costs are sufficiently low that any transaction account holder who wishes to switch to a bank offering 3 per cent lower fees would be able to do so and recover their costs within three years. Although not explicitly stated it appears that because that percentage falls below the 5 per cent threshold required for a SSNIP, Genesis concluded that switching costs do not confer meaningful market power on Standard Bank.

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160 Cf FRB, August 2007. FRB view on the costs of switching bank accounts, p 2.

161 Church and Ware, 2000, *Industrial Organisation – a Strategic Approach*, p 617: “A monopolist will always raise price until demand is elastic, thereby making it more likely that there are, as the Supreme Court found in *Cellophane*, products “that have reasonable interchangeablility for the purposes for which they are produced – price, use and qualities considered”. “*Cellophane”* refers to the now-notorious “cellophane fallacy” introduced in *U.S. v E.I. du Pont de Nemours & Co.* 351 U.S. 377, 76 S.Ct. 994 (1956), where the court found that there was no distinct market for cellophane because other flexible packaging materials would be substituted by consumers if cellophane prices were to rise. As Prof Hovenkamp explains the fallacy (*Antitrust*, 4th edition, p 133): “When the monopolist charges its profit-maximizing price, it is trying to charge as high a price as it can without losing a substantial number of customers. In that case the cross elasticity of demand will appear high, not because the monopolist has no monopoly power, but because it is *already* charging a monopoly price.” See also *York Timbers Ltd v SA Forestry Company Ltd (1)* [2001-2002] CPLR 408 (CT) at 424, par 79.

162 Genesis Report to Standard Bank, 08/11/2006, pp 6-8, pp 20-24.

163 See also Transcript 18 June 2007, pp 192-195.

In our opinion, there are a number of problems with the Genesis analysis which invalidate the conclusion that switching costs do not confer meaningful market power on Standard Bank and, by implication, on other banks.

First, Genesis underestimated the costs associated with certain important steps in the switching process. These include transport costs incurred in the switching process and the opportunity cost of time spent by the customer instructing the new bank about the customer's previous banking arrangements (e.g., salary deposits and debit orders etc).

Second, Genesis failed to take into account the cost of searching. Although searching is distinct from switching, the cost of searching is important in assessing market power as consumers must first search for the best alternative before they can switch to it.

Third, the base price used by Genesis relies on prevailing prices. This is incorrect. The SSNIP test is appropriately applied to the notional competitive price – not prevailing prices.[164] Nevertheless we shall, for purposes of the exercise, disregard this problem, and proceed with the use of prevailing prices as the basis for the test.

Table 4 presents the calculations made by Genesis.

Table 4 Calculation of switching costs by Genesis

	Mzansi	E Plan	Classic	Achiever	Prestige	
Transport costs	R 5.50	R 5.50	R 14.00	R 14.00	R 14.00	Confidential: SBSA
Cost of closing existing account	R 0.00	R 0.00	R 0.00	R 0.00	R 0.00	
3 month bank statement (for DOS)	n/a	R 6.00	R 6.00	R 6.00	R 6.00	
Cost of opening new account	R 0.00	R 0.00	R 0.00	R 0.00	R 0.00	
Value of time spent opening new account	R 3.13	R 10.42	R 32.96	R 33.70	R 110.34	
Cost of debit order switching	n/a	R 0.00	R 0.00	R 0.00	R 0.00	
Total cost of switching	R 8.63	R 21.92	R 52.96	R 53.70	R 130.34	
Average annual total banking cost	R 111.00	R 374.00	R 978.00	R 1,399.00	R 1,868.00	
Total switching cost as a % of average annual total banking costs	8%	6%	5%	4%	7%	
Total switching cost as a % of the NPV of average annual total banking costs for three years	2.80%	2.11%	1.95%	1.38%	2.51%	

Source: Genesis Report for Standard Bank, 08/11/2006, p 23.

At the request of the Enquiry Panel, the Technical Team performed its own calculation of switching costs, incorporating and costing basic elements of the switching process not included or (in our view) not adequately allowed for in the Genesis analysis, as well as including the minimum cost of searching. Note that these calculations adopt the figures for the typical hourly cost (i.e. value) of time spent by various categories of customer as used by

164 See footnotes 154 and 161 above.

Genesis. We also make use of the base price (average annual total banking cost) provided by Genesis. Strictly speaking, as explained above, the latter is not correct as prevailing prices will already reflect any existing effect of market power. The consequence of this is that the base price is likely to be *overstated* and thus the switching cost percentage *understated*.

Table 5 Calculation of switching costs by Enquiry Technical Team

Extended & revised table of switching costs	Mzansi	E Plan	Classic	Achiever	Prestige
Value of time spent searching for suitable cheaper alternative, including calculation of best alternative (1 hour)	R 9.38	R 31.25	R 43.95	R 44.93	R 147.12
Transport costs for opening the account (half return journey)	R 5.50	R 5.50	R 14.00	R 14.00	R 14.00
Transport costs for closing the account (half return journey)	R 5.50	R 5.50	R 14.00	R 14.00	R 14.00
Value of time spent in transport (half hour)	R 4.69	R 15.63	R 21.98	R 22.47	R 73.56
Parking cost for upper income/time spent walking from the taxi rank to the bank (15 min) for lower income	R 2.35	R 7.81	R 5.00	R 5.00	R 5.00
Fee for closing existing account	R 0.00	R 0.00	R 0.00	R 0.00	R 0.00
Fee for opening new account	R 0.00	R 0.00	R 0.00	R 0.00	R 0.00
Value of time spent closing existing account (same as in Genesis table)	R 3.13	R 10.42	R 32.96	R 33.70	R 110.34
Value of time spent opening new account (same as in Genesis table)	R 3.13	R 10.42	R 32.96	R 33.70	R 110.34
Value of time spent instructing new bank on customer portfolio incl. debit order switching (20 min)	n/a	R 10.42	R 14.65	R 14.98	R 49.04
3 month bank statement (for DOS)	n/a	R 6.00	R 6.00	R 6.00	R 6.00
Fee for debit order switching	n/a	R 0.00	R 0.00	R 0.00	R 0.00
Transport costs for the collection of cards/cheques etc. (half return journey)	R 5.50	R 5.50	R 14.00	R 14.00	R 14.00
Total cost of switching	R 39.18	R 108.45	R 199.50	R 202.78	R 543.40
Average annual total banking cost	R 111.00	R 374.00	R 978.00	R 1,399.00	R 1,868.00
Total switching cost as a % of average annual total banking costs	35%	29%	20%	14%	29%
Total switching cost as a % of the NPV of average annual total banking cost over 3 years	12.72%	10.45%	7.35%	5.22%	10.48%

Confidential: SBSA

We consider the assumptions made in Table 5 to be quite conservative and thus, if anything, to favour the bank. For example significant waiting in a queue at a bank has been assumed not to occur.[165] But like Genesis, we have considered it inappropriate to assume that typical customers will close existing bank accounts by telephone.[166] And like Genesis, we do not

165 Contrast in this regard the experience of customers surveyed by KLA, Transcript 17 July 2007, p 175.

166 Cf Transcript 18 June 2007, p 197 (Standard Bank).

accept that the value of customers' time can be disregarded.[167]

According to these calculations total switching costs as a percentage of the net present value of average annual banking costs over three years is likely, on a conservative estimate, to be well in excess of 5 per cent. This means that, on the basis of switching costs alone, the market power of each bank is appreciable as each bank is in a position to impose a small but significant non-transitory increase in price, even from current price levels which are in all probability already supra-competitive.

We do not accept the argument that existing customers are protected from the exercise of such pricing power by the existence of vigorous price competition between the banks for new customers. All the indications are, as this chapter has explained, that the banks' competition for new customers is not based fundamentally on price competition. Thus, the real dynamic is that the market power of banks over existing customers is extended into the market for new customers.

The above calculations make no allowance for one of the most formidable barriers to switching, namely, the procedures requirements under the Financial Intelligence Centre Act (FICA) for verifying the identity of bank customers. Necessary though these procedures may be for combating financial and other serious crime, they constitute an additional deterrent that impedes customers from readily switching banks.

Furthermore, the above calculations include only those switching costs readily capable of being quantified, and thus represent the minimum level of switching costs. They are likely to under-represent the full extent of switching costs faced by consumers. In this regard we note that there are also other switching costs that cannot easily be measured.[168] For example, perceptions play an important role in influencing customer behaviour. If some costs are perceived rather than real they will nevertheless factor into the customer's calculation of what it costs to switch. If these perceptions are shared by a significant number of customers then they must be factored into the calculation of the actual switching cost. The results of the KLA survey [169] and the Monitor Report discussed above show that there is a strong perception among consumers that switching is costly. In the Monitor report it is suggested that the perceived cost of switching is greater than the actual cost of switching.[170]

The analysis of switching costs by Genesis assumed that the customer in question has

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167 Cf Transcript 9 July 2007, p 196 (FNB).

168 Cf Shy, "A quick and easy method for estimating switching costs", *International Journal of Industrial Organisation*, Vol 20, pp 71-87. The reality is that it would be very difficult, if not impossible, to directly observe actual switching costs. As noted by Shy: "The reason why switching costs are not observed is that they are partly consumer-specific, reflecting the individual's human capital needed for switching among systems, and are therefore treated as a utility loss which cannot be directly calculated from any data."

169 Exhibit GGG, slides 41-42.

170 Monitor Group, Competitiveness Report, 20 October 2006, p 158.

already made her/his choice and identified her/his preferred provider. Genesis thus completely ignores the costs involved in shopping around, searching for, and identifying the most competitive alternative. While switching costs may be distinct from search costs, search costs cannot be ignored when assessing the market power of firms.[171]

Assuming access to the Internet, we estimated that a relatively well informed middle income individual would take at least one hour to search for a suitable alternative and calculate which alternative is most affordable. A monetary estimate of the value of this time to the consumer is contained in Table 5. We note again that this is a conservative estimate and is meant to reflect the minimum time and minimum cost associated with searching.

Although some search costs are unavoidable the Enquiry found that search costs in the market for personal transaction services in South Africa are inordinately high. These inordinate search costs are the result of a lack of transparency and inadequate disclosure of product and price information. These factors increase considerably the amount of time that consumers must spend searching in order to determine which product is most competitive. Actual search costs in the market for personal transaction services in South Africa are thus likely to be much greater than indicated in Table 5.

2.9 Nature of strategic interaction among firms

We have seen that retail banking in South Africa, and the market for personal transaction services in particular, is an oligopoly consisting of four banks (that collectively hold in excess of 90 per cent of the market) and a competitive fringe. The defining characteristic of an oligopoly is that each firm makes strategic decisions based on the expected reactions of its rivals.[172] Whether or not firms' strategic decision-making will result in effective competition depends on the structural and behavioural features of the relevant market.[173]

Strategic interaction between oligopolists is distinct from outright collusion.[174] It refers rather to the situation where firms are able to anticipate and rely on each other's behaviour without either expressly or tacitly entering into an agreement or understanding to co-ordinate. We find that in the market for PTAs and related services the nature of strategic interaction

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171 Cf Wilson, "Markets with Search and Switching Costs," MPRA Paper No. 131. http:/mpra.ub.uni-muenchen.de/131/. Wilson notes: "Due to the assumption that search costs, unlike switching costs, are incurred unconditionally on the decision to switch suppliers it is shown that the anticompetitive effects of search costs are consistently larger than those from an equivalent level of switching costs. The finding suggests that obfuscation practices that aim to deter consumers from searching, such as competing on deliberately complex tariffs, may be particularly powerful relative to practices that increase the costs of substitution between firms, such as loyalty programs or termination fees."

172 "Oligopoly behavior is necessarily strategic behavior. Oligopolists must take into account how their rivals will react to their actions. In deciding on strategies, oligopolists face a basic dilemma between *competing* and *cooperating.* The firms in an oligopolistic industry will make more profits as a group if they cooperate; any one firm, however, may make more profits for itself if it defects while the others cooperate." Lipsey, Courant and Regan, *op cit*, p 261.

173 The outcome cannot be determined *a priori*: See Mark Blaug, *Economic Theory in Retrospect*, 5th edition (Cambridge University Press, 1997) pp 302-303.

174 See Appendix on "Complex monopoly", "collective dominance" and "tacit collusion".

among the four major banks is such that effective competition tends to be restricted rather than enhanced. There are two main factors present in this market which facilitate competition-restricting strategic interaction among participants.

The first factor arises from customer inertia or “captivity”. The expected reaction of rivals to price changes is affected by the responsiveness of consumers to price changes. In the course of this chapter we have examined a range of indications pointing to market power of banks in providing PTAs and related services. This power rests on a combination of objective and subjective factors. We found that the nature of product differentiation, the extent of information asymmetries, and the considerable costs of searching and switching all provide strong evidence of a high degree of inertia on the part of the majority of consumers of personal transaction services in South Africa. Hence these consumers are not very responsive to price changes in the short to medium-term. Their demand is thus *inelastic*. An important consequence is that a small but significant reduction in price by one firm will result in an immediate reduction in its revenue without an increase in its volumes to make up for that. Under these conditions, it makes more sense for the rational oligopolist to raise prices cautiously or at least leave them unchanged. For example, because of the degree of customer inertia or “captivity”, a small increase in the firm’s price would result in an immediate increase in its revenue. Strategically, the best response of its rivals would be to leave their prices unchanged or to raise prices in line with the leader.

The second factor arises from the fact that interbank arrangements are required in order for the payment system to work effectively. Interoperability obviously has positive benefits but it also has the potential to restrict competition because it brings competitors together on a common platform. We have found arrangements in certain payment streams that facilitate non-competitive outcomes. The chapters of this report dealing with ATM transactions and interchange arrangements between the banks provide illustrations of this. The nature of interbank arrangements that underlie many personal transaction services are such that unilateral moves to reduce transaction fees would tend to disadvantage the fee cutter relative to the rivals who do not change their fees.

The disadvantage for a bank in moving alone to reduce its charge to customers when its fee arrangements with other banks are unchanged was graphically illustrated during the hearing on 3 April 2007. In 2006, FNB had recommended that the so-called “Saswitch premium” (i.e., the disincentive fee that a bank charges its customer for using another bank’s ATM) should be eliminated. However, FNB had argued that it would not be commercially viable for one bank to unilaterally eliminate its disincentive fee for off-us ATM transactions. It recommended that such a move would have to be done at an industry level, i.e. all the banks would either have to agree or be compelled to eliminate their disincentive fee for off-us ATM transactions.

At the hearing the Panel asked FNB to explain why it would not be possible for FNB to

unilaterally eliminate its disincentive or "Saswitch premium".[175] Mr Jordaan replied that FNB would then lose a lot of volume from its own ATMs, which would go to competing ATMs. "[I]t would be extremely naïve from a commercial perspective if we were to do something like that. This would really have to be an industry solution that would involve all the banks."[176]

Crucial in this reasoning was that FNB believed that if it acted alone it would probably not be able to attract enough customers from the other banks to make up for the loss in revenue that would follow as a result of the reduction to zero of its own disincentive or "Saswitch" fee. This is summed up in the following comments by Ms Durbach and Mr Jordaan of FNB:

> MS DURBACH: And if I can also just address the possibility of us attracting enough customers by dropping that fee to cover the very significant loss that we would take: in our assessment it's probably unlikely. I know in our previous submission we also addressed, [and] I think to some extent in this one, what actually attracts customers to banks. I know it's not a topic of this hearing but with reference to your question about "Would more customers come to FNB?", there are a wide range of factors that drive the choice of banking and it is very uncertain whether the drop in this fee would attract sufficient to justify it.
>
> MR JORDAAN: We [would be] uncomfortable discussing the exact number. But I mean just to illustrate the point, not a theoretical point. It is on the bottom of page 7 of our submission. We have modelled what that then will do to FNB, and I think if you look at that figure in the second column at the bottom it has got a minus next to it.[177]

The fact that FNB would not be able to attract enough customers from other banks to cover their direct revenue losses indicates that the customers of those other banks are effectively captured when it comes to their ability to exercise choice in respect of what they pay for off-us ATM cash withdrawals.[178]

In addition to the immediate loss of disincentive or "Saswitch" fee revenue the expected revenue loss would also be a consequence of the fact that many of FNB's own account holders would have no reason to avoid using other banks' ATM infrastructure whenever convenient, thus increasing the amount of interbank carriage fees that FNB would have to pay out to other banks.[179]

Therefore the nature of the interbank arrangement in respect of ATM transactions is such that any unilateral reduction of the disincentive fee for off-us ATM withdrawals would result in significant losses for the bank reducing the fee.[180] Consequently, individual banks gain much more from shadowing each other in respect of upward movements in price as they face

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175 Transcript 3 April 2007, pp 106-107.

176 *Id.*, p 108.

177 *Id.*, pp 109-110. The reference is to FRB, March 2007, Second Submission, ATM transactions (Initial questions), p 7. The anticipated net position, given confidentially, was R113 million.

Confidential: FRB

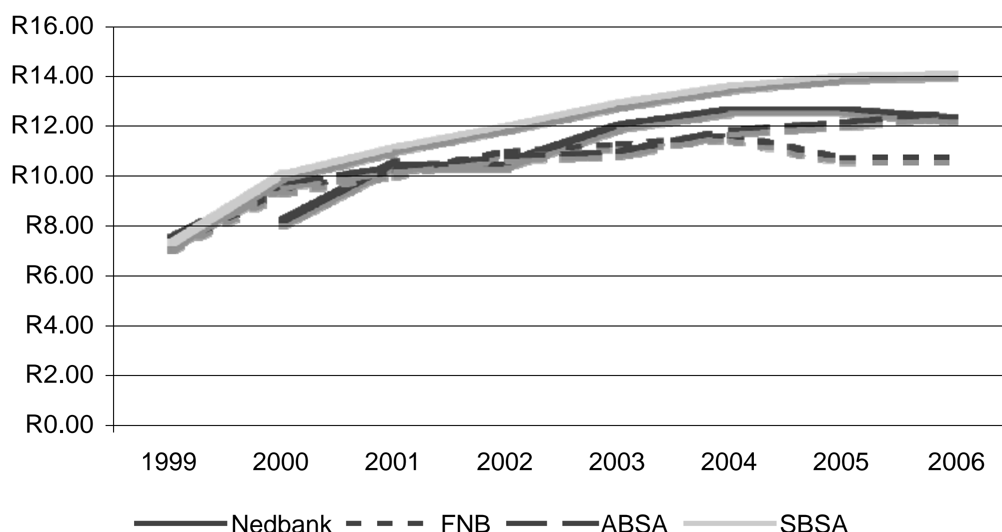
178 Conversely, the customers of FNB would be similarly captured if another bank were to act unilaterally in dropping its ATM "off-us" disincentive fee.

179 FRB, March 2007, February, Second Submission, ATM transactions (Initial questions), p 8.

180 To eliminate this problem *inter alia*, we propose that South Africa move to a model of direct charging for ATM transactions. This is explained and discussed fully in the chapter on ATMs and Direct Charging.

considerable costs if they attempt to compete through unilateral price reductions. As can be seen from the graph below, the fees the banks charge for off-us ATM transactions have followed each other quite closely since 1999.

Figure 4 Fees for "off-us" ATM withdrawals (R500), current accounts 1999 - 2006



Source: Infochoice.

As outlined above and analysed further in the chapter on Costing and Pricing, the banks engage generally in a strategy of differentiated pricing aimed at segmenting the market so as to maximise revenues generated from different customer groupings. The bank may charge a lower fee (or no fee) for a particular transaction service in order to differentiate its product. However, for the same product, it will be prepared to charge a higher fee than its competitors for another transaction service. This suggests that the banks will exploit inelasticities in respect of individual transaction services in order to maximise revenue at the product level.

In this regard the banks are cautious that their fees are not set so out of line with those of the competition that it would weaken the hold of the differentiated offering. Evidence regarding the setting of off-us ATM fees, where price comparison is relatively simple, suggests a tendency on the part of the banks to set their fees within a sufficiently close range of their rivals' such that no rival would be likely to impinge on the market share of the other. Given a high degree of customer inertia and substantial switching costs, we consider that this behaviour tends to result in price rigidities with prices moving gradually upwards over time.[181]

As is demonstrated in the Costing and Pricing chapter of this report, the lack of any identifiable relationship between the cost of providing PTAs and related services and the

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[181] See Shy, *The Economics of Network Industries*, p 309. This kind of behaviour is formalised in Shy in terms of the Undercut-Proof Equilibrium UPE. UPE states that firm A will charge the highest price it can while preventing its rival from undercutting and grabbing firm A's customers. In terms of UPE prices tend to rise with "distaste costs". Distaste costs include transport costs and switching costs.

price charged for them, points strongly to the exercise of market power by the major banks whose figures are presented and analysed. In the case of penalty fees on debit order transactions, its abuse is absolutely manifest.

2.10 Conclusions on market power

Although there is considerable scope to improve the competitive conditions of entry and participation, particularly in the case of payment services, the persistence of high fixed costs and scale economies is such that competitive conditions on the supply side in full-service banking are likely to continue to be restrictive.

Competition problems on the supply side in the payment system are dealt with in detail in the chapter on Access to the Payment System, as well as in the chapter on ATMs and Direct Charging. Proposed remedies to address these problems are put forward in those chapters. It is particularly important that the supply of payment services (and components of payment services) independently of deposit taking should be encouraged, and thus cease to be the preserve of the banks. The growing potential for this should be assisted through the removal of unnecessary barriers and through proactive and effective regulation which aims to facilitate rather than deter such a development. In our view, a change of mind-set on the part of the regulatory authorities is called for in this regard.

We find that there are five main features of the market for PTAs and related services which, either singly or jointly, confer on (at least) the major banks an appreciable degree of market power and which tend to prevent, restrict or distort competition in respect of the provision of PTAs and related services throughout South Africa:

- Complexity – both inherent and undue – in the provision of products and the structure of charges and fees.
- Inadequate disclosure and inadequate transparency of information in respect of product features and charging structures.
- Failure of consumers to actively question fees and charges associated with personal transaction accounts, both for objective and subjective reasons.
- Considerable costs of searching and switching and resulting failure of consumers to actively search for competitive alternatives and switch to them.
- Oligopolistic conditions which reduce any incentive to lower prices, reinforce the confidence of each bank in the expected reactions of its rivals, engender price rigidities, and produce a tendency towards upward price-following behaviour.

To the extent that these problems are rooted in the conditions which produce banking concentration – a global as well as South African phenomenon – they are not susceptible to being resolved by any recommendations that we can make here. However, there are a

number of particular changes that can be made which would serve to improve competitive conditions. Many of them are more appropriately presented and explained in the subsequent chapters of this report. In this chapter we concentrate on remedies that we believe would stimulate price competition between banks in the provision of PTAs and related services.

2.11 Recommendations

There is a clear need for measures aimed at improving the ability of bank customers to:

- Compare product offerings and prices
- Switch providers with a minimum of cost and difficulty.

In order to achieve these objectives we recommend the following:[182]

2.11.1 Standards and criteria for transparency and disclosure

The Banking Association – after consultation with the Ombudsman for Banking Services,[183] consumer protection agencies and organisations, the regulatory authorities, the Competition Commission and other relevant bodies – should develop a set of minimum standards for the disclosure of product and price information to be included in the Banking Association Code of Banking Practice. This code should at least include criteria regarding:

- Standardisation of terminology and a plain language requirement
- Communication and provision of information to clients
- A requirement for at least certain minimum information to be included in bank statements
- A summary and breakdown of charges and interest (both debit and credit) on every account

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182 We have been greatly assisted in deciding on these recommendations by the off-the-record and non-binding exploratory process which was undertaken by the Enquiry's Technical Team with the participation of all the major banks and several others, after the formal hearings had been concluded. The exploratory process took place as part of our engagement with the banks and others envisaged by paragraph 6(c) of the Enquiry Terms of Reference. On this basis, meetings to consider the practicality of various measures to improve comparability of bank products and prices, and to improve the ability of customers to switch banks, were held on 15 August and 4 September 2007. While we have drawn on ideas raised and points debated during those consultations, the views formulated here are our own and are not attributed to any participant. The particular remedies that were formally proposed by different banks in their extensive written submissions and at the public hearings became subsumed into broader discussions during the exploratory process. Accordingly, we do not deal with them separately here in the form in which they were originally advanced, nor do we identify them as having emanated from particular banks. Those original proposals remain, of course, on the record of the Enquiry should it be necessary to refer to them specifically.

183 See http://www.obssa.co.za/. The Ombudsman for Banking Services is an incorporated association not for gain registered under section 21 of the Companies Act 61 of 1973 (as amended). It was established by the banking industry to provide an independent, impartial dispute resolving service for bank customers and their banks. The service is provided free to bank customers who have failed to resolve their dispute with their bank through its own internal procedures. Its jurisdiction is limited to banks that are members of the Banking Association, and it may not assist in disputes involving a bank's commercial decision about lending or credit, interest rates or bank charges, unless there has been "maladministration" or a fee or charge has been incorrectly applied. The Ombudsman for Banking Services is recognised in terms of the Financial Services Ombud Schemes Act 37 of 2004, which commenced on 1 April 2005. (See OBS Annual Report 2006, p 2.) The Act serves *inter alia* to ensure the independence of ombuds, both in the manner of their appointment and in the procedures for resolving a complaint or making a determination (see section 10).

- Advance notice of new charges and altered charges
- A regular rights reminder to customers.

The code on transparency and disclosure should be subject to a process of periodic review, involving similar consultation.

The provisions of the code should be incorporated by reference into banks' standard customer contracts, so that the protection which they afford to customers become part of the customer's contractual rights capable of being enforced with the assistance of the Ombudsman for Banking Services. Although membership of the Banking Association is not compulsory for banks, and its code is therefore not binding on every bank, all the major banks are members and would be bound by changes to its code. Should this position change, or should the provisions of the voluntary code prove inadequate for the purpose described, a legislative or regulatory intervention would be warranted to impose appropriate standards on all banks.

2.11.2 Measures to reduce search costs and to facilitate comparisons

While improvements in transparency and disclosure of product and price information should help reduce the costs of searching, more direct and proactive measures are needed to simplify comparisons between the prices and product offerings of different banks.

Generic customer profiles

We recommend that generic customer profiles be drawn up and publicised to facilitate comparison shopping. In this regard, a generic profile is essentially a typical combination of customer needs.

For this purpose, the Banking Association should initiate and support an independent process – carried out by persons of standing and experience or expertise, who cannot be considered to be beholden to or interested in supporting the preferences of any particular bank – to establish a limited number of generic profiles that would apply to various typical customers of all banks in the middle market segments.

This will not be a simple task, as banks themselves apply somewhat different criteria when deciding on the segmentation of their product market. Thus the profiles must be constructed from the point of view of various *typical customers*, and *not* from the point of view of particular banks. To the extent, say, that some customers may typically prefer a product bundle emphasising electronic payment channels, and others the facility of branch and paper-based transactions, that would have to be taken into account in deciding on the range of appropriate profiles.

Too many profiles would defeat the remedy whilst too few profiles would tend to distort investment decisions and stifle needed variety in banks' offerings and the range of consumer choices.

Once the profiles are established, and publicised by the Banking Association, the different banks can reveal in their own advertising and other information whether, how and to what extent they accommodate them, and their respective prices in that regard. Misleading advertising could then be combated via the Advertising Standards Authority,[184] or with the assistance of the Ombudsman for Banking Services.

A regular review would be needed:

- To account for changes in technology and consumer behaviour
- To monitor the effectiveness of the process in facilitating comparability and stimulating price competition
- To determine whether or not any changes to profiles and/or the process is necessary in order to achieve the stated objectives.

Banking fee calculator

In addition to the process around generic customer profiles, we are also in favour of other measures to facilitate comparative shopping. One that has been suggested is a centralised banking fee calculator service. Established by the Banking Association on a similarly independent basis, this should provide an accessible facility for consumers to input their own product requirements – with assistance if necessary – and obtain (without cost) an automatic, objective indication of where they could obtain exactly those services and for what prices.

It would be up to the banks to make available reliable product and pricing data (open to public inspection and to audit and correction by the Banking Association in the event of dispute), if they wish their services to be included in the answers supplied by the calculator service.

Comparative advertising

It was suggested by one of the major banks that laws and codes currently prohibiting or restricting comparative advertising by firms should be changed to allow banks to compare their own prices and product offerings directly and explicitly with those of their rivals. There is much to be said for this proposal. However, because it might require changes to trade mark and other complex legislation, which might have various consequences in other industries that we are not in a position to assess, we refrain from making a definite recommendation to

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184 http://www.asasa.org.za/

that effect.

We recommend that the Competition Commission propose to the Minister of Trade and Industry that serious consideration be given to such a step.

Basic banking product or products

During the hearings on 18 June and 9 July 2007, the Enquiry's Technical Team mooted the idea that competition between banks would be enhanced if banks operating in the retail market were obliged to provide one or more basic banking products with similar content, capable of being simply and directly compared.[185] This would enable customers, whose needs would be satisfied by such a particular product, to compare prices and choose their bank accordingly. That in turn would intensify price competition, and cut across the existing segmentation of the market at least to the extent that segmentation has been contrived by banks in order to maintain market power.

This gave rise to protests from banks, with strong echoes in the financial press. In our view, this resistance – to the extent that it is not based on misunderstanding – is mainly because banks' supra-competitive pricing in the retail market is heavily dependent on unnecessarily complex product bundling and segmentation of the market.

Much of the argument raised against the basic banking product idea seems specious. Although initially conceived as a single package, it was not maintained that one size should fit all. There is no reason why there could not be several different basic product bundles offered, just as there could be several generic profiles (see above). Moreover, there would be nothing to prevent banks offering add-on features (separately priced) or bundling complete parallel offerings as they do at present, provided the basic product or products were also offered alongside.[186]

Nevertheless, to compel the adoption of such a measure would involve considerable difficulties in practice and might serve to hamper product innovation. Thus benefits through intensified price competition might be offset by disadvantages to consumers which are difficult to assess in the abstract.

Our recommendation is therefore that the "basic banking product or products" idea should be put on hold. If, after two or three years, the other recommendations put forward in this chapter have not been implemented or (once implemented) have not had the desired effect of increasing price competition and bringing prices for PTAs and related services down significantly, then the Competition Commissioner should revisit the idea with a view to

185 Exhibit YY, slides 33-35; Transcript 18 June 2007, pp 33-35; Transcript 9 July 2007, pp 12-13.

186 This was made clear from the outset: *id.,* slide 35.

evaluating it further and securing its implementation if so advised, if necessary by legislation.

2.11.3 Measures to reduce switching costs and to assist consumers in switching

Easier product and price comparison will not help consumers much if it remains too expensive or troublesome to switch banks. Measures to reduce switching costs and assist bank customers in switching are therefore of crucial importance.

Code of switching practice

We recommend that the Banking Association, after consultation with bodies referred to in paragraph 2.11.1 above, develop a set of criteria for a switching code to be included in the Banking Association Code of Banking Practice. This code should include criteria regarding:

- The provision of sufficient information and documentation by banks to new and existing customers explaining the process of switching in their branches.
- A schedule in terms of which the old bank is to provide the new bank with information on standing orders and direct debits within a specified period of time of receiving the request to do so.
- A schedule in terms of which the balance on the account, standing orders and direct debits, net of any charges and interest but including any interest due, will be transferred from the old bank directly to the new bank, and the account with the old bank closed, within a specified period of time.
- Provision to be made for customers to be exempt from paying, or be refunded, any fees and/or interest charges which are incurred within a specified period after the new account is opened as a result of a failure in the switching process.

The code on switching should also be subject to an independent process of periodic review, following similar consultation.

Central FICA information "hub"

Several banks raised during the Enquiry the advantages that would flow from having a central repository of customer information which could be used to facilitate compliance with FICA, and so make switching easier for bank customers. It is clear that a considerable amount of work has already been done in the banking industry to explore the feasibility of establishing and operating such a hub.

This has a number of complex implications which we have not been in a position to explore. Nevertheless, the potential benefits in facilitating switching are such that we would recommend that the National Treasury encourage and pursue this investigation in consultation with the banking industry, to see whether such a central hub could be

established and operated in a manner that is consistent with the anti-money laundering objectives of FICA.

Bank account number portability

In a number of other jurisdictions, bank account number portability (i.e. the customer retaining the same account number, irrespective of bank) has been explored with a view to facilitating switching. All the major banks, at our request, made detailed submissions on the implications of introducing such a measure here.[187] It seems clear that, while bank number portability would facilitate debit order switching to some extent, the costs that would be entailed in introducing such a change throughout the banking industry would far outweigh the potential advantages. Accordingly, we do not recommend the introduction of such a measure. We note that this was also the conclusion reached by the Competition Commission in the UK.

However – particularly because a great deal of comparative research material on the matter has already been gathered by the banks – bank account number portability should be kept under consideration by the Banking Association, as new technology develops.

2.11.4 Expand the mandate of the Ombudsman for Banking Services

We recommend that the role of the Ombudsman for Banking Services be expanded to include enforcement and monitoring of compliance with the proposed codes of conduct for information disclosure and switching.

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[187] Absa, March 2007, Access and interoperability, p 9; FRB, March 2007, Bank Account Number portability Position paper 2. Nedbank, March 2007. Access and interoperability, pp 36-38. Standard bank, April 2007. Access and Interoperability, pp 52-53.

Chapter 3

Costing and Pricing

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3.1 Introduction and synopsis

The tendency of South African banks to charge a fee for almost every service associated with a bank account sets them apart from banks in many other countries.

In a 2005 study for the FinMark Trust, in which South Africa was compared with India, Kenya, Malaysia, Mexico, and Nigeria, it emerged that South Africa was the only country that charges a fee for cash deposits and one of only a few that charges a fee for branch and ATM cash withdrawals.[1] When compared with developed countries, a similar picture emerges. For example, in the 2004 Task Group Report (Falkena III), it was noted that South African banks charge a fee for transaction services for which there is no explicit fee in many other countries.[2]

The charging of an explicit price for a service is generally a desirable practice insofar as it conveys useful information to consumers. This can be contrasted with a situation where services that are not directly charged for are subsidised by revenue collected from the consumer in other ways. That can lead to inefficient outcomes as it may convey misleading information to consumers.

We note that the mere absence or presence of an explicit price for a service does not say anything about whether or not competition is effective with respect to the provision of that service. A service which appears to be free may convey misleading information to the consumer about the true cost of the service. However, an explicit price may be either higher or lower than the competitive price, also conveying misleading information to the consumer.

In a competitive market consumers should be able to make rational choices on the basis of appropriate price signals. This is because effective competitive pressure tends to align the incentives of producers with the preferences of consumers. In particular, this balancing of consumer and producer interests should result in an efficient allocation of resources in which the price reflects both the value of the service to the consumer and the underlying costs associated with providing the service.

In our analysis of market power in chapter 2, we have shown that the banks do not compete fundamentally on price and that clear price signals are very difficult for customers to obtain.

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1 GENESIS: "An inter-country survey of the relative costs of bank accounts", 14 March 2005, p 36. (Quoted in Absa, October 2006, First Submission, Annex 4, p 22).

2 *Task Group Report for National Treasury and the South African Reserve Bank, Competition in South African Banking*, April 2004, pp 114-115. Certain transaction services, associated with cash deposits, cash withdrawals, statements, account payments, debit orders, and returned cheques were identified. South Africa was compared with the United Kingdom, Ireland, the USA, Canada, Singapore, New Zealand, Australia, and Switzerland to determine which country does or does not levy a charge for each transaction service. South Africa was the only country in which charges are levied for each and every transaction service identified. See also the Appendix on Updated statistics in Task Group (Falkena III) report .

With a view to assessing whether or not competition is effective as far as the provision of retail banking and/or payment services is concerned, the terms of reference of the Banking Enquiry required us to address the following subject matter:

- The relation between the costs of providing retail banking and/or payment services and the charges for such services
- The process by which charges are set
- The level and scope of existing and potential competition in this regard.

In this chapter, we focus on the first two points above, and not the level and scope of fees and charges. However, subsequent chapters of this report are devoted to particular pricing issues such as ATM and penalty fees, and their impact on consumers.

We commence (section 3.2) by providing an overview of the charging practices of the banks. In this regard we look at the pay-as-you-transact and bundled packages of the banks and examine the fee structures applicable to them. We find considerable price complexity in the fee structures of the banks, who apply a combination of *ad valorem* and flat fee formulas. Although bundled packages with fixed fees are easier to understand for consumers, they are currently differentiated to such an extent that comparison is almost impossible. Further, complex pay-as-you-transact pricing is applied to bundled packages for transactions which exceed the limits set by the bank providing the package. Such transaction pricing is also applied to transactions which the bank does not include in the bundle.

Next we examine the process by which charges[3] for personal transaction accounts are generally set. Section 3.3 deals with unbundled options and section 3.4 with bundled options). We find that pricing decisions of the banks are driven by a number of considerations but are generally constrained only by what the customer will bear. Competition is not driven by price but rather by strategic positioning on the basis of differentiated product offerings, the prices of which are difficult to compare. In particular, the banks employ a strategy of differentiated packaging that seeks to segment customers into groupings based largely on patterns of usage and divided on the basis of income levels and ability and willingness to pay. In this regard each bank will conduct market research and, on the basis of their understanding of customer preferences and behaviour, will implement price structures and set price levels which they calculate will maximise profit generated from these customers in the medium to longer term.[4]

We go on to examine the relationship between the costs of providing transaction services and the charges for those services (section 3.5). We find that banks do not consider per transaction costs in the setting of transaction fees. Until recently, most of them have been

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[3] The terms charges, fees and prices are used interchangeably.

[4] See the analysis of oligopoly behaviour in Chapter 2.

either unable or unwilling to find out what these costs are. We find that – while there may be objective difficulties of measurement and interpretation arising from the high fixed and common cost nature of multi-product banking – the fact that the banks have not had direct reference to the costs of transactions in the setting of prices reinforces our conclusion that they are sheltered from effective price-competitive pressure.[5] The fact that banks in South Africa have not been subject to vigorous price competition explains, in part, why they have had little or no interest in determining costs at the transaction level – and why fees for transaction services do not bear any identifiable relation to the costs of providing those transaction services.

3.2 Overview of charging practices of the banks

Banks offer an array of transaction accounts and pricing options to consumers. Transaction accounts are broadly divided into current (i.e. cheque) accounts and transmission accounts. The services provided by these transaction accounts generally include:

- Receiving deposits either from the customer directly or indirectly by receiving payments to the credit of the customer from third parties (whether by cash, cheque, or electronic transfer)
- Repaying funds deposited, either directly to the customer (e.g. by cash dispensing through an ATM or otherwise) or indirectly by way of payments to third parties on the customer's behalf.

The pricing structures on each of the transaction services within the transaction accounts, as well as the pricing packages for transaction accounts themselves differ greatly. There are two main transaction account charging packages.

3.2.1 Unbundled (pay-as-you-transact) options

With this option the bank charges a fee per transaction or service. The structure of the fee – i.e. whether it is a flat fee or an *ad valorem*[6] fee – will depend on the type and value of the transaction. There will also usually be other basic charges, like subscription fees and monthly account fees, which do not directly relate to transactions on the account.

3.2.2 Bundled package options

Most package options offer a specified bundle of transactions for a fixed fee. Limits are placed on the type and number of transactions included in the bundle. If the allowed number

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[5] Under effective competition the banks would surely need to better understand per transaction costs to determine whether internal resources are being allocated efficiently.

[6] A fee paid according to the value of the transaction.

of transactions is exceeded there will be additional charges. Transactions which are excluded from the bundle (e.g. in many instances off-us ATM withdrawals) are available to the consumer but are charged on a pay-as-you-transact basis. Some banks offer packages where a specified bundle of transactions are provided 'free' for as long as the customer maintains a minimum balance in their account.[7] If the balance falls below the required minimum, per transaction charges are applied.

3.3 Pricing of unbundled options

Banks apply a number of different pricing formulas. Transactions are charged on a flat fee basis, an *ad valorem* basis, or on a banded fee basis. There are certain accounts offered by banks which charge a monthly account administration fee in addition to charging on a per transaction basis. We describe each type of pricing formula below.

3.3.1 Flat fees

A flat fee simply refers to a fixed amount that is charged per transaction. For example, Absa Flexi Account holders are currently charged a flat fee of R5.50 for external debit orders.[8] The fee stays the same for each debit order transaction, regardless of the value of the transaction.

For some accounts a tiered flat fee structure applies whereby a limited number of transactions are charged at a lower flat rate per transaction, after which a higher flat rate applies per transaction for all subsequent transactions beyond the limit. This penalty applies in varying degrees to specified transactions on the Mzansi accounts provided by the banks.[9] For example, for Absa Mzansi Account holders in 2006 the following transaction limits applied:

> You are allowed 5 credit transactions for depositing money into your account (e.g. cash deposits or transfers into your account) and 5 debit transactions for using the money in your account (e.g. cash withdrawals or debit card purchases) per month on your Absa Mzansi account.
>
> From the sixth debit or credit transaction onwards you will be charged the normal transaction fee plus R12.50 per transaction.[10]

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7 This option is not truly free because the customer will forgo the interest that would have been earned had the money been placed in an account that does earn interest.

8 Absa 2008 Pricing Brochure, Absa Flexi Account, p 7. By an "external debit order" we mean one where the beneficiary is a customer of another bank.

9 Mr. Rowlinson of Wizzit pointed out "I have never heard of a product …that penalises you for use. [With Mzansi], you get your first few transactions really cheap and or nearly free, but if you go and do ten transactions a month, you [are] actually penalised to the extent that those extra five are more expensive than [charges on] one of the traditional accounts." Transcript, 9 November 2006, p 167.

10 Absa 2006 Pricing Brochure, Absa Mzansi, p 2.

3.3.2 *Ad valorem* fee structures

Under an *ad valorem* formula the fee will increase as the value of the transaction increases. There are three different *ad valorem* pricing formulas that can be applied.

Three-part formula

Most *ad valorem* fees have a three-part formula that consists of:

- A minimum fee
- A value-related fee
- A maximum amount that can be levied.

The second part of this formula, the value-related fee, can either be inclusive of the first R100 paid or exclusive of that first amount. To illustrate:

Table 1 Three-part *ad valorem* fee

	Absa Flexi Account - ATM withdrawal	**SBSA Classic Current Account - Debit orders**
Pricing structure	R 3.00 / R0.60/ R 12.50	R3.25 / 1.10% / R29.00
Result	R3.00 for the first R100 withdrawn; R0.60 for each subsequent R100 withdrawn (or part thereof); and A maximum charge of R12.50 which can be levied per transaction.[11]	R3.25; Plus 1.1% of the value of the transaction A maximum charge of R29 which can be levied per transaction.[12]

Source: Pricing Brochures, 2008.

Two-part formula

In a two-part *ad valorem* formula only the following apply:

- A minimum fee
- A value-related fee.

The third element in the three-part formula is not shown, and this means that no maximum fee limit will be applied per transaction. Once again the second part of this formula, the value-related fee, can either be inclusive of the first R100 paid or exclusive. For example, see Table 2.

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[11] Absa 2008 Pricing Brochure, Flexi Account, 2008, p 6.

[12] Standard Bank 2008 Pricing Brochure, Classic current account.

Table 2 Two-part ad valorem fee

	Absa Flexi Account - ATM deposits	SBSA Classic Current Account – Autobank withdrawals
Pricing structure	R0.90 / R0.90	R3.25 / 0.95%
Result	R0.90 for the first R100 deposited; and R0.90 for each subsequent R100 deposit (or part thereof).[13]	R3.25; Plus 0.95% of the value of the transaction.[14]

Source: Pricing Brochures, 2008.

One-part formula

In other cases a simple one-part *ad valorem* formula applies. For example, an Absa FlexiSelect account holder wishing to make a branch counter deposit will be charged 1.05 per cent of the deposit value.

Other *ad valorem* formulas

In the above examples we have used the Absa Flexi Account transaction account products to illustrate the application of standard one-part, two-part, and three-part *ad valorem* formulas. Standard Bank and Nedbank apply similar *ad valorem* formulas in their pricing structures, although not necessarily for the same transaction types. FNB also applies *ad valorem* formulas, however, as will be discussed below, FNB has moved away from three-part *ad valorem* formulas in favour of value-banded fees for certain transactions.[15] Confidential: FRB

In addition to applying the standard *ad valorem* formulas discussed above, Nedbank also applies its own, somewhat different, *ad valorem* formulas to certain transactions. For example, in the Nedbank pricing brochure for 2006/2007 the following formula is applied to cash deposits:

R1.10 / R10 min R10; which means, according to Nedbank:

> ...you will pay R1.10 per R100 or part thereof, with a minimum of R10. To illustrate: on a R750 cash deposit you will pay: (R1.10 X 8) = R8.80. However, the minimum applies and you will therefore pay R10.[16]

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13 Absa 2008 Pricing Brochure, Flexi Account, p 6.

14 Standard Bank 2008 Pricing Brochure, Classic current account.

15 FNB, March 2007, Second Submission, Response to Data Request Part A, pp 2-3.

16 Nedbank 2006 Pricing Brochure, p 5.

Other formulas are also applied which mix a flat fee with an *ad valorem* formula. For example, a Nedbank Ordinary Current Account holder (in 2006/2007) was charged according to the following formula for a Nedbank ATM cash withdrawal:

R2.85 + R0.90 / R100; which means:

- R2.85 per transaction, plus
- R0.90 per R100 or part thereof.

Absa applies the following formula to off-us[17] ATM withdrawals on FlexiSelect Accounts:
R6.00 + R3.00 / R0.95; which means:

- R6.00 per transaction, plus
- R3.00 for the first R100 withdrawn, and
- R0.95 for each subsequent R100 withdrawn.[18]

3.3.3 Banded fee options

FNB has argued that the three-part *ad valorem* formula is not well understood by customers. In order to simplify pricing for their customers FNB replaced the three-part formula with a banded fee for certain transactions.[19] For example, in November 2005 FNB introduced the following three-band formula for FNB ATM cash withdrawals:
R5 | R10 | R15; which means:

- R5 for up to R500 cash withdrawal
- R10 from R501 to R1000 cash withdrawal
- R15 for more than R1001.[20]

Banded fee options like this have not, as yet, been adopted by the other banks.

FNB also stated that:

> It is likely that a banded fee option will be retained for ATM Cash Withdrawals, as the reduced fee charged to customers making smaller withdrawals encouraged usage by account holders who would not otherwise use ATMs.[21]

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17 "Off-us" in this context refers to a withdrawal from another bank's ATM. Absa refers to this in its pricing schedule as a "Saswitch ATM" cash withdrawal.

18 Absa 2008 Pricing Brochure, FlexiSelect, p 15.

19 FRB, March 2007, Part A Data request , pp 2, 3, 4, and 5.

20 *Id.*, p 4.

21 *Id.*

Nevertheless, revenue per transaction on FNB ATM cash withdrawals increased by 11 per cent following the introduction of the banded formula.[22]

Confidential: FRB

We now examine the banks' rationale for adopting *ad valorem* pricing formulas.

3.3.4 Rationale for *ad valorem* pricing formulas

In February 2007, the Enquiry Technical Team addressed a number of questions to the four biggest banks regarding *ad valorem* fee formulas.[23] In addition to providing detailed information regarding *ad valorem* fee formulas, the banks were asked to explain:

- Their rationale for applying *ad valorem* formulas to particular transactions.
- The implication for each bank of changing from an *ad valorem* formula to a simple or flat fee formula.
- Why it would not be feasible to change from an *ad valorem* formula to a flat fee per transaction.

In their submission, Absa identified three main factors to justify the use of an *ad valorem* pricing mechanism:

> *Ad valorem* pricing is used more generally by Absa where one or more of the following factors apply:
>
> (1) …to enable pricing to be varied across customers, in particular to reduce the charges faced by lower income customers or customers making low value transactions.
> (2) Where costs and/or risks vary with the magnitude of the transaction (e.g. ATM cash withdrawals, where cash handling costs increase with the value of the cash withdrawn).
> (3) Where competition and substitution between alternative means of payment must be considered. Where a means of payment competes with an alternative payment mechanism which is priced on an *ad valorem* basis, Absa uses *ad valorem* pricing to encourage customers to use the more efficient (lower cost) means of payment. For example, electronic payments are encouraged over cheque payments.[24]

Confidential: Absa

Similar reasoning is echoed in the responses of Standard Bank[25] and Nedbank.[26] Both banks emphasised that *ad valorem* pricing is necessary where the risk associated with the transaction increases as the transaction value increases. It was submitted that the *ad valorem* formula allows the bank to lower its fees to customers making low value transactions by preventing the subsidisation of customers making high value transactions by

Confidential: Nedbank

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22 *Id.,* p 6.

23 Competition Commission Data Request Part A. Addressed to Absa, Standard Bank, FNB and Nedbank. February 2007. Question 5 Regarding *ad valorem* formulas.

24 Absa, March 2007, Second Submission, Data Request Part A, p 12.

25 "*Ad valorem* pricing prevents subsidisation of wealthy customers by lower income customers." Standard Bank, June 2007, Second Submission, Costing and Pricing, p 5.

26 "The application of an *ad valorem* fee structure assists in identifying the most appropriate price for a service in a particular market." Nedbank, March 2007, Second Submission, Part A Data Request, pp 6, 7, and 8.

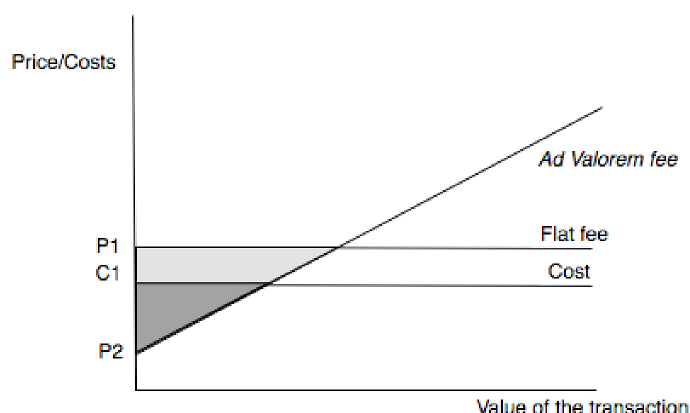
Confidential: Nedbank

Confidential: Nedbank

customers making low value transactions – which would occur if a flat fee formula were applied. Absa, Standard Bank, and Nedbank argued that this is beneficial to low income customers who "typically make low value transactions".[27] FNB has over time changed most of its *ad valorem* fees to flat fees or banded fees, stating that customers better understand banded or flat fee formulas. They do, however, argue that with certain transactions, where risks and costs increase with the value of the transactions, flat fees would not be feasible.[28]

The subsidisation argument, which the banks claim as a consumer welfare justification for *ad valorem* pricing, implies that in the absence of an *ad valorem* formula and in the presence of a flat fee structure, the current pricing to low income customers would not be sufficient to cover the costs of providing the services to those customers. Accordingly, a higher flat fee would have to be charged for low value transactions. The concomitant implication is that, at least in respect of transactions where transaction costs do not vary significantly with value, *ad valorem* prices for low-value transactions are generally set below cost. This is illustrated in the figure 1.

Figure 1 Flat fee vs. *ad valorem* fees



The banks' subsidisation argument, regarding the application of an *ad valorem* fee structure, seems to imply that for low value transactions, the cost of the transaction is above the prices charged to those consumers (i.e. C1>P2). The application of a flat fee would require a price higher than the current price charged for low value transactions (i.e. P1>P2).

However, the banks have not provided any costing information to substantiate this. We therefore cannot accept the subsidisation argument implicit in the banks' consumer welfare justification for *ad valorem* pricing, plausible though it may sound. Given the presence of market power in the provision of personal transaction accounts, it may well be the case that

27 Absa, March 2007, Second Submission, Part A Data Request, p 11. In some instances, low-income customers prefer to make only a few high value transactions. See Transcript 4 April 2007, p 21, where Capitec point to the difficulties of steering client behaviour away from withdrawing all their funds on pay-day.

28 FNB, March 2007, Second Submission, Part A Data Request, pp 3 and 6.

even the lowest *ad valorem* prices applied are enough to cover those transaction costs that are not value-dependent. Furthermore, it is likely that at current *ad valorem* fee levels in respect of such transactions, customer preferences regarding high value and low value transactions would be distorted relative to what one would find in a competitive market.

We find that there is not a straightforward relationship between the pricing formula applied and the benefit to the consumer. It would be naïve to accept that banks are driven simply by consumer welfare objectives when deciding what pricing formula to apply. In this regard it is instructive to examine the response of the banks to the question of the implication and feasibility of a shift from an *ad valorem* formula to a flat fee.

In its submission of 10 August 2007 Standard Bank confirmed that there is no simple answer to this question. Regarding the revenue implication for the bank of such a change, banks noted that the impact could be either positive or negative depending on the level at which that flat fee is set. If the flat fee is set at a level higher than the current average fee value then the revenue of the bank will increase. However, if the flat fee is set at a level that is lower than the average fee value then revenue to the bank will decrease, all else equal.[29]

Unfortunately none of the banks was able to quantify the impact on revenue of a shift from an *ad valorem* formula to a flat fee formula. As noted by Absa in its submission: "the amount by which customer fees for low transaction amounts would increase, the impact on customer transaction behaviour, and hence the precise magnitude of the impact on Absa's revenues will depend on factors including the pricing structure and level of competitor offerings and customer reactions to changes in fees".[30]

We do not suggest that *ad valorem* pricing is never appropriate. Competitive, cost-related pricing would itself imply that price would vary with transaction value in respect of those transactions where cost varies with value. But in that case, a subsidy would not enter into the variations in price.

In their submissions Absa, Standard Bank, and Nedbank emphasised that a flat fee is not appropriate where the level of risk to the bank increases with increases in the value of the transaction.

Confidential: Nedbank

Standard Bank points out that the transaction costs and risks of cash and cheque withdrawals and deposits at the branch are directly related to the underlying transaction value and tend to increase as the transaction value increases. Therefore, for these transactions a flat fee would not be appropriate.[31]

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29 Standard Bank, August 2007, Part A Data Request, question 5.

30 Absa, March 2007, Second Submission, Part A Data Request, 2007, p 17.

31 Standard Bank, August 2007, Part A Data Request, question 5.

While not referring explicitly to risk considerations regarding the application (or not) of an *ad valorem* formula, FNB stated:

> ... ATM cash withdrawals, branch withdrawals and deposits, could NOT feasibly be charged at flat fees. Under a flat fee system, the average fee paid would have to increase above the current average paid in order to maintain revenues that cover the fixed costs of providing these services. A flat fee at the current average rate would not be sufficient due to the decline in transaction volumes that would result from some of those customers previously paying the discounted rate for low value transactions not being willing to pay the higher flat fee.[32]

As we have pointed out, in the absence of adequate costing information from the banks we are unable to accept the bald assertion that the average flat fee paid would have to increase in order to cover fixed costs. Nevertheless, we accept in principle that *ad valorem* pricing may well be appropriate in instances such as those pointed out above where transaction costs obviously rise with transaction value. Whether or not it might be acceptable in other cases would depend upon *first* establishing reliably what a competitive cost-related price for the transaction would be, and *then* considering the consumer-welfare argument for differentiating between customers based on their ability to bear the true cost burden. No bank has put us in a position to make such an evaluation, and we remain unconvinced by the consumer-welfare argument advanced.

FNB acknowledges that for certain transaction types the demand for low value transactions is very price elastic while the demand for high value transactions is relatively price inelastic. The *ad valorem* fee also has the effect of “creating demand by charging less for small value transactions”.[33] The *ad valorem* formula is therefore a mechanism by means of which banks price-differentiate between low value transactions and high value transactions based on the different price elasticities of demand for these transactions, irrespective of differences in cost between low value and high value transactions. That they are able to do so is itself a manifestation of a degree of market power, or, put differently, of the degree to which they are sheltered from simple and direct price competition in respect of each of these services.

A bank’s decision on whether or not to shift to a flat fee would depend on the extent of revenue losses arising from reduced volumes of low value transactions. This reduction in volumes would be due to the increase in the fee for low value transactions that would be required to bring the level of revenue generated from the flat fee on par with *the current level of average revenue* (which is not to be equated with the average level of costs). If there are economies of scale the loss of volumes of low value transactions would push up average costs – thus reducing profitability (or potentially leading to losses) for the bank.

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32 FRB, March 2007, Second Submission, Part A Data request, p 6.

33 *Id.,* p 3.

Calculating the magnitude of loss or profit arising from a move to a particular flat fee for a particular transaction would require knowledge of the average cost of that transaction. However, as will be discussed subsequently in this chapter, the banks have submitted that they do not set fees on the basis of per transaction costs. Rather, fees are reviewed with reference to the overall revenue generated from the customer's entire transaction basket. To repeat, without reference to the cost of the transaction one cannot say what level for the flat fee would be sufficient to cover costs. Given the presence of appreciable market power on the part of the banks it is likely that the prevailing average fees under *ad valorem* structures for particular transactions are above competitive levels. Any change to a flat fee structure would thus result in a fee that would be high relative to the competitive benchmark so long as the banks are able to exercise market power in their pricing decisions.

The claimed benefit of *ad valorem* pricing to lower income customers transacting on standard transmission accounts – the claim that such pricing enables the banks to reduce the charges faced by such customers[34] – is not reflected in the actual pricing structures applied by the big four banks (see Table 3). In the table, the first four accounts (Absa's Flexi account, Standard's EPlan, FNB's Smart account and Nedbank's Transactor account) are low income customer accounts. The application of *ad valorem* fee structures, bundled pricing options and banded fee options takes prominence in the middle to higher income products, not readily available to the low income and low-middle income customers. Hence lower income customers do not benefit from these pricing initiatives.

Table 3 Flat fees vs. *ad valorem* fees

	Cash withdrawals from Own ATM	Electronic account payments	Debit Orders External (Furniture/ HP/Car/Loans)	Debit Card Purchase
Absa Flexi Account	*Ad valorem*	Flat	Flat	Flat
Standard Bank E-Plan	Flat	Flat	Flat	Flat
FNB Smart Account	*Ad valorem*[35]	Flat	Flat	Flat
Nedbank Transactor	Flat	Flat	Flat	Flat
Absa Silver Current account	*Ad valorem*	Flat	*Ad valorem*	*Ad valorem*
Standard Bank Classic Current account	*Ad valorem*	*Ad valorem*	*Ad valorem*	*Ad valorem*
FNB Personal Cheque Account	*Ad valorem*[35]	Flat	Flat	Flat
Nedbank Current account	*Ad valorem*	Flat	Flat	Flat

Source: Pricing Brochures, 2007/08.

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[34] See e.g. Absa, March 2007, Second Submission, Part A Data Request, p 12; Standard Bank, June 2007, Costing and Pricing, p 5.

[35] This is a banded fee, and changes with the value of the transaction. Hence this cannot be seen as a flat fee.

For example, in the case of Mzansi Accounts, ATM withdrawals are priced on a flat fee basis at a lower price for a limited number of transactions and at a higher price for subsequent transactions. Absa notes that the flat fee on Mzansi ATM cash withdrawals is “to ensure Financial Sector Charter compliance”. Absa also applies a flat fee for cash withdrawals on the Mega Save account to “ensure affordability for youth market customers”.[36] Both Mzansi and Mega Save account holders are likely to be low-income customers. This does not reconcile with their earlier arguments advanced regarding the benefits of *ad valorem* fees.

Standard Bank applies a flat fee to its low income Mzansi and E Plan customers. However, unlike Absa, the majority of Standard Bank’s current account customers are on bundled packages where neither *ad valorem* nor flat fee structures apply. FNB argued that a banded flat fee formula benefits consumers because it is easier to understand than an *ad valorem* formula and “the reduced fee charged to customers making smaller withdrawals encourages usage by account holders who would not otherwise use ATMs”.[37]

While an *ad valorem* structure may result in a lower unit charge for low value transactions, it does not necessarily lower the overall cost and utility to customers of doing transactional banking. There are a number of reasons behind this:

- The *ad valorem* formula contains a built in mechanism for fees to increase over time with inflation. As average transaction values rise, *ad valorem* fee revenue rises per transaction without the fees having to be explicitly raised. While this generates more revenue for the banks it is harmful to consumers who end up paying more in fees. In its submission FNB acknowledged that average revenue from *ad valorem* based fees increases over time as transaction values increase with inflation. So if the *ad valorem* fee remains unchanged, average revenue will increase with inflation.[38]
- An *ad valorem* structure is likely to increase the demand (and thus volume) of low value transactions relative to high value transactions. This will not necessarily lower the cost to the consumer. For example, it is possible that an increase in the number of low value transactions relative to the number of ‘high value’[39] transactions could be more costly for consumers. The outcome here would depend on consumers’ behaviour, preferences and incentives regarding the optimum number of transactions to minimise overall costs.
- *Ad valorem* fee structures are not always understood properly by consumers, who may end up making sub-optimal decisions.

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36 Absa, March 2007, Second Submission, Part A Data Request, p 13.

37 FRB, March 2007, Second Submission, Part A Data request, p 4.

38 *Id.,* p 5-6.

39 Simply because a transaction is classified as high value does not mean that a low income consumer will not want to make it. For example, a low income consumer who earns R2000 a month may prefer to make a single withdrawal of R1000 rather than a number of smaller low value transactions.

- While the *ad valorem* structure may well result in a lower unit charge for low-value transactions, low-income customers are not afforded this benefit.

3.3.5 Findings regarding pay-as-you-transact fee structures

We have recognised that there may be potential benefits for consumers in *ad valorem* fee structures insofar as they may prevent high income customers from being subsidised by low income customers in cases where transaction costs do increase with transaction values. However, as explained above, in the absence of costing information the banks' consumer welfare justification for *ad valorem* fee structures has not been substantiated.

The *ad valorem* fee formulas (especially the three- and two- part *ad valorem* formulas) of the banks have tended to be complicated and are often not well understood by consumers and thus potentially convey misleading price signals to consumers. Although there has been some movement to introduce simpler fee structures this problem still remains.

The sheer number of transaction types that are charged on a pay-as-you-transact basis and the variety of formulas applicable to each of them further complicate choices for consumers. In particular, it is very difficult for consumers to calculate the total cost for their entire transaction basket without detailed and predictable information about their expected transaction usage and without a proper understanding of the various pricing formulas. As we have found ourselves, this process of estimation and calculation is difficult and time consuming. It is therefore not surprising to find that South African consumers are not well informed about what they pay in bank charges. It is also not surprising to find that their choices are largely driven by considerations other than price.[40]

We find that overall the existing pay-as-you-transact options and applicable pricing structures have not been conducive to effective competition and have tended to support the maintenance of prices at above competitive levels. It has been shown in the chapter on market power that despite benefiting from economies of scale, the banks have failed to pass these unit cost savings through to lower prices.

The results of international fee comparison studies like Capgemini[41] and the Monitor Report[42] also reveal interesting results regarding the impact of pay-as-you-transact pricing structures on product level prices. Capgemini based its study on unbundled pay-as-you-transact current account products and found that fees paid *per annum* by South African current account customers on this basis were approximately double the international average.

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40 See the chapter on Market power for a discussion of the evidence in this regard.

41 Capgemini, World Retail Banking Report, 2007.

42 Monitor Group, Competitiveness Report, 2006.

The fee comparison study in the Monitor report was also based on unbundled pay-as-you-transact products. Like Capgemini, Monitor found that South African banks' pricing was high in relation to other countries.

The South African banks criticised the validity of these reports on a number of grounds. Among other things the Capgemini and Monitor reports were criticised for failing to take into account the bundled or package fee options of the banks. However, information obtained through the submissions to the Enquiry and Technical Team meetings with the banks indicate that the majority of customers at the big four banks are on pay-as-you-transact options,[43] not on bundled or package fee options. Moreover, the criticism does not adequately answer the point. It appears to be acknowledged that unbundled or pay-as-you-transact pricing structures have involved higher fees being paid on average by customers transacting on that basis.

In the next section we examine the package fee options of the banks and assess whether or not the pricing structures associated with bundled options are conducive to more competitive and affordable transactional banking.

3.4 Pricing of bundled options

For this option the bank charges a fixed monthly fee for a bundle of transactions. For each package the bank will specify the type and number of transactions included in the bundle. The customer is charged on some or other pay-as-you-transact basis for transactions exceeding the number allowed. For those types of transactions not included in the bundle the customer will also be charged on some or other pay-as-you-transact basis. For some packages the standard pay-as-you-transact fees are applied for transactions not included in the bundle whereas for other packages special charges are applied.

Table 2 in Chapter 2 shows a comparison of bundled current account options with the pricing and the terms and conditions applicable to each of them. Given the value proposition of the bundles provided by the big four banks, uptake of the bundles seems to be very low.[44] The bundled packages have the benefit of a single monthly fee for a basket of transactions and this simplifies to some extent the calculation required to determine the customer's total monthly cost of banking. Also, because the transaction bundles are structured around defined profiles of customer behaviour they have the potential to be less costly for customers whose behaviour falls within the parameters of those profiles.

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[43] SBSA is the leader with regards to the provision of packaged options. Yet according to the data provided by SBSA (June 2007, Costing and pricing, Appendix 1) only 8,6 per cent of all their personal transaction accounts are packaged options. We do not have information regarding what percentage of accounts of FNB and Absa are bundled and what percentage are unbundled. In the case of Nedbank, less than 1 per cent of all their personal transaction accounts are bundled (Nedbank, May 2007, Second Submission, Part A Data Request).

Confidential: Nedbank

[44] Information provided regarding the number of personal transaction accounts in the banks' Submissions, March 2007, Costing and Pricing.

In criticising the Capgemini report, Standard Bank stated that its bundled current account customers paid 45 per cent less than the international average claimed by Capgemini.[45] Standard Bank claims it has had success with packages – over 60 per cent of its existing current account customers use bundled options.[46] However, it appears that bundled options are not available to basic saving and transmission account customers – the overwhelming majority of the bank's account holders. Only 8,6 per cent of the total number of personal transaction accounts at SBSA are bundled.[47]

The result is that the customers most in need of the cheapest transaction options facilities are not provided with them. We tested whether or not a bundled option would be cheaper than the unbundled pay-as-you-transact option for a particular profile.

We could only carry out this test on a current account as this is the only account type where bundled options are provided. Standard Bank Classic current account customers choosing the bundled option typically carry out more transactions than those choosing the unbundled option and do so for much lower aggregate fees. If a pay-as-you-transact customer carried out all the transactions provided for in the bundle, the monthly fee would be more than R700, compared to the bundled fee of R80 per month according to SBSA's 2008 pricing brochure. Not surprisingly, bundled customers tend to be less constrained in the number of transactions they perform relative to pay-as-you-transact clients.

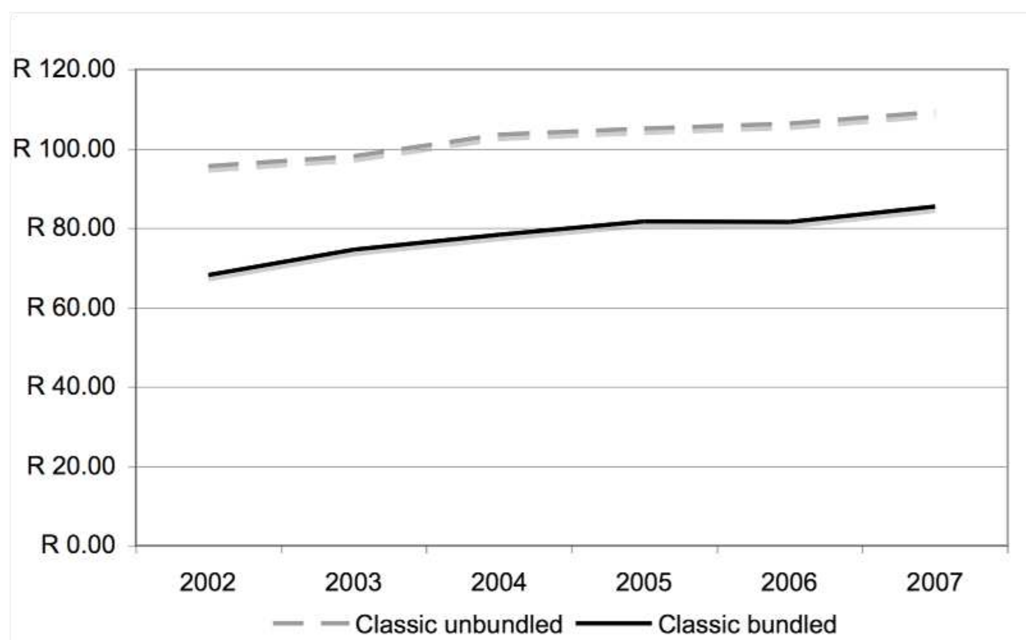
The following graph shows fees, based on a median profile, as paid by customers of Standard Bank's Classic bundled and unbundled options:

45 SBSA, August 2007, Response to Outstanding Issues Raised by the Banking Enquiry, Annexure 7, p 1.

46 SBSA, June 2007, Costing and Pricing, p 5.

47 See SBSA, June 2007, Costing and pricing, Appendix 1.

Figure 2 Total cost to customer: bundled versus unbundled options



Source: SBSA, August 2007, Response to outstanding issues raised by the Banking Enquiry, Annexure 4.[48]

In chapter two, we have shown how the product offerings between the big four banks are differentiated to such an extent that it is difficult to compare them. On top of these difficulties, customers, even within a single bank face difficulties in choosing the most cost effective product offering. Capitec, for example, referred to the difficulty associated with comparisons:

> Many complaints are lodged by the public about high bank fees. More simplified comparative models may be needed to enable financially unsophisticated clients to compare bank fees.[49]

Customers who exceed the limits imposed on a bundle or who make transactions not included in the bundle can end up potentially paying much more than the fee charged on a pay-as-you-transact basis. (See Table 2 in the chapter on Market Power.) A customer who selects a package which turns out to be unsuitable for his or her purpose could end up being severely penalised as a consequence of charges incurred for out of bundle transactions. Customers transacting on packages incompatible with their needs can also end up paying for items that are never used.

Given the presence of search and switching costs consumers cannot easily switch to more appropriate packages. This implies greater costs for consumers but potentially increased revenue for banks. It is important that high standards are set for transparency and disclosure and that measures are introduced to improve comparability of bundled options.

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48 SBSA, August 2007, Response to Outstanding Issues Raised by the Banking Enquiry, Annexure 4.

49 Capitec, October 2006. First Submission, p 22.

3.5 The process by which charges for transaction services are set

In their submissions the banks have pointed to a bewildering variety of factors, some of them overlapping, that are taken into account in setting prices:

- Competitive environment
- Typical customer transaction profiles
- Price signals to customers
- Customer education objectives
- The economic and social environment
- The regulatory framework
- The social and Financial Sector Charter objectives
- Cost recovery and cost recovery method per customer
- The convenience provided to the customer
- Client's needs
- The need to meet shareholder expectations
- Competitor activity in new product design
- Pricing of existing products and services
- Competitors' market shares
- The life stage of the customer
- The channels to be used
- Value to client
- Market level
- Product and market maturity
- Price transparency
- Minimize complexities
- Client behaviour
- Total cost paid by the customer.

The banks announce their fee changes to the public on an annual basis. Standard Bank announces their annual fee changes in January, Absa in April, and Nedbank and FNB in July. The new fees will usually become effective for customers at the beginning of the month after the fee changes have been announced.

Each bank usually has an executive committee which manages the price setting process and decides on the level and structure of fees. These pricing committees consist of representatives of different business units who make inputs regarding the relevant cost, revenue, and strategic interests of their business units. The committee is responsible for making sure that these interests are balanced, consistent, and aligned with the overall pricing principles and strategy of the bank.[50]

3.6 Value-based pricing

The on-line *Investopedia* (a Forbes Media publication) defines value-based pricing as a pricing strategy in which a product's price is actively dependent upon its demand. "This method of pricing allows companies to take advantage of highly demanded products by charging more. A good example is how refreshments generally cost more at sporting events."[51]

Stated more generally, value-based pricing occurs where the firm's product is not readily substitutable by other products or by the offerings of other firms.

Value-based pricing is distinguished conceptually from both cost-based pricing and pricing that is competition-based. It depends either on the absence of rivals or on the good or service being sufficiently differentiated from its rivals so as to enable a degree of market power to be exercised in the supplier's pricing decisions. In other words, it is designed to exploit inelasticities of demand. Value-based pricing makes conscious and systematic the identification of what different customers or segments of customers can be expected to bear in paying for the goods or services offered.

It is, of course, not remarkable that firms price to what the market will bear. An emphasis on value-based pricing suggests simply that effective competitive constraints on price are either absent or relatively weak. The question, then, from society's point of view, is how to reduce or eliminate the factors conferring on firms the power to price their goods or services without reference (or at least without primary reference) to competition or unit cost. Where market power is appreciable, the question also arises whether or not that power is being abused in the prices charged.

In their submissions the banks emphasised that value-based pricing is applicable to retail banking. At the hearing on 9 July 2007 Mr Shuter of Nedbank submitted that value based

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50 SBSA, June 2007, Second Submission, Costing and Pricing, p 16; Nedbank, March 2007, Second Submission, Part A Data Request, p 6; and Absa, May 2007, Second Submission, Part B Data Request, page 4.

51 http://www.investopedia.com/terms/v/valuebasedpricing.asp

pricing is a well established technique often applied in service industries, particularly in banking.[52] In its written submission Nedbank described this approach as follows:

> Nedbank adopts a value-based approach to pricing, taking multiple factors into account, of which cost is only one consideration. Additional considerations include value to client (perceived and actual as identified through market research); market level: product and market maturity; cost and client behaviour.[53]

During the same hearing Mr Ntombela of Nedbank elaborated on the value-based approach to pricing, with reference to Nedbank's pricing strategy:

> MR NTOMBELA: We get feedback from clients on their transactional needs and preferences from a number of channels. From interaction with them through our branches, call centre, and a complaints tracker system we analyse the feedback from clients regarding their needs and preferences. We also run specific research to get feedback from clients around their needs and preferences. What we then do is go into an analysis of local and international features and functionality to fulfil those needs and we then run research using; (a) client focus groups; (b) surveys with clients, to get a feedback from them around which of these features and functionalities would they like in an offering that they regard as offering them value to fulfil their needs. This is not an exact science. … The value that people attach to services varies. It varies with customers, it varies with the segment the people are in, it varies with the way that they interact with the banks. … We then specifically ask questions from clients around price: What do you think?, what are you prepared to pay for this that will in your mind make this a good offer to you?, what do you think you are currently paying for a similar service if it exists? We then do a competitive analysis to get a view of what the market is charging for similar services. We will then consider what strategic objectives we are trying to achieve with this offering. … We then estimate how many clients are going to take this up: [expected volumes, values etc]. The next step is then to consider the revenue that this new offering is going to generate and then test this against the incremental costs that providing a new service will incur. In this process we do not look at the cost of specific transactions.[54]

This approach to pricing is broadly in line with the approach adopted by all the other banks. Essentially, this is a strategy of differentiated pricing that seeks to segment customers into groupings based largely on patterns of usage and according to income levels. In this regard each bank will conduct market research and, on the basis of their understanding of customer preferences and behaviour, will implement price structures and set price levels which they calculate will maximise profit generated from customers transacting across the different channels.[55] Costing information obviously plays a role to the extent that banks must check whether or not revenue generated is sufficient to cover overall costs across the range of products or, in the case of new products, is sufficient to cover the incremental costs in this regard. As noted by Mr Ntombela, no consideration is given at all to the cost of specific transactions.

In addition to differentiating within and across their own product ranges, each bank uses pricing to differentiate their offerings from those of their competitors. Again this is based on

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52 Transcript 9 July 2007, p 39

53 Nedbank, April 2007, Second Submission, Part A Data Request, p 3.

54 Transcript 9 July 2007, p 88 – p 90.

55 SBSA, June 2007, Second Submission, Costing and Pricing, p 16 and Absa, May 2007, Second Submission, Part B of Data Request, p 4.

market research which seeks to determine the sensitivity to price of different customer segments. For example, Standard Bank claims to differentiate itself from the other banks through its product offerings, associated price levels, price structures, and competitive strategy.[56]

The channel strategy of the banks is an important consideration affecting the setting of prices. Absa, for example, has noted that price structures are implemented and price levels set in order to signal to customers to use lower-cost and more efficient channels.[57] For example, ATM transactions are generally less expensive than equivalent branch transactions because the branch is a more costly channel than ATMs. FNB submitted that an important part of its strategy is "to encourage customers to use more efficient transaction channels, for example to move from branch to Internet banking".[58]

The banks have submitted that they take account of competing transaction types and competing accounts – both from accounts within each bank and from accounts offered by competitors. For example, pricing structures applicable to Mzansi are such that there is little chance of Mzansi cannibalising the other mass market account products within each bank. *Ad valorem* pricing is also effective in maintaining segments within banks and preventing unwanted competition or arbitrage between products within banks. For example, Absa noted that "if personal banking fee structures were changed from *ad valorem* to flat fees, fees would have to be set at a level sufficiently high to discourage Business Banking customers from using personal accounts in lieu of business accounts for cash deposits".[59]

Given the extent to which the product offerings of the banks are differentiated there is little scope for direct price competition on the level of fees for transaction services on unbundled pay-as-you-transact options. Bundled fee options are also not subject to direct price competition on the fixed fee because the bundles in each bank's package are differentiated to such an extent that they cannot be compared directly.

Each bank does have reference to the pricing of its competitors – but only to ensure that its own pricing is not significantly out of line with that of the other banks. In this regard we find, particularly for unbundled transactions which are more directly comparable across banks, that fees tend to follow each other (upwards on average) within a fairly narrow range.

Nedbank provides a good example of what happens when fees step too far out of line. Nedbank lost market share by focussing its pricing on a high income niche which, it believed,

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56 Genesis: Report prepared for Standard Bank "Critique of the Monitor Group's Report "Competitiveness Report": International Price Comparison and Competitiveness Analysis, page 2.

57 Absa, May 2007, Second Submission, Part A of Data Request, p 4.

58 FRB, March 2007, Second Submission, Part A Data Request, p 6.

59 Absa, May 2007, Second Submission, Part A Data Request, p 17.

would absorb the higher fees. It ended up losing customers and, further, did not have appropriately priced options to attract customers in the growing middle and mass market.[60] As a consequence the other banks, who had positioned themselves for the middle and mass market, were able to grow their share of the market while Nedbank lost ground. Insofar as Nedbank has begun to reposition itself to serve the middle and mass market, its pricing seems merely to have moved broadly into realignment with the pricing of the other banks. With the exception of Capitec, which is limited at present to a particular (i.e. lower) segment of the market, we found no evidence in the unbundled fee data we examined of undercutting of each other by any of the banks.

In conclusion, we find that the banks implement price structures and set price levels on the basis of a strategy of differentiated pricing which seeks to extract maximum sustainable profit from a segmented customer base. The customer base is segmented according to transactional behaviour patterns which tend to be associated with different income groups.

With each subsequent price review the banks learn more about consumer behaviour and preferences and adjust their pricing structures accordingly with a view to achieving a more accurate segmentation of the market. As a consequence, banks have been able to increase revenue and volume.

3.7 The relationship between the costs of providing transaction services and the fees charged for those services

It is clear from the above discussion that prices for transaction services are not set on a cost plus margin basis. Rather, sophisticated qualitative and quantitative techniques are used to assess price sensitivities and other aspects of consumer behaviour in order to determine price structures and price levels.

In competitive markets, there is a tendency for forces to drive prices down to the level of costs. In such markets firms face downward pressure on price and are thus driven to reduce cost in order to increase or maintain their margins. Prices and costs therefore tend to move together.

As we noted in the introduction to this chapter effective competitive pressure tends to align the incentives of producers with the preferences of consumers. In particular, this balancing of consumer and producer interests should result in an efficient allocation of resources in which the price reflects both the value of the service to the consumer as well as the underlying costs associated with providing the service.

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60 See Nedbank, May 2007, Second Submission, Part A, Data Request, p 5, and Transcript, 9 July 2007, pp 32, 37, 38, 79, for example.

It is to this end that the terms of reference of the Enquiry have included in the subject matter to be considered, the relationship between the charges for retail banking services and the costs of providing those services. The Enquiry Technical Team requested the four largest banks to submit detailed information regarding the costs of transactions. In particular, a template was presented to the banks, with the following request:

> As part of the Competition Commission enquiry into banking services, the [Technical Team] needs to gain a better understanding of the costs and revenues that are attributable to services that are supplied through different banking products and banking channels. To this end, we have constructed a template for each of the three main, entry level accounts maintained by banks…[61]

The template was to be completed along the following lines:

> Costs per transaction should be specified in the column "Cost per transaction", for each transaction type in the left hand column. If a direct costing allocation per transaction is not undertaken by the bank, please indicate how costs are allocated, and show the cost apportionment methodology workings in the space provided. Where the cost allocation keys are different to those indicated in the template, please specify the allocation methodology that you believe more appropriate. The end result is that we are seeking your calculation or best endeavour to allocate costs per transaction. In the absence of known costs or allocated costs, please apply the methodology outlined in the template.[62]

In response, each bank provided comprehensive descriptions of their approach to costing and cost allocation. Although there were differences in detail in the approach to costing by each bank, they were unanimous in insisting that the difficulties of allocating costs and revenues to particular transactions are such that no meaningful conclusions can be drawn about the level and structure of charges from a comparison of revenues and costs on particular transaction types and particular account types.

We summarise their main arguments below:

- Banks are multi-product firms with substantial common and fixed costs which cannot be directly allocated to particular transaction services, or even to products.[63] Banks offer multiple products including transaction accounts, personal loans, mortgages, credit cards, and insurance products. Products are also offered to a variety of customers including individuals, small businesses and corporate customers. Many of the costs incurred by banks are common or shared across the different transaction types, products, and customers. For example:
    - Branch costs – Branches are used for the sale and delivery of a variety of products and services to a variety of customers. The staff, building, and equipment costs are shared across all these products and services.[64]

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[61] Part B Data Request: Costing and Pricing Template for Basic Banking Products.

[62] *Id.*

[63] SBSA, April 2007, Second Submission, ATM Transaction, p 11.

[64] Absa, May 2007, Second Submission, Part B Data Request, p 3.

- o Information Technology infrastructure – The IT infrastructure, the data communication links between branches and ATMs, and IT data centres themselves incur costs which are common to the provision of multiple products and services of the bank.[65]
- o Head office infrastructure – The infrastructure, office space, staffing and equipment in the head office support the full range of products and services of the bank. While staff and office space may be allocated to certain product lines, many of the head office functions are shared across all products and services of the bank and thus cannot be easily allocated to product lines.[66]

- There is a distinction between Economic Costs and Accounting Costs. The latter cost method fails to take into account measures such as brand image, development costs, and the position of the product or service in the stage of the life cycle of the product or service.[67]
- Approximately 80 per cent of costs are fixed and will therefore not vary significantly with changes in account or transaction usage. Different methods of allocating such fixed costs to individual transactions would give varying results, depending upon the method of allocation used. Standard Bank says: "The vast majority of our costs (our capital, our computer systems, our branches and ATM networks, our staff in the distribution network and our head-office expenses) are fixed".[68] Staff costs appear to be the single largest expense item for banks in general. Staff costs for Absa accounted for R7,810 million or 45 per cent of total costs,[69] for FNB staff expenses represented 45.3 per cent of its total cost base of R10 billion.70 The banks therefore argue that it is not clear how staff costs should be allocated and what proportion of these costs should be considered fixed or variable.[71]

Confidential: Absa

Confidential: FNB

- A number of different costing approaches can be used. Each will yield different results and each can be used for different purposes. It has been argued that because cost allocation exercises will be carried out differently by different banks it is unlikely that cost information provided by different banks will be comparable.[72] Nevertheless, to the Enquiry, the relationship between costs and prices of each bank still takes precedence over comparability between banks.

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65 SBSA, April 2007, Second Submission, ATM Transaction, p 12.

66 *Id.*

67 FRB, March 2007, Second Submission, Part B Data Request, p 7.

68 SBSA, October 2006, First Submission, p 14.

69 Absa, May 2007, Second Submission, Part B Data Request, p 3.

70 FRB, October 2006, First Submission, p 35.

71 Nedbank also mentioned staff costs as a significant component of overall costs. See Transcript 9 July 2007, p 40. Standard Bank discussed the significance of staff costs in its second submission, June 2007, Costing and Pricing, p 6.

72 Absa, May 2007, Second Submission, Part B Data Request, p 4.

- There are activities and transactions which incur costs but do not generate revenue. These include telephonic and branch queries, and the opening and closing of accounts. This means that revenue to cover these costs must be obtained from other sources. This further complicates any attempt to allocate revenues and costs to particular transactions.[73]

Absa and Standard Bank were not able to complete the costing information in the template, as requested by the Technical Team.

In this regard Absa stated:

> The areas where Absa has been unable to provide detailed information in response to the [Enquiry's] data request relate to unit costs by type of transaction, and account-level specific information (e.g., account opening, maintenance and closing costs, and account-level cost to income ratios and contribution). While Absa collates and monitors cost information at a more aggregated level (e.g., at business unit level) and by cost category (e.g., staff costs, impairment costs), the estimates of detailed transaction and account-level costs contained in Absa's management information systems do not currently reconcile to Absa's general ledger, and are not relied upon within Absa for pricing or investment decisions. Inconsistencies in Absa's cost allocation processes were identified during a review of Absa's costing methodologies in 2004, following which Absa commissioned an activity based costing project in 2005. This project is now in its final stages of completion and is expected to be completed in early 2008. Until that date, Absa does not have consistent costing data at the transaction and account level.[74]

Confidential: Absa

In a written submission Standard Bank repeated its stance, communicated at a meeting with the Technical Team on 5 April 2007, as to why it was not able to "populate the cost elements of the template":[75]

> In relation to Part B, SBSA is unable to provide average cost per transaction … Costing data not generated. The data that SBSA is not able to provide is not generated by SBSA in the course of managing its business. Whilst the data could, in theory, be generated by a large team of accountants working for a period of time, such a once-off exercise would, in any event, be unreliable. Plausible costing can differ widely depending on the set of assumptions that are used. SBSA believe that for a costing approach to be accepted it must be proven through adoption and use. This view is mirrored in the Basel II approach to capital adequacy, which includes the so-called "use-test", where estimation methodologies are considered to be reliable only to the extent that they are used in the day-to-day management of a bank.[76]

Although FNB and Nedbank did complete the costing information in the templates, they nevertheless submitted that there is no meaningful relationship between costs and revenues (and therefore between costs and prices) at the level of the transaction.

FNB submitted:

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[73] FRB, March 2007, Second Submission, Part B Data Request, p 4.

[74] Absa, May 2007, Second Submission, Part B Data Request, p 4, 5.

[75] SBSA, June 2007, Costing and Pricing, p 2.

[76] *Id.*, p 5,6.

> The relationship between costs and revenues is not meaningful at the "revenue generating transaction" line as 31 per cent of the actual costs required to service these accounts are not accounted for. Costs are generated to support the ongoing servicing and support of the account. Since the cost allocation to specific transactions is not very meaningful, FRB, as noted in their first submission, assesses profitability at a product level.[77]

Confidential: FRB

In its submission Nedbank noted:

> The current allocation of costs … is generally done on an activity basis relating to a system, support structure, service or sales channel. It is not a basis for determining product or channel profitability. In this regard it is noted that while Nedbank has endeavoured to provide the information in the format requested, such information does not reflect the manner in which the Nedbank business is managed and operated.
>
> For this reason it is Nedbank's belief that an analysis of the information provided by it in accordance with the requested format will not be able to yield a meaningful understanding of Nedbank's business, its fee structures (and the appropriateness of such structures) or profitability.[78]

Confidential: Nedbank

Table 4 presents a comparison of costs of similar transactions as calculated by FNB and Nedbank. (Standard Bank and Absa did not supply comparable figures.)

Table 4 Average cost per transaction

Transaction	FNB	Nedbank
Mzansi		
Electronic Deposits (Salary/Pension/Other)	1.90	0.88
Cash withdrawals from Own ATM	2.01	3.90
Cash withdrawals from Other ATM	3.71	3.51
Cash deposits Own ATM	8.63	9.92
Cheque Deposits Own ATM	2.84	3.00
Balance Enquiry ATM	1.86	3.00
Cheque Payments	N/A	N/A
Electronic account payment	1.86	N/A
Cheque deposits at teller	6.35	29.24
Cash withdrawal at teller	7.21	11.52
Debit Orders Internal (Homeloan/Card etc)	1.90	0.88
Debit Orders External (Furniture/HP/Car/Loans)	1.90	1.42
Rejected Debit orders	4.18	4.88
Airtime top-up	1.86	N/A
Cheque card purchases	1.90	4.00
Cash deposit at teller	6.12	6.85

Confidential: FRB Nedbank

77 FRB, March 2007, Second Submission, Part B Data Request, p 11.

78 Nedbank, May 2007, Second Submission, Part A Data Request, p 3.

Transaction	FNB	Nedbank
Transmission		
Electronic Deposits (Salary/Pension/Other)	1.90	0.88
Cash withdrawals from Own ATM	2.10	4.56
Cash withdrawals from Other ATM	4.06	5.83
Cash deposits Own ATM	9.89	20.46
Cheque Deposits Own ATM	2.84	3.00
Balance Enquiry ATM	1.86	3.00
Cheque Payments	N/A	N/A
Electronic account payment	1.86	3.93
Cheque deposits at teller	6.55	29.24
Cash withdrawal at teller	11.16	21.54
Debit Orders Internal (Homeloan/Card etc)	1.90	0.88
Debit Orders External (Furniture/HP/Car/Loans)	1.90	1.42
Rejected Debit orders	4.18	4.88
Airtime top-up	1.86	3.00
Cheque card purchases	1.90	4.00
Cash deposit at teller	7.10	15.05
Basic Cheque		
Electronic Deposits (Salary/Pension/Other)	1.90	0.88
Cash withdrawals from Own ATM	2.13	4.61
Cash withdrawals from Other ATM	5.19	5.85
Cash deposits Own ATM	10.01	63.66
Cheque Deposits Own ATM	2.84	3.00
Balance Enquiry ATM	1.86	3.00
Cheque Payments	5.25	N/A
Electronic account payment	1.86	3.93
Cheque deposits at teller	6.58	29.24
Cash withdrawal at teller	11.97	42.44
Debit Orders Internal (Homeloan/Card etc)	1.90	0.88
Debit Orders External (Furniture/HP/Car/Loans)	1.90	1.42
Rejected Debit orders	28.34	4.88
Airtime top-up	1.86	3.00
Cheque card purchases	1.90	4.00
Cash deposit at teller	8.19	22.03

Source: Nedbank and FNB, March 2007, Second submission, part B data request.

We note that while costs appear similar for some transactions, they differ considerably in respect of many others. Given that this information was submitted with caveats and, given the objective difficulties of interpretation and measurement, we are unable to draw meaningful conclusions from a comparative analysis of this data. However, to the extent that they are indicative, it is clear that the prices charged for these transactions bear no relationship to the costs of providing them.

3.8 Conclusion

Banks do not consider per transaction costs at all in the setting of transaction fees. Until recently, most of them have been either unable or unwilling to find out what these costs are. There are objective difficulties of measurement and interpretation arising from the high fixed and common cost nature of multi-product banking. For example, it would be unrealistic to expect that there should always be a very close relationship between fees for transactions and the direct costs of providing them.

On the other hand, however, the fact that the banks have not had any reference to the unit costs of transactions in the setting of prices suggests that they are sheltered from effective competitive pressure. Under effective competition the banks would need to know what these costs are in order (at the very least) to determine whether internal resources are being allocated efficiently. Consider, for example, the possible entry of non-bank ATM service providers. If competition from these providers threatened to undermine the revenue stream of the banks from ATM transactions, then one would expect that the banks would require detailed information regarding the costs of providing ATM transaction services. This is because they would need to know how the allocation and utilisation of resources hinders or facilitates their strategic positioning in respect of the provision of these services.

The same argument applies in respect of the provision of any other payment service that could potentially be a substitute for any of the transaction services traditionally provided by the bank to its account holder. This is because these providers would themselves incur costs that would have to be covered by appropriate pricing. To the extent that these providers could potentially impose a significant competitive constraint on the banks, this would bring into sharp focus the costs of providing these services – for both the banks and the new providers. The fact that banks in South Africa have not been subject to vigorous price competition explains, in large part, why they have had little or no interest in determining costs at the transaction level – and why fees for transaction services do not bear any identifiable relation to the costs of providing those transaction services.

However, with advances in technology expanding the scope for alternative and innovative payment service providers, this situation may be beginning to change. A number of banks have indicated a move towards adopting procedures to estimate costs more accurately at

the transaction level.[79] Absa indicated that in 2005 it commissioned an activity based costing project which is to be implemented in early 2008, by which time Absa will have consistent costing data at the transaction and account level.[80] Nedbank noted that "... it is Confidential: our intention in the long term to use Activity Based Costing to determine accurate product Nedbank profitability at a detailed level".[81] FNB is already engaged in sophisticated costing and has noted that "these models are continuously improved over time as new information is collected".[82] Standard Bank, on the other hand, appears sceptical about the benefits of detailed costing studies. Although it has done some limited activity based costing, it submitted that data and methodological problems have hampered its application at Standard Bank. However, as we have noted above, competitive pressure and advances in technology, may mean that all banks, including Standard Bank, will eventually be able to conduct detailed costing exercises. If competition for payment services is allowed to develop – by improving access conditions and otherwise lowering barriers to entry – then one would expect to see prices and costs for transaction services aligning more closely with one another. This is further discussed in the chapter on Access to the Payment System.

In a market characterised by direct price competition firms price their products to attract and hold their customers. In such a world competition tends to drive prices towards costs and so one would expect a reasonable and rational relationship between price and cost.

In the case of retail banking it appears that banks capture their customers to price to them. Such capture is a consequence of the market power of the banks. Search, switching costs and information asymmetries are all important factors in this regard and have been dealt with in some detail in the chapter on Market Power. This market power allows the banks to segment the market through the application of differentiated price and product options. The application of complicated fee structures, the addition of new fee categories, and general increases in the level of fees are all manifestations of this power. In this regard it is very important that high standards are set for transparency and disclosure and that measures are introduced to improve comparability of bundled options.

The pricing initiatives said to be aimed at reducing the fee-burden on customers – such as *ad valorem* pricing, banded fee options and appropriate bundled packages – which were highlighted by the banks during the course of the Enquiry, do not appear to be generally offered to lower-income customers. It is puzzling that the benefits of such initiatives do not accrue to those who most need it. Building on from our recommendations in the Market Power chapter, we recommend that together with improving transparency, standardising

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[79] Absa, May 2007, Second Submission, Part B Data Request, p 5; Nedbank, May 2007, Second Submission, Part A Data Request, p 2.

[80] *Id.* (Absa).

[81] *Id.* (Nedbank).

[82] FRB, March 2007, Second Submission, Part B Data Request, p 4.

terminology and educating customers, the Banking Association should encourage the appropriate application of these pricing initiatives to entry level accounts by the banks.

The Mzansi initiative, which is making considerable progress in extending banking services to the previously unbanked, also needs constant scrutiny to ensure that the structure of its bundling and pricing is truly pro-poor.

Consideration should also be given to ensuring that recipients of social grants are not disadvantaged by the cost of receiving and accessing their grants through bank accounts.

Chapter 4

Penalty Fees

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Introduction

The market power of the major banks is particularly manifest in their charging of penalty fees.

In dealing separately with the subject of penalty fees, we confine our analysis to the fees charged by banks to individual retail customers when the customer's payment order is refused, usually for lack of funds. These fees are commonly referred to as *dishonour fees*. The data relied on relate only to personal transaction accounts (PTAs) and thus exclude corporate and other business customers.

Within the category of dishonour fees, we have further concentrated on fees charged for rejected debit orders. In this area we have seen clear indications of a growing problem of abuse. Cheques, on the other hand, are in decline as a means of payment and the risks for banks which arise when cheques are written against insufficient funds are significantly different from those involved in the routine processing of debit orders.

Penalty fees are difficult to define and banks ascribe different meanings to the term. For example the higher per transaction fee that may be charged to a customer who uses more than the permissible number of transactions in a particular bundle may or may not be specified as a penalty. There is no magic in the label. We have not considered it necessary to analyse such fees separately from our general treatment of costing and pricing in the previous chapter. The same applies to fees charged for rejected ATM transactions – even though, technically, they could be included among dishonour fees.

A number of other categories of penalty fees, charged in the past by South African banks, are now outlawed in terms of the National Credit Act. These have been summarised by FNB at our request:[1]

- *Honouring Fee (Excess Item or Excess Availment Fee).* These fees are charged when a bank makes the exceptional decision to honour a cheque or debit order presented for payment against an insufficient balance, based on the bank's knowledge of, and relationship with, the customer in question.
- *Late Payment Fees on Credit Cards.* This is a fee charged when the minimum payment due on a credit card is not received by the following statement date (i.e. payment is a month or more late). Confidential: FRB
- *Over Limit Fees on Credit Cards.* This is a fee charged when a customer exceeds his/her credit card limit by 10 per cent or more. Confidential: FRB

[1] FRB, August 2007, The impact of the NCA on the charging of penalty fees, p 2. The document explains: "The NCA, among many other things, governs the interest, fees and charges that may be levied in respect of any applicable credit transaction from 1 June 2007. The NCA lists the interest, fees and charges that are permitted, sets out how these should be calculated and imposes maximum interest rates, fees and charges. No other interest, fees or charges relating to any lending or credit transaction are permissible under the NCA."

- *Penalty Interest.* This is additional interest at 3 per cent on the portion of a balance that exceeds the agreed account limit.
- *Early Settlement Penalty Interest.* Certain term loans (such as vehicle finance loans) charge three months penalty interest on early settlement of a loan, unless three months' notice of settlement of the loan is given.

Our concern is essentially with fees for dishonoured or rejected debit orders (dishonour fees), which make up the bulk of the penalty fees still levied by banks, primarily for insufficient funds. In the data presented below, the figures for dishonoured cheques and stop orders are lumped together with the figures for debit orders because these figures have not generally been separated in the information submitted by the banks. The welcome exception to this is FNB, whose more detailed data is considered further below.

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Table 1 shows the four major banks' fee revenues from dishonour fees in 2006, together with the volumes (i.e. number) of such transactions. Almost R1 billion accrued to the big four banks in 2006, for almost 24 million dishonoured or rejected transactions, from around R11 billion non-interest revenue for PTAs.

Table 1 Dishonour fee revenues and volumes (debit orders, stop orders & cheques)

2006 Data	Total PTA non-interest income (R)	Revenue from dishonour fees (R)	Number of dishonour transactions	Average revenue per transaction (R)	As % of Total PTA non-interest revenue
Absa	3,967,024,000	215,564,644	10,269,538	21	5%
FNB	2,806,928,000	303,404,001	4,305,560	70	11%
Nedbank	1,315,164,000	106,299,001	2,712,030	39	8%
Standard Bank	2,955,360,000	267,656,742	6,523,081	41	9%[2]
Total	11,044,476,000	892,924,388	23,810,209	43	8%

Confidential: Absa FRB Nedbank SBSA

Source: Banks' Submissions, March & April 2007, Part A Data Request.

Table 2 and Table 3 show the levels of the penalty fees charged by these banks for each dishonoured transaction on basic transmission accounts (savings accounts) and on current accounts respectively. They provide a recent historical view of changes in the dishonour fees (which have been applied at the same level to all rejected debit orders, stop orders and cheques). Comparative data for Capitec Bank is also included where applicable, namely in respect of basic transmission accounts.

[2] Standard Bank has stated that its penalty fee revenue is less than 3% of its total fee income from personal and business banking. However, by including business banking, a much larger category than PTAs is created, within which rejected debit orders (on the paying side) would obviously have a far smaller part. (See SBSA, August 2007, Second Submission, Part A Data Request, Annexure 2, p 2.)

Table 2 Penalty fees for dishonoured transactions on basic transmission accounts

Dishonour fee (cheques, debit orders and stop orders)	2003	2004	2005	2006	2007	2008
FNB Smart Accounts	R 110.00	R 110.00	R 55.00	R 40.00	R 40.00	R 30.00
Absa FlexiSave[3]	R 65.00	R 110.00	R 110.00	R 36.00	R 36.00	R 36.00
Nedbank Transactor	R 110.00	R 75.00	R 75.00	R 50.00	R 50.00	R 28.00
SBSA E Plan	R 30.00	R 30.00	R 31.50	R 31.50	R 31.50	R 31.50
Capitec Global One	R 10.00	R 10.00	R 2.00	R 3.00	R 3.00	R 3.50

Source: Infochoice, 2007 and Banks Pricing Brochures 2008.

The data in Table 2 suggests that – typically from 2004/2005, although Standard Bank was slightly earlier – the banks revised their dishonour fees on transmission accounts downwards. It was around this time that the fees on basic transmission accounts came under scrutiny due to the Financial Sector Charter. The downward trend in fees is less apparent, if at all, in the case of current accounts (see Table 3[4]).

Table 3 Penalty fees for dishonoured transactions on current accounts

Dishonour fee (cheques, debit orders and stop orders)	2003	2004	2005	2006	2007	2008
FNB Personal Cheque Accounts	R110.00	R110.00	R110.00	R95.00	R95.00	R95.00
Absa Sliver Current Account	R100.00	R110.00	R110.00	R100.00	R100.00	R 100.00
Nedbank Everyday Current Account	R110.00	R75.00	R75.00	R75.00	R75.00	R75.00
SBSA Classic Current Account	R100.00	R110.00	R115.00	R99.00	R99.00	R 105.00

Source: Infochoice, 2007 and Banks Pricing Brochures 2008.

Figure 1 and Figure 2 present in graphic form the historical data contained in Table 2 and Table 3 respectively, together with comparable information going back to 1999 where available.

It should be noted that FNB's dishonour fees indicated in Table 2 and Table 3 – and thus carried over to the graphs in Figure 1 and Figure 2 – are expressed in the bank's pricing brochures as "minimum" fees. The same applies to Absa's 2008 pricing brochure. We shall return to the significance of this in due course (Section 4.4.3).

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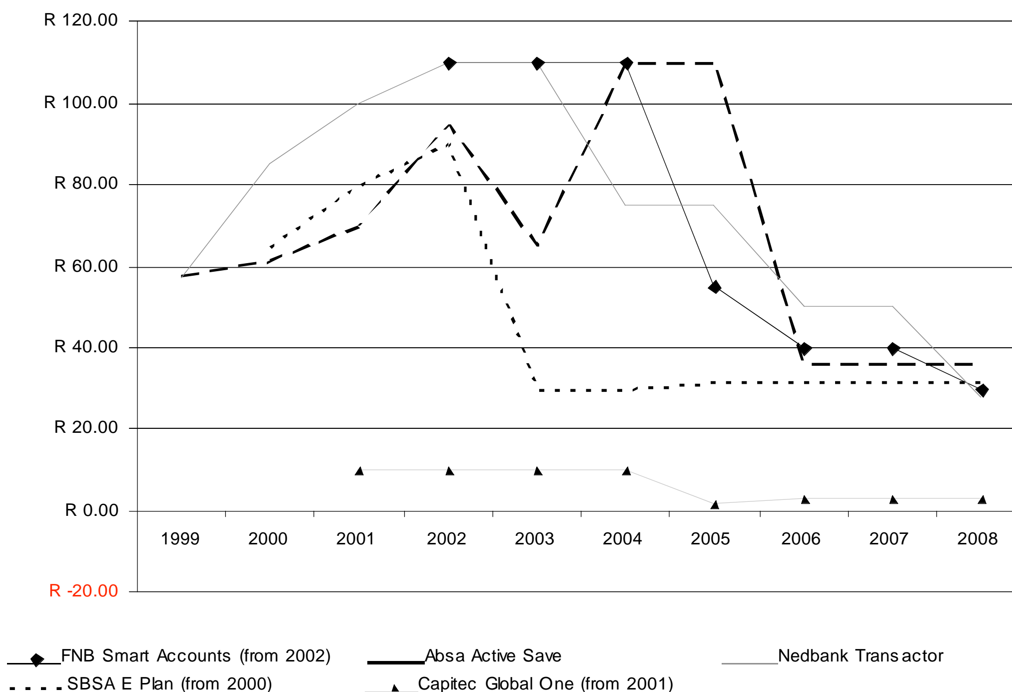
3 This account has been renamed the Flexi Account in 2008.

4 This is perhaps one of the few areas where price changes have been to the benefit of transmission account holders rather than more affluent current account holders.

Figure 1 Historical view of dishonour fees on transmission accounts



Source: Infochoice, 2007[5] and Banks Pricing Brochures 2008.

Between 1999 and 2002, it appears that dishonour fees charged by the four major banks on transmission accounts were generally increasing despite the entry of Capitec.[6] After 2002, Standard Bank was the first to reduce its fee, followed by FNB and Nedbank. Even then, however, their fees remained much higher than those of Capitec. Capitec's dishonour fees are set at only R3.50 per item in 2008, compared with R28.00 per item charged by the lowest among the major banks. All this suggests that, while other major banks' penalty fees may provide a restraint on each of the big banks' pricing of such fees (which are simply comparable across banks), there does not appear to be an imperative to price-compete with a relatively minor player like Capitec. Moreover, as we shall go on to show, penalty fees are not competed down to any identifiable relationship to cost.

As Figure 2 shows, dishonour fees on current accounts have not decreased in recent years to the extent observed on transmission accounts.

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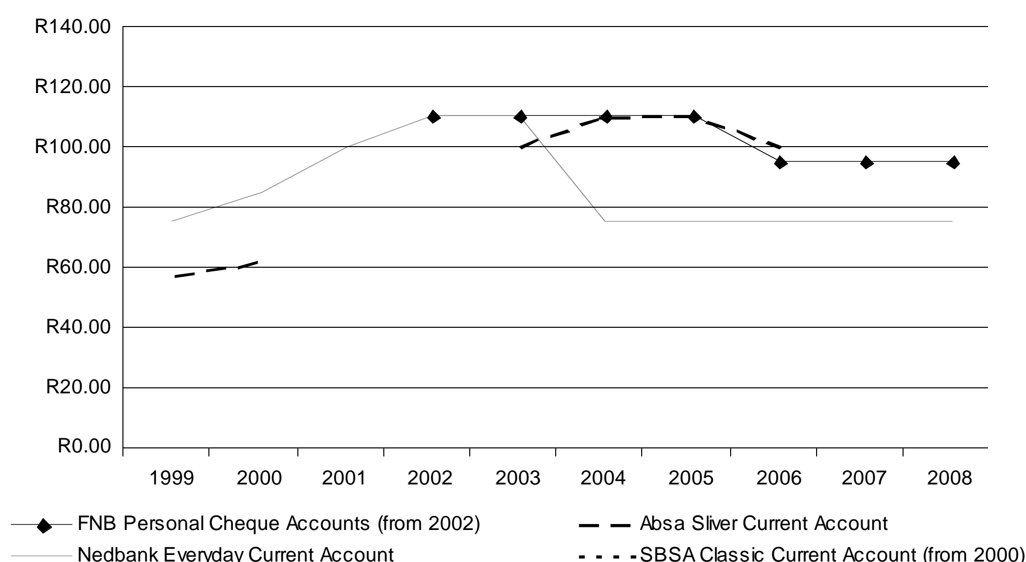
5 Data is incomplete for some of the banks, prior to 2002. This is as provided by Infochoice, and does not necessarily suggest that there was no fee charged at the time.

6 Excluding the Mzansi accounts, these are the account types most similar to the Capitec Global One account.

Figure 2 Historical view of dishonour fees on current accounts



Source: Infochoice, 2007[7] *and Banks Pricing Brochures 2008.*

4.1 Relationship between the cost of and fees for rejected debit orders

It is evident that no relationship exists between costs incurred by the major banks and the dishonour fees which they charge. This basic evaluation by Mr Weeks of the Enquiry's Technical Team at the outset of the hearings on pricing behaviour and market power, presented in Figure 3, was never refuted.[8] The same transaction type, which should have roughly similar processing costs, attracts a substantially different penalty fee on different types of account. Moreover, there are huge disparities in the penalty fees charged by different banks for the same transaction.

The four major banks were asked to provide unit costs for various transactions in PTAs. Two banks, FNB and Nedbank, provided the requested information – although with qualifications that cost allocations can be misleading where used for different purposes. We accept that the unit costs reported are only approximations. Nevertheless, on savings accounts, FNB reported a transaction cost of R1.80 per successful debit order, while Nedbank reported a cost of R1.42 per successful debit order, compared with the cost of a rejected debit order of R4.18 and R4.88 respectively. These values bear no evident relationship to the fees charged per debit order and rejected debit order on, for example, the FNB Smart and Nedbank Transactor accounts.

Confidential: FRB Nedbank

[7] Data is incomplete for some of the banks, prior to 2002. This is as provided by Infochoice, and does not necessarily suggest that there was no fee charged at the time.

[8] Transcript 18 June 2007, p 30.

FNB stated that, in general, "penalty fees are levied at high enough levels to cover the costs of the transaction" – a considerable understatement – "but more importantly to change customer undesirable behaviour."[9] Mr. Shuter of Nedbank maintained at the hearings that "the level of penalty fees in Nedbank are reasonable relative to the various costs the bank incurs when clients default relative to the market", but Nedbank's own costing figures for rejected debit orders – which he insisted should be kept confidential – show this not to be so.[10]

Confidential: Nedbank

Figure 3 Estimated cost and pricing of debit orders (FNB and Nedbank, 2006)

Oops, Could not Uncensor! :-(

Confidential: FRB Nedbank

Source: FRB and Nedbank, March 2007, Second Submissions, Part A data request, Infochoice, 2007, and Pricing Brochures[11]

We have no reason to suppose that the situation is significantly different where Absa and Standard Bank are concerned.

4.2 Penalty fees as a growing stream of revenue for the major banks

The volumes (number) of transactions attracting penalty fees have increased substantially over the past five years. This is apparent from the detailed figures supplied by FNB, which are set out in Table 4. Disaggregated historical data of this kind was not supplied by the other major banks, so a direct comparison has not been possible. However, there is no

9 See FRB, March 2007, Second Submission, Part A Data Request, p 8.

10 See Transcript 9 July 2007, pp 124-128.

11 In FRB, March 2007, Second Submission, Part A Data Request, p 11, the dishonour fee "currently charged" on Smart Transmission Accounts was given as "R30 per item for the first 3 unpaid items in a rolling 12 month cycle, thereafter R60 per item". In fact, according to FNB's pricing brochures, the minimum dishonour fee at that time was R40 per item. It was reduced to R30 with effect from 1 June 2007.

Confidential: FRB

reason to suppose that the trends have been significantly different in their case. It is clear from the information below that rejected debit orders make up the vast majority of dishonoured transactions. The volume of rejected debit orders increased by more than 90% between 2002 and 2006, As has been mentioned above, the decline of cheques as a payment instrument has been influential in the decline in the number of rejected cheques over this period.

Table 4 Volumes of selected transactions on which penalty fees were charged (FNB)

Type of fee	2002	2003	2004	2005	2006
Dishonour fee - debit order	2,124,004	2,327,592	2,559,754	2,911,673	4,056,967
Dishonour fee - stop order		3,295	102,321	119,249	162,134
Dishonour fee - cheque	202,355	156,146	122,570	97,017	86,459
Card replacement fee	563,692	547,138	572,902	680,206	776,502
Declined transaction fee - another ATM	11,052,240	13,475,980	12,463,300	13,169,681	15,525,441
Declined transaction fee – own ATM	2,546,063	3,080,225	3,237,249	3,138,481	3,587,390
Grand Total	16,488,354	19,590,376	19,058,096	20,116,307	24,194,893

Confident FRB

Source: FRB, March 2007, Second Submission, Part A Data Request.

The penalty fee revenue submitted by FNB is presented in Figure 4. The bar chart illustrates the exponential increase in penalty fee revenue, as it increasingly becomes a core source of income for the bank. Included in the chart as “other” penalty fees are honouring fees which are no longer permitted under the National Credit Act (see above). Even if these are disregarded, the historical trend remains clear. Revenue from dishonouring fees has increased most substantially. Again, while we lack comparable data from Absa, Nedbank and Standard Bank, we have no reason to think that the broad pattern of development would be significantly different for them.

Confidential: FRB

Confidential: FRB

Figure 4 Revenue from penalty fees (FNB)

Confidential: FRB

FRB, March 2007, Second Submission, Part A Data Request.

Total revenue is the product of price and quantity. Since the penalty fee (or "price") charged for a dishonoured transaction has been reduced, it is important to ascertain whether or not the annual growth in the bank's penalty fee revenue has been due simply to a growth in the number of PTAs. At the same time any annual change in the average number of dishonoured transactions per PTA must be identified.

Figure 5 indicates that the growth rate in the number of PTAs has contributed significantly to the growth in the number of dishonoured transactions. At the same time, however, the number of dishonoured transactions per PTA has been rising significantly.

Confidential: FRB

Figure 5 Growth in the number of PTAs and dishonoured transactions (FNB)

Confidential: FRB

Source: FRB, March 2007, Second Submission, Part A Data Request.

Although FNB's dishonour fees decreased in 2005 and 2006 (see Table 2 and Table 3), the bank's revenue from dishonour fees still increased by 54 per cent in 2005 and 35 per cent in 2006. This is attributable to the increases in the volumes of penalty fee transactions observed in Table 4.

Confidential: FRB

Figure 6 Average dishonour fees, and growth in dishonour fee revenue (FNB)

Confidential: FRB

FRB, March 2007, Second Submission, Part A Data Request, Pricing Brochures and Infochoice, 2007.

Data provided by the major banks in respect of penalty fees have not been sufficient, or have not been sufficiently consistent, to allow precise comparisons to be made. However, analysis of the banks' responses to Parts A and B of the Technical Team's Data Request has revealed that the average rate at which debit orders are rejected, and thus attract a penalty fee, is roughly twice as high for basic savings or transmission accounts as for all PTAs taken together. In other words, in accounts typically held by lower income customers, a relatively high proportion of debit orders presented for payment are dishonoured for insufficient funds.[12] This means that the burden of penalty fees is falling disproportionately on those least able to afford them.[13] Where detailed data has been provided, indications are that as much or even more revenue is earned by banks from rejected debit orders on these accounts than from the processing of successful debit orders.

That more revenue is earned from rejected debit orders than from successful ones, appears to be the case with Nedbank's Transactor Account and FNB's Smart Account. Where Absa's FlexiSave Account is concerned, the bank's revenue from rejected debit orders is not much lower than that from successful debit orders. (The omission of Standard Bank from this analysis is the result of that bank's failure to provide comparable data at the product level.)

Confidential: FRB, Absa, Nedbank

12 Standard Bank reports that "89 percent of unpaids are due to the customer having insufficient funds in his or her account." (SBSA, August 2007, Second Submission, Part A Data Request, Annexure 3, p 2.)

13 Cf the evaluation by Mr Weeks, Transcript 18 June 2007, p 29.

4.3 Need for consumer protection against exploitative penalty fees

Both the level and the volume of the fees charged for rejected debit orders by the major banks provide grounds for grave disquiet. In general, the vulnerability of the ordinary customer to exploitation and abuse through penalty fees is considerable. Payment by debit order is routinely required nowadays for all manner of regular services, which have become an essential part of everyday life. Reliance on debit orders is widespread throughout the mass market served by banks, and it is notable that debit order facilities have recently been added to the basic Mzansi account offerings.

True, the customer undertakes when opening a transaction account to have funds available in the account to meet any payment instruction which the customer issues. Penalty fees in the strictest sense are said to provide compensation for the bank for breach of contract by the customer, while discouraging such further behaviour. Although the bank, in rejecting the payment instruction, does not pay money out, it does incur costs and is said to be exposed to risk through the undisciplined and undesirable behaviour of its customer. Penalty fees are said to be a necessary means of protecting banks. While this argument may have validity where customers write cheques for which they have not provided sufficient funds, we are not persuaded by it as a justification for the dishonour fees currently being charged by the major banks where electronically-processed periodic payment orders are concerned.

The argument that penalty fees are necessary to deter “kite-flying” or “cross-firing” (the depositing of worthless cheques and drawing against them by the customer before the funds are cleared) has no evident relevance to debit orders. References to the cost of risk management systems needed to detect and forestall such activities would seem to be similarly limited in relevance.[14] Costs incurred by a bank in deciding whether or not to extend a credit facility to its customer who lacks sufficient funds to meet a debit order cannot legitimately be recovered by way of a dishonour fee; and honouring fees are now evidently prohibited by the National Credit Act (see above). The assertion that banks suffer significant harm to their commercial reputations when their customers’ debit orders are rejected as unpaid is supported neither by evidence nor (in our view) by the probabilities.[15] Merchants accepting or declining to accept debit orders from particular customers surely evaluate the likelihood of the customer defaulting, not the customer’s bank.

All the major banks assert that penalty fees, including fees for rejected debit orders, are readily avoidable by the customer – by the simple expedient of keeping enough money in

Confidential: Absa

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[14] See Transcript 18 June 2007, pp 89-93 (Mr Tshabalala of Standard Bank). Mr Shuter of Nedbank likewise sought to defend existing penalty fees for rejected debit orders with arguments which combined all types of customer default and the bank’s costs in managing them – including even the costs of debt collection: see e.g. Transcript 9 July 2007, p 134. We are not persuaded that penalty fees on rejected debit orders can be justified by these arguments.

[15] Cf Transcript *id*., pp 140-141; SBSA, August 2007, Second Submission, Part A Data Request, p 2. Also see (FNB) Transcript 9 July 2008, pp 149-150.

their accounts to meet any debit orders they choose to sign.[16] This fails to take account of social reality, a little like Marie Antoinette saying "Let them eat cake!"

Confidential: Absa

Many ordinary bank customers are not in a position to pad their bank accounts. They face the situation where, when credits such as salary payments are delayed, this causes the debit orders which they have signed in good faith to "bounce" for insufficient funds. It is not a matter of neglect, or irresponsibility, but of circumstances beyond their control.[17] Yet the penalty fee is applied per debit order item, so that a customer may face multiple penalties to add to the primary misfortune of getting paid late. It is also not unusual for debit orders to allow the creditor to increase the amount of the payment claimed when the price of the service is increased. Customers on low incomes, with tight credit margins, can readily find themselves lacking sufficient funds without having had any intention of defaulting on their payments or of breaching their undertakings to the bank.

It seems to us quite unacceptable that a bank should recover more than the cost incurred in processing the rejections in such cases.[18] It is no answer for banks to say that, on application, they might reverse the penalty fee in a deserving case.[19] Very many consumers – even if they were assured of the possible indulgence – would suffer in silence rather than muster the confidence, or find the time, to challenge the debit when it appears on their account.[20] Where a particular customer repeatedly issues payment instructions for which he or she fails to provide sufficient funds, the bank can protect itself by terminating the banker-customer relationship and closing the customer's account. Where serious harm is suffered by the bank through a particular customer's breach of contract, an action for damages is available. There is no reason to suppose that fraudsters are deterred by the existence of penalty fees. At the same time the alleged deterrent effect of penalty fees on the behaviour of ordinary customers is not reflected in the rate of dishonoured transactions on PTAs, which has been rising steadily (see Figure 4 above).

The assertion by Mr Shuter of Nedbank[21] that penalty fees are deterring default is unsupported by facts. Ms Durbach of FNB also argued that penalty fees have been effective

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16 See Absa, March 2007, Second Submission, Part A Data Request, p 26; FRB, Second March 2007, Second Submission, Part A Data Request, p 11; Nedbank, March 2007, Second Submission, Part A Data Request, p 10; SBSA, August 2007, Second Submission, Part A Data Request, Annexure 2, p 2.

17 Absa argues that the customer can avoid a returned or rejected debit order inter alia by "[e]nsuring that the timing of salary/credits is matched with the due date of the debit order." Absa, March 2007, Second Submission, Part A Data Request, p 26. We do not agree that this deals with the problem. See also KLA, Exhibit GGG, slide 38; Transcript 17 July 2007, pp 151-153 (Ms Matterson).

18 Cf the submission in this regard by Mr. Weeks for the Technical Team, Transcript 18 June 2007, p 37.

19 Cf e.g. FNB (Mr Jordaan), Transcript 9 July 2007, p 162; Exhibit EEE, slide 17; SBSA, August 2007, Second Submission, Part A Data Request, Annexure 2, p 3.

20 See e.g. the evidence of the Ethekwini Civic Forum, presented by Mr Siva Naidoo, regarding the sense of intimidation or disempowerment felt by many ordinary people when dealing with banks. (Transcript 29 November 2006, pp 64-65; Exhibit X, p 4.) Also the evidence to similar effect of Ms Stella Rai (*id.*, pp 88-89), and of Ms Nevana Srikissoon (*id.*, pp 92-93 and 99). See also KLA, Exhibit GGG, slide 38; Transcript 17 July 2007, pp 151-153 (Ms Matterson).

21 Transcript 9 July 2007, p 42.

in inhibiting undesirable behaviour, and that this is demonstrated by the fact that "the number of customers who incur a penalty fee more than once is much less than the number of customers who incur the first one."[22] We do not find that reasoning convincing, and least of all where debit orders are concerned. Most customers signing debit orders will have no intention of defaulting, inter alia because they will want to retain the services for which their periodic payments are to be made. It is also unclear how many poorer customers simply abandon their bank accounts when faced with a penalty fee debit. Moreover, calculations based on FRB's submission[23] show that dishonoured debit orders as a percentage of total debit orders decreased from 6.7 per cent in 2003, to 6.1 per cent in 2004, and to 5.9 per cent in 2005 – but then rose again sharply to 6.8 per cent in 2006. The claimed link between penalty fees and improved customer behaviour is thus not persuasive.

Confidential: FRB

In our view, moreover, the whole argument based on "disciplining the customer" by way of the routine charging of penalty fees rests on an objectionable premise. By this line of argument, banks in effect assert a right to be judges in their own cause. Where dealings between ordinary mortals or companies are concerned, when one contracting party breaches their obligations and causes expense or loss to the other, the latter has to claim compensation and enforce that claim in the courts if payment is not forthcoming. Where a contractual penalty is specially provided for, the same applies. A bank, however, is in the unique position of having the customer's deposit at its disposal, into which it can dip its own spoon. Although the funds deposited become in law the bank's money, with the bank having an obligation to repay the balance to the customer on due demand,[24] in effect the bank is able, by debiting a penalty fee, to help itself to "compensation". The law should be taking a dim view of this form of self-award in much the same way as it frowns on other forms of extra-judicial self-help.

The fact that the banker-customer contract may authorise the bank to make the debit does not alter the essential iniquity from a social perspective where routine transactions such as debit orders are concerned. Here we have *pacta sunt servanda* – the legal principle that contractual obligations once undertaken must be observed – operating in conditions of gross inequality both of bargaining power and means of enforcement. The fact that major banks can also exercise market power in determining the level of the penalty only makes matters worse.

It was suggested in the hearings that the prevailing penalty fees should be regarded as justified because banks' customers are protected by the Conventional Penalties Act.[25] This

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22 Transcript 9 July 2007, p 171.

23 FRB March 2007, Second Submission, Part A Data Request.

24 *Foley v Hill* and others (1843-60) All ER Rep 16 (HL); *Standard Bank of SA Ltd v Oneanate Investments (Pty) Ltd* 1995 (4) SA 510 (C) at 530G-532E; *Liebenberg v ABSA Bank Ltd t/a Volkskas Bank* [1998] 1 All SA 303 (C) at 308*b*-309*j*.

25 Act 15 of 1962 as amended. See Transcript 18 June 2007, p 89, pp 151-152 (Standard Bank); FRB, July 2007, Penalty fees, p 4.

idea is without merit. The Act provides for the enforceability of contractual penalty stipulations "in any competent court".[26]

> If upon the hearing of a claim for a penalty, it appears to the court that such penalty is out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated, the court may reduce the penalty to such extent as it may consider equitable in the circumstances: Provided that in determining the extent of such prejudice the court shall take into consideration not only the creditor's proprietary interest, but every other rightful interest which may be affected by the act or omission in question.[27]

First, banks are not in the habit of claiming penalty fees by suing their customers in court: they simply debit the fees to the customers' accounts – in fact, about 24 million times in one year by the big four banks alone (see Table 1 above). Second, for the customer to have to challenge the debit each time by way of court action in order to have the fee reduced is patently ridiculous. Third, even in such a case it would be far from certain that the proceedings initiated by the customer would be characterised as "a claim for a penalty" to which the Act would apply. Fourth, even if the Act were to be held to apply, the customer would bear the onus of proving the disproportion between the penalty and the prejudice suffered by the bank[28] – this, when banks themselves claim not to know precisely what particular transactions cost them, and when the broadest non-proprietary interests of the bank would also have to be quantified. Fifth, it would be an easy matter for a bank to avoid the Act by so wording its banker-customer contract that the fee would be triggered by an act or omission by the customer not technically treated as a contractual breach.[29] In short, it would take a Franz Kafka to imagine a more hopeless legal labyrinth for banking consumers needing a way out of unfair penalties.

Apart from their overall vulnerability to having their deposits unceremoniously eroded by their banks, customers are, in our view, kept significantly in the dark over penalty fees. Very often, customers are not aware of the full extent of the penalty fees they can incur and will only become aware of these fees to their horror after substantial sums have been deducted from their accounts.[30]

Penalty fee categories – including fees for rejected debit orders – are now generally disclosed by the banks. But the information remains incomplete.

In the case of FNB, only the "minimum charge per item" for dishonoured payments is disclosed in its fee brochures. The customer would not appreciate from the brochure that the indicated "minimum" fee of R30 per item on a savings account would increase to R60 per

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26 Section 1(1).

27 Section 3.

28 *Smit v Bester* 1977 (4) SA 937 (A); *Chrysafis and others v Katsapas* 1988 (4) SA 818 (A) at 828I-J.

29 Cf *Sun Packaging (Pty) Ltd v Vreulink* 1996 (4) SA 176 (A).

30 Cf Transcript 18 June 2007, p 28 (Mr Weeks).

item after three unpaid items in a rolling twelve-month cycle, and a “minimum” fee of R95 per item on other PTAs would increase to R120 per item.[31] In Absa’s case the meaning of “minimum” fee in its 2008 pricing brochure remains obscure. By taking note of this particular feature of penalty charges where FNB and Absa are concerned, we do not mean to exonerate other banks. In our view it is not at all clear to banks’ customers how penalty fees are applied. This is something which we have tried to uncover during the Enquiry.

Let us take as an example an ordinary debit order drawn on a savings or current account, which provides for a series of periodic payments on the first day of each month for twelve months, from January to December. On the third occasion that it is presented (1st March), the debit order is rejected for insufficient funds. The bank charges its customer (the debtor) a dishonour fee of, say, R100. (If other debit orders falling due at the same time have also “bounced”, which is quite likely, then the dishonour fee imposed on the customer would be multiplied since the fee is charged per item.) Suppose the creditor holding the debit order wishes to have it presented again for payment after a few days, expecting that the debtor may by then be in funds. Can the creditor do this, and if rejection occurs again, will the dishonour fee be charged again? And if the payment due in March has failed, can the debit order be presented again for purposes of the April instalment (etc)?

It turns out that the only general protection that the debtor has against repeated levying of penalty fees for the same debit order arises indirectly from the rules that are applied to inter-bank clearing of debit orders. When our hearings began, these PCH rules – although submitted to us – were covered by a claim of confidentiality. Certainly banks’ customers have been altogether in the dark about their provisions. During the hearings, the claim of confidentiality was lifted. In the Rules governing the clearing of debit and credit electronic funds transfer payment instructions (i.e. the PCH clearing rules applicable inter alia to ordinary debit orders)[32] paragraphs 3.1.9.2 to 3.1.9.4 provide as follows:

> When an item is returned unpaid the user[33] must attempt to get payment outside the system.
>
> If an item is returned “Not provided for” on two consecutive mandated action dates the user must remove the payment instruction from the system unless the user has received a new subsequent commitment from the payer to meet future payments.
>
> When an item is returned “Account Closed” or “Payment Stopped” the user may not submit the item again.

These provisions evidently mean that the ordinary monthly debit order in our example, once it had been rejected on 1st March, could not be presented again for payment during March. The creditor would have to attempt to get payment from the debtor for the March instalment

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31 FRB, March 2007, Second Submission, Part A Data Request, p 11. Compare Mr. Jordaan, Transcript 9 July 2007, p 159: “We have brochures which detail the fees, every single fee, that we charge our customers, including penalty fees.” Likewise FRB’s Additional Submission, July 2007, Penalty fees, p 3: “All FNB’s penalty fees are fully disclosed and transparent.”

32 Commonly referred to as the EFT PCH rules.

33 The “user” means in effect the creditor holding the debit order.

"outside the [interbank payment clearing] system". However, the debit order could still be presented again for purposes of the April instalment once that instalment fell due – and so on. If the debit order were to be rejected again for insufficient funds in April (or on any two consecutive due dates), then it would have to be removed from the system unless replaced by a renewed commitment from the debtor to meet future payments. A debtor may at any time instruct his/her bank to stop payment of a debit order, or close the account on which it is drawn, whereupon it may not be submitted again. The creditor's recourse against the debtor would then lie outside the system.

We believe that banks' customers are not generally aware that they have the power to stop a debit order by a simple instruction to their own bank, and that they do not need the permission of the creditor (the holder of the debit order) in order to get the bank to discontinue payments on their behalf. Customers generally should be more clearly advised of this by their banks (see further below). This is a separate matter from any breach of contract that may result as between debtor and creditor when payment is stopped.

Despite the existence of these rules, Absa acknowledged that "multiple rejected debit order fees can arise when the merchant presents the same debit order multiple times."[34] Although the EFT PCH rules state that the mandate in respect of a debit order that has been returned for lack of funds on two consecutive occasions is regarded as cancelled, Mr von Zeuner explained:

> Banking systems do not currently identify those instances where a debit order is presented more than twice. Manual checks are, however, performed when concerns are raised about this by a specific user.[35]

FNB agreed that the rule is difficult to monitor. [36]

It should be noted, furthermore, that the PCH rules relate to inter-bank clearing. They have no application to debit orders processed within a single bank – i.e., where both the debtor and the creditor (beneficiary) are customers of the same bank.[37] Moreover, the PCH rules restrict the number of times a single debit order can attract a dishonour fee. They do not deal with the problem of multiple debit orders hitting the account of the customer with insufficient funds.

The banks' own rules and practices regarding the number of times that penalty fees could be charged to a customer in respect of refused or rejected debit orders have remained far from clear.

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34 Transcript 17 July 2007, p 5 (Mr von Zeuner).

35 *Id.*, p 7.

36 FRB, Additional Submission, July 2007, Penalty fees, p 3.

37 The penalty fee to the customer is the same in both cases.

Mr Ntombela of Nedbank, while referring to the limitations imposed by the PCH clearing rules, nevertheless said: "The fee will be charged as often as the default happens."[38] He confirmed that every incident of default attracts a penalty, except in the case of Mzansi accounts where the first such incident attracts no fee.[39]

Mr von Zeuner of Absa referred to the fact that the Enquiry Panel had raised the question of default charges where electronic payments are concerned. "When we look at the issue," he said, "we believe that there is room for improvement in the area of rejected debit orders."[40] In a written submission, Absa had acknowledged:

> There is generally no limit on the number of times that default charges are levied – a fee will be levied each time the default behaviour occurs. Returned or rejected debit orders are an exception to this: from June 2007, Absa will be introducing a pricing cap on mass market savings accounts (e.g. Mzansi and Flexi Save) to limit the maximum number of charges that can be posted to customer accounts.[41]

Absa's 2008 fee brochure now indicates that, on Mzansi accounts, the first dishonoured transaction per month attracts no penalty fee while dishonoured transactions thereafter attract a minimum fee of R30. In the case of Flexi Accounts, the minimum dishonour fee is R36, with only the first four being charged per month. The reference here to minimum fees is a curious new feature. The position for the customer therefore remains obscure.

In the case of FNB, the first dishonoured transaction on an Mzansi account attracts no penalty fee, while a flat fee of R30 is applied to dishonoured transactions thereafter. In the case of Smart Transmission Accounts and other PTAs, however, the fee for dishonoured transactions is described as a minimum fee. After three unpaid items in a rolling 12 month cycle, the fee indicated in Table 2 and Table 3 above is further escalated substantially.[42] This important detail makes no appearance in the bank's pricing brochures.

Mr Tshabalala of Standard Bank, while contending that penalty fees are normal and ubiquitous and that it was the duty of the bank to charge them,[43] acknowledged that it was unfair to treat rejected debit orders in a similar way to cheques, especially where the low end of the market is concerned.[44] Thus Standard Bank had now capped its penalty fees for rejected debit orders on certain accounts:[45]

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38 Transcript 9 July 2007, p 57, p 117. See also Nedbank, May 2007, Second Submission, Part B Data Request, pp 9-11.

39 *Id.*, pp 57-58. The penalty fee on Nedbank Mzansi accounts is R10 per incident of default thereafter.

40 Transcript 17 July 2007, p 5.

41 Absa, March 2007, Second Submission, Part A Data Request, p 29.

42 FRB, March 2007, Second Submission, Section 6, p 11.

43 Transcript 18 June 2007, p 62, p 89.

44 *Id.*, p 88.

45 *Id.*, p 93. See also SBSA, August 2007, Second Submission, Part A Data Request, Annexure 2, p 3.

- E Plan: capped at two per month per account.
- Savings Account: capped at two per month per account.
- Mzansi: the first two rejected debit orders attract no penalty fee; thereafter capped at two penalty fees (for the next two debit orders run sequentially with no funds in the account). This effectively means that Mzansi account holders can be charged a maximum of two rejected debit order penalty fees per month.

Nevertheless, the penalty fees remain substantially out of proportion to relevant costs and there is no cap to the number of times penalty fees can be imposed for rejected debit orders on current accounts.[46]

In an attempt to address the concern where the same payment order is presented numerous times by a creditor, there have been some industry innovations.

> MR. TSHABALALA: …The industry working with the regulator has come up with two systems AEDO and NAEDO….the essence of it is that the customer is in control….The benefit of this is that the rules are that first the salary has to go in. So no lender can jump the queue and hit the account before the salary has gone in…. The point being that you cannot do it more than once. If you do it more than once, you are only charged once. So you only charge the penalty once as opposed to 5, 10, 15 or 20 times.[47]

AEDO and NAEDO are the types of Early Debit Order (EDO). Their operation is analysed in some detail in the chapter of this report on Payment Cards and Interchange. Here only one aspect need be considered. The PCH rules allow for credit tracking in the EDO payment streams, whereby payment instructions are processed a minimum of twice per day for up to 32 days. This raised the concern that multiple penalty fees could potentially be applied by the defaulting customer's bank to the same debit order item in the same month.

In a submission dated 10 July 2007, PASA has clarified at our request how the credit tracking process works. If a beneficiary user of an EDO stream requests credit tracking in respect of an early debit order, then the paying bank will implement it.[48] The service is paid for by the beneficiary. Credit tracking is applied in two forms – limited and full credit tracking. In the case of limited credit tracking, the paying bank ascertains twice a day over the requested period whether or not funds have been credited to the customer's account, so that the debit order can then be paid. In the case of full credit tracking, the posting of a credit at any time of the day will cause the pending debit order to be fetched for immediate processing. PASA regards credit tracking as repeated re-presentment of the payment

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46 *Id.,* p 4.

47 Transcript 18 June 2007, pp 93-94.

48 Transcript 17 July 2007, p 6 (Absa). Cf also SBSA, August 2007, Second Submission, Part A Data Request,, Annexure 3, p 1; FRB, March 2008, Response to request for additional information, p 8.

order.[49] It must follow that the number of times that a customer's bank could potentially levy a penalty fee is a matter currently within its own hands. This is not satisfactory.

When it comes to major banks charging their account-holders for unsuccessful early debit orders, the pattern is currently uneven.

- Nedbank testified that it charges no penalty at all for failed debit orders in the EDO streams, and indeed sees that as one of the objects of AEDO and NAEDO.[50]
- Absa has also not been charging its account-holder for default in these streams.[51]
- In the case of Standard Bank, Mr Shunmugam testified:

  > Obviously the charge to the customer is at the end of the tracking cycle. So if after three days he tracks and he picks up there is funds there and it is successful, there is no unpaid charge but if at the end of the 32 days or whenever is stipulated there is an unpaid then we will generate an unpaid fee at the end of the tracking cycle, once.[52]

  However, this statement appears to have anticipated things to some degree. In a subsequent written submission, Standard Bank clarified its position:

  > At this stage, SBSA only charges the corporate for unsuccessful AEDO and NAEDO transactions. SBSA's intention is to levy an unpaid fee on the paying customer in the future in the same manner as for an ordinary debit order at the end of the tracking period. This is not being done at present due to technical limitations. [53]

  According to a subsequent submission by Standard Bank on 20 March 2008, this seems to have taken effect.
- FNB, in a response to a request for additional information (17 March 2008) has stated that it charges the account holder R2.65 as an unsuccessful transaction fee in the NAEDO stream (the EDO stream in which it is involved).[54]

This evidence shows the vulnerability of the customer to penalty fees being imposed in the EDO streams at the discretion of individual banks. As the case of Standard Bank shows, this can be at the same exploitative level as now prevails for rejected ordinary debit orders. At the same time, as the case of FNB reveals – with its "unsuccessful transaction fee" of only R2.65 – the earlier argument about the vital need for penalty fees to be high in order to deter customers from signing debit orders which they cannot meet is radically undermined.

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49 "[S]ince the EDO systems are not real time systems, no pinging can take place."

50 Transcript 9 July 2007, p 121 (Ms Whateley), p 122 (Mr McLachlan).

51 Transcript 17 July 2007, p 6.

52 Transcript 18 June 2007, p 157.

53 SBSA, August 2007, Second Submission, Part A Data Request, Annexure 3, p 1.

54 FRB, March 2008, Response to request for additional information, p 8.

The Panel raised the question of whether the corporate beneficiary which attempts unsuccessfully to collect on a debit order for which the debtor has no funds should be charged a penalty fee. Mrs Nyasulu of the Panel suggested that "it is fairer to the end consumer if you levy the charge against the beneficiary because after all they were the ones who went through a credit granting process and took the responsibility to lend to that particular individual."[55] However, Standard Bank argued that, since no breach of contract by the corporate is involved, such a fee would not be applicable.

On the other hand:

> If a customer incurs no fee for a returned debit order, he or she would have no incentive to advise the corporate of a change of bank account or salary payment date. The corporate has no means of monitoring these changes, no matter how careful it is at the time of accepting the debit order. If there was no fee for the customer, the number of unpaid debit orders would increase.
>
> Aside from the adverse consequences to the bank of high levels of unpaid debit orders, the corporate would incur increased costs (in the form of increased administration, increased credit exposure and related interest) and would increase its charges to the customer.[56]

FNB submitted earlier:

> The fact that a debtor will pay his bank for failing to honour a commitment to a creditor provides the latter with comfort that debit orders and cheques will most likely be honoured.[57]

Unmistakable in these passages is the banks' assigning to themselves the role of protectors of the collecting customer (the corporate) by penalising their own account-holding customers – the man and woman in the street – for failing to pay.

In contrast, Mr von Zeuner of Absa suggested that banks should actually assist their customers in cancelling debit orders, in order to reduce the incidence of rejected transactions. He proposed –

> … exploring the possibility of cancelling debit order agreements at the bank. This will enable banks to provide customers with the ability to cancel direct debits. This is analogous with the BACS scheme rules in the UK, which allow customers to cancel a direct debit at any time by phone or internet, although in some instances written confirmation can be required. The customer still bears the responsibility of making alternative payment arrangements.[58]

This is something we believe should be supported and implemented by all banks and we recommend accordingly.

It would not, however, alter the need for decisive regulatory intervention in order to protect banks' customers from exploitative dishonour fees in respect of all debit orders.

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55 Transcript 18 June 2007, p 160.

56 *Id.,* pp 1-2.

57 FRB, March 2007, Second Submission, Part A Data Request, p 9.

58 Transcript 17 July 2007, p 6.

4.4 Recommendation for regulatory cap on debit order dishonour fees

The Task Group Report (Falkena III) recommended that penalty fees should be on a cost-plus basis and open to regulatory oversight.[59] This recommendation appears to have been ignored. In our view the abuse of debit order dishonour fees analysed above needs to be addressed through the recommendation below without delay. We do not think that it is likely to be combated effectively enough, or with the necessary clarity and certainty, by way of section 8(a) of the Competition Act.

The data provided above shows that, in 2006, the cost to banks of processing rejected debit orders was below R5 per item (See Figure 3). Indeed, Capitec charged *the customer* only R3 per dishonoured item and was presumably covering its cost (See Table 2). Today, Capitec charges R3.50. The processing costs of the major banks may well be even lower than those of Capitec. Therefore, based on this data, we have no reason to believe that, currently, banks would be unable fully to recover their costs ordinarily incurred in respect of rejected debit orders (including a fair return on outlays) by means of a fee capped at approximately R5 per dishonoured item.

The appropriate cap should be imposed by regulation. It should apply both to savings and current accounts, and to ordinary as well as early debit orders. The cap should be regularly reviewed in order to take into account changes in costs. Banks, which incur additional expenses or losses in particular cases through their customers' default in respect of debit orders, can terminate those customers' accounts and/or sue for damages. They ought not to have the liberty to help themselves to some self-determined compensation out of their customers' accounts.

The regulatory remedy should also include a provision to ensure that the re-presentation of dishonoured items cannot itself amount to an abuse.

Whether such price regulation should be imposed using existing regulatory powers of the SARB, or by way of section 9(1) of the Sale and Service Matters Act 25 of 1964 (as amended), or by other existing or special legislation is a matter on which we are not best placed to express an opinion.

In our view, if the necessary regulatory intervention is not forthcoming within a reasonable time, the Commissioner, after consultation with National Treasury and SARB, should recommend to the Minister of Trade and Industry that he consider directing the Consumer Affairs Committee established under the Consumer Affairs (Unfair Business Practices) Act

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[59] Exhibit H, p 155.

71 of 1988 (as amended) to conduct a full-scale investigation into dishonour fees in respect of debit orders charged by the four major banks.

Should the latter Act be replaced by the enactment of the Consumer Protection Bill, 2007, now before Parliament, then the necessary investigation could be initiated or continued as may be appropriate under the new Act.

Chapter 5

ATMs and Direct Charging

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5.1 Introduction and synopsis

ATM cash withdrawals are a common activity for most bank customers. In 2006 around 1 billion ATM transactions were made through the network, generating gross revenues in excess of R4 billion for banks. We have come to the conclusion that pricing arrangements between banks have served to shelter the provision of ATM services from effective price competition, and that this situation needs to be changed.

It seems clear to us that the market power of the banks in the provision of personal transaction accounts, set out in Chapter 2, extends to the provision of ATM cash dispensing services. This is so because the big four banks dominate the provision of ATM services; such services are linked to the provision of bank accounts and are not offered separately; the current interbank pricing arrangements shelter fees from price competition; and the restriction of the acquiring of such transactions exclusively to registered banks, inhibits competition from non-bank ATM service providers. Together, these factors reinforce the market power of banks over customers.

In this chapter, we are concerned with the pricing arrangements that are currently in place when a customer of one bank uses the ATM of another bank. While only 15 per cent of ATM transactions are of this kind, analysis shows that they have been unduly restricted and that the pricing arrangements in respect of them have had and continue to have repercussions for all cash withdrawal transactions made at an ATM.

We have concluded that the problem can best be addressed by a shift to a direct charging model, which would enable price competition for ATM services and contribute to the development of a market for cash dispensing services that is no longer the special preserve of banks.

So far as possible in our analysis, we adhere to the terminology conventionally used by banks. Among the key terms are: “on-us”, “off-us”, “issuer” and “acquirer”.

When a customer uses an ATM other than that of his or her own bank, it is known as an off-us transaction. The converse is an on-us transaction, where the ATM of the customer’s own bank is used.

The bank which has the customer’s account is known as the issuer (or issuing bank), because it has issued to the customer the payment card necessary for the transaction. The bank providing the ATM service is known as the acquirer (or acquiring bank), because it acquires the transaction into the network when the ATM is used.

In an on-us ATM transaction, the same bank is simultaneously both the issuer and the acquirer, and it directly charges its customer for its services in both roles. In an off-us

transaction, on the other hand, the roles of issuer and acquirer are separated. This raises the question of how the customer is to be charged.

Currently, where the customer of Bank B (holding a payment card issued by that bank) uses an ATM provided by Bank A, the cash dispensing service is provided to that customer by Bank A *on behalf of Bank B*. In this situation Bank A does not charge the customer directly; the customer remains simply the customer of Bank B, and is charged by the latter for the service actually provided by Bank A. Bank A charges its fee to Bank B. At settlement, later in the day, the amount of the dispensed funds is transferred by Bank B to Bank A, together with the fee. In other words, in this case, Bank B compensates Bank A by sharing its own fee revenue from its customer with Bank A.

The fee that is paid by the issuing bank (Bank B) to the service provider (Bank A) for an ATM transaction is generally referred to as carriage. Carriage is a fee agreed upon between banks – i.e. an interbank fee. In South Africa carriage is uniform across the banking industry.[1] While carriage is uniform, the fees charged by issuing banks to their customers for off-us ATM withdrawals vary significantly.

The consumer is typically charged a substantially higher fee for off-us transactions, and for an average sized cash withdrawal a substantial part of this fee is retained by the issuing bank although it has not provided the cash dispensing service. Not only is carriage itself sheltered from competitive forces; the consumer is not free to shop around for ATM services but – also by interbank arrangement – treated as belonging to the issuing bank in all ATM transactions. Accordingly banks' own ATM services to their customers are also significantly sheltered from competition.

If the carriage fee is abolished and the cash provider instead charges the consumer *directly* for the cash dispensing service (i.e. if the direct charging model is adopted), price competition can become more effective. We recommend that the current interbank pricing system of carriage be replaced with a model of direct charging in the ATM stream as soon as possible.

Some argue that carriage is merely a particular form of interchange (a term widely used to refer to interbank charges) and that if interchange is necessary and permissible in other payment streams, there is no reason it should not also be so in ATM transactions. For reasons developed in this chapter, we do not accept the comparison between carriage and interchange, and we do not consider that the continuation of interbank arrangements in respect of carriage is justifiable.

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1 For ATM cash withdrawals the only exception applies to off-us withdrawals by Mzansi account holders. Here carriage is also set at a uniform level, but is calculated by a slightly different formula.

The service of cash dispensing by means of an ATM transaction is not inherently different from a purchase made at a store where a payment card is offered to pay for the merchandise or other service provided. The customer's card is swiped through a terminal, allowing the merchant to recover its price by having the customer's payment instruction presented electronically to the customer's bank (the issuing bank).

In principle the payment made by the issuing bank, which finds its way to the merchant through the merchant's own bank, constitutes a withdrawal by the customer of funds held on deposit (or otherwise made available through a credit facility) at the issuing bank. The fact that cash dispensing in an off-us transaction ultimately involves a withdrawal of funds from a bank account is not a reason to treat the service of cash dispensing as different in principle from the dispensing of value in other forms.

The question to be confronted in off-us ATM transactions is why the firm (in this case a bank) actually providing the cash dispensing service should not directly charge the customer for doing so.

Interbank agreements affecting prices have anti-competitive features in the ATM stream. The direct charging pricing model for ATM cash dispensing services will eliminate the need for interbank agreement on any aspect of the level of ATM charges as each bank will set its own fee for that service, and the client will not be deemed to be the customer of the issuing bank for the cash dispensing service when provided by another bank.

Any off-us transaction involves a process of authorisation and confirmation that the customer has funds available, which in South Africa takes place through the information technology (IT) network which links all ATMs, known as Saswitch. Transactions are switched from the ATM to the IT mainframe of Saswitch, then to the issuing bank's IT infrastructure and back again. Hence reference is often made to switching, which involves this electronic process of authorisation. The cost of the electronic switching, which is not substantial,[2] would presumably continue to be paid for on the issuing side. In principle, the issuing bank also should be compensated for processing the transaction and for making the necessary payment on the customer's behalf to the ATM service provider.

The use of an agreed interbank fee to compensate the ATM service provider is far less desirable than through direct and transparent pricing to the consumer, as the latter method should increase competition in this regard also, and thus tend to reduce overall ATM prices to the consumer.

The practice evolved by the banks, and currently approved within the prevailing regulatory framework of the South African Reserve Bank (SARB) and Payments Association of South

[2] It is currently 13,5 cents, or less, per transaction where high volumes are involved (FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 9. Confidential: FRB

Africa (PASA), does not cater for direct charging in off-us ATM transactions. There appears to be no good reason why off-us transactions in respect of domestic ATM transactions should not be conducted by a system involving direct charging by the service provider – within a continuing framework of interoperability duly regulated in order to ensure reliability and to manage risk. There is precedent for the adoption of this system – both in the UK, where providers can choose between carriage or direct charging – and more recently in Australia, where the entire ATM network will convert to direct charging in October 2008.

The prevailing regulatory framework furthermore excludes non-banks from providing ATM services except through terminals contracted to a bank; hence all ATM cash dispensing services are currently conducted in the name of a registered bank. The dispensing of cash to customers using payment cards has developed as a commercial activity that can potentially be carried on directly by firms other than banks. Given sensible changes in the regulatory requirements intended to ensure reliability and intended to manage risk within the national payments system, it is a service that could be offered separately from a bank account, i.e. separately from the business of deposit-taking which is the legal preserve of banks. In our view it is unnecessary and anti-competitive for cash dispensing services to be restricted as is the case today.

While not necessarily linked, the direct charging pricing model opens the way for non-bank ATM providers to become members of the payment system network. The UK provides international precedent for this, although it may be that a different institutional structure may be necessary for this to occur here. In South Africa, currently, only banks may be members of the Payments Association of South Africa (PASA) and only banks may be members of payment clearing houses (PCHs) – such as the ATM PCH, where rules for participation are established. In the chapter on Access to the Payment System, we deal fully with the need to extend participation to non-banks, within an appropriate regulatory framework.

5.2 History and evolution of ATMs

ATMs have been with us for about forty years. While there appear to be a number of inventors globally who developed the concept of a cash dispensing machine, it was Luther Simjian who patented an early, but not so successful, version of a cash dispensing machine in 1939 in the US. The ATM we have become familiar with was developed and patented in 1968 in the US by Docutel, an automated baggage handling company.[3]

The provision of ATMs stemmed originally from the need of banks for a reliable cash dispensing machine that would relieve pressure on bank tellers. The first ATMs were operated off-line from the banks' operating systems and access to these machines was restricted to those customers in good standing with the bank. Subsequent developments in

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3 Bellis, 2007. *ATM Cash Machines*

connectivity allowed banks to validate the account balance within the bank from which the money was being dispensed.[4]

It is claimed that until 1994 in the US, the ATM machines were costly (US $50,000 to buy)[5], and expensive to operate as each machine had to be connected to a leased telephone line. It appears that innovation in the design of new and cheaper models of ATM was stimulated by competition for local ATM transactions between rival regional and national networks in the early 1990s and by legislative changes which challenged the network rules of fixed and standardised pricing to consumers.[6] As a consequence of innovation, ATM machines are manufactured at a fraction of the cost of early models and can now “break even” with a few hundred transactions a month.[7]

Technological developments in communication connectivity have also lowered the operating costs of ATMs over the years and the acquisition and processing costs declined at the same pace as IT costs declined. With improved communications technology, ATMs were not restricted to being placed in banking halls, but could be placed in sites such as shopping centres, service stations, etc.

ATM machines operated with common technology that accepted a card containing a magnetic stripe with the customers’ account details embedded therein and recognized a unique PIN (Personal Identification Number) for each card user.

The developments in the USA and the UK were of interest to South African bankers, who had the same desire to relieve pressure on branch tellers – particularly when salary and wage cheques were being cashed – often on Fridays and at month ends. By the mid-1980s, the banks saw the need to be able to service more customers with a more efficient infrastructure. Furthermore, there was a perception that low income earners were dominating banking halls to the detriment of high income customers.

At about the same time, banks were encouraging industry and business to switch from conventional payroll processing to a process whereby the business would supply the bank with payroll details and the bank would credit the employees’ bank accounts and debit the businesses’ accounts. This saved the businesses the problems of cash handling and cheque processing and allowed the banks to open and operate accounts for the employees. While these benefits were obvious to the employer and the employee, there were certain drawbacks. One of the main drawbacks was that employees normally needed access to their

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[4] ATM Cash Machines, 2007.

[5] *Id.*

[6] Grimm and Balto, 1992, How the antitrust laws limit pricing policies of shared ATMS networks. *Banking Law Review.*

[7] ATM Cash Machines, 2007.

salaries on, or soon after, pay-day. This then compounded the problems of overcrowded banking halls.

By the time South African banks adopted ATM technology, ATM machines were connected to the banks' mainframe processors and had enhanced functionality. These machines could dispense cash and provide bank balance detail. Later they were capable of accepting deposits by cheque or in cash. Building societies led the way and introduced ATMs as early as the 1970s, and the commercial banks followed in the 1980s (Standard Bank claims to be the first of the commercial banks to launch ATMs in 1981;[8] First National Bank (FNB) – now part of the FirstRand Group – followed in 1983[9]). With improved communications technology, ATMs were not restricted to being placed in banking halls, but could be placed in shopping centres, etc. Generally, banks owned the ATM machines and serviced them with their own resources.

In this manner, banks were able to accommodate increased volumes of transactions without significantly increasing their "bricks and mortar" infrastructure. Later enhancements enabled customers to make transfers to other accounts, request cheques, make third party payments and top-up their cell phones.

The establishment of shared ATM networks by banks or bank holding companies is common in many countries, where pricing and rules are set by collective agreement by directors of the joint venture. In the US, for example, the biggest regional ATM networks are jointly owned by banks. The two national networks are owned and affiliated to MasterCard and Visa respectively.[10]

In SA, it has been the trend that each bank provides its own ATM infrastructure, in some cases with considerable outsourcing to other firms. Joint ventures between banks in the provision of ATM services are not part of the South African landscape.[11]

It is generally agreed amongst South African bankers that ATMs did relieve pressure on the branch infrastructure. However, while ATM transactions have become the most common bank interaction for customers,[12] they have ultimately not replaced branches.

In the survey of low-middle income consumers, commissioned by the Technical Team of the Banking Enquiry, consumer views about banks were strongly associated with their ATM experiences. Brand strength, for example, appeared to be related to widespread presence

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8 SBSA, April 2007, Second Submission, ATM transactions, p 2.

9 FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 14.

10 Grimm and Balto, 1992, *op cit.*

11 As to inter-bank arrangements for reciprocal access to each other's ATMs, see further below.

12 FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 14 and Transcript 9 November 2006, p 119 ff.

of ATMs, and the cost of retaining a bank account was associated with the price of cash withdrawals.[13]

5.3 Interoperability and the origins of carriage in South Africa

Initially, the use of ATMs was restricted to transactions with the customer’s own bank. It should be borne in mind that, even as the costs of ATMs were declining, the volume of ATM usage and the fees generated by such usage determined their profitability. Usage, in turn was determined by the positioning of the machines. It was therefore important that as many transactions as possible should be processed by these machines. This could be achieved, not only by positioning the machines in strategic locations, but also by allowing the customers of other banks to access these machines.

The convenience that ATMs offered ensured that as the technology developed, the ability to draw cash from an ATM became a necessity for most bank customers.

It follows that no one bank could afford not to provide its account holders with convenient access to an automated cash dispenser. Banks could roll out their own ATM network to provide this functionality, but this could be greatly enhanced if they could enter into reciprocal arrangements with other banks, thereby agreeing to provide ATM services to each other's clients.

The sharing of the ATM network infrastructure was achieved through interoperability between banks, which came about in the 1980s. In South Africa, interoperability was achieved through two different networks – Multinet and Saswitch.

The Multinet network was launched in March 1985 and involved direct arrangements between banks. Ultimately there were four members, including Standard Bank, United Building Society, Volkskas and the Post Office, each with direct links to each other. The system worked well, but the number of links required would have had to increase exponentially if new members were added to the network. This made it too cumbersome for large scale expansion of the number of members.

The alternate system was developed more or less in parallel, and involved switching through a central hub, with banks linking to each other through the hub. The hub, known as Saswitch, was launched in October 1985. The Saswitch infrastructure was owned by the banks and seen as a cost centre to them, with a simple charging model per transaction. Originally created with imported software and hardware, the system was redesigned locally during the sanctions era and became highly functional. In order to serve its customers better,

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[13] The survey was conducted by Kaufman Levin Associates. A synopsis of the survey was presented at the hearings on 17 July 2007. See Exhibit GGG. Slide 60.

United Building Society, a member of the Multinet switch, also joined the Saswitch network and ultimately the other Multinet members followed. For a period of time the two networks ran in parallel, but ultimately, the Saswitch hub was better able to accommodate links between all of the 14 or 15 banks and building societies at the time and Multinet ultimately fell into disuse.[14]

Entry into the Saswitch network – which is now incorporated into Bankserv[15] – was restricted to banks with at least one ATM, and some only just met this requirement.

A fee charged by one bank to another when the customer of one bank utilised the ATM of another bank was set in place to avoid the free rider problem, which banks with the larger ATM networks naturally wanted to address.[16] An interbank charge known as carriage was introduced by agreement, applicable to all banks participating in the network. Carriage flowed from the issuing bank (whose customer was using the service of the acquiring bank) to the acquiring bank. In one submission, carriage has been described as the fee for interoperability – "Early entry players offered interoperability to competitors at an interbank fee."[17] Table 1 sets out what is currently known about the application and level of the carriage fee in the 1980s and 1990s.

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14 The Multinet/Saswitch history was recounted by Dr. Serge Belamont, at a meeting on 29 March 2007. In the 1980s he was a technologist involved in the redesign of Saswitch.

15 Bankserv is the key national retail payments switch, owned by the banks – 92,5 per cent divided equally between the big four (ABSA, FRB, Nedbank and Standard Bank) and the rest owned jointly by a consortium of 6 smaller banks.

16 See, for example, FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 16.

17 *Id.,* p 14.

Table 1 ATM Timeline for SA

ATM Saswitch and PCH history	Date	Carriage fee history
Banks roll out own ATM infrastructure	1980s	
Saswitch launched	1985	R 0.50
Carriage fee increase (amount uncertain)	1989	R1.00 + 15c handling fee? R1.00 + 50c/R100?[18]
Bankserv established, Saswitch incorporated into Bankserv	1993	
Carriage fee increase by SBSA. All others follow	March 1997	R2.00 + 50c/R100[19]
Carriage fee increase by SBSA. All others follow	March 1999 to date	R3.25 + 65c/R100[20]
ATM PCH Agreements are compiled	2000	
Banks' first bilateral price negotiations for mini-ATMs commences	2003	

The justification for carriage presented by the banks is that it serves both as revenue to cover costs and as financial reward for investing in and maintaining an interoperable system. With regard to the former, the ATM costs include:

- ATM maintenance.
- Costs of cash (including security, crime prevention and insurance).
- ATM software, monitoring and servicing.

The banks see themselves as obliged to offer the service to customers of other banks, "in the name of interoperability".[21] The interoperability of the system relates to the ability of cardholders from any issuing bank to use any ATM in the country, regardless of which bank's brand it carries.

Technically, interoperability has been achieved in large part by the central switching hub, Saswitch, although the technical specifications of ATMs, including the standards of

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18 There is some confusion as to the amount of carriage applicable at that time. SBSA has it that there was a R1,00 basic charge plus a 15c handing fee (SBSA, April 2007, Second Submission, ATM transactions, p 39).

19 Saswitch was notified by letter from Standard Bank to South African Bankers Services Co Ltd (Bankserv) dated 16 January 1997. See Exhibit GG1

20 Saswitch was notified by letter from Standard Bank to South African Bankers Services Co Ltd (Bankserv) dated 18 December 1998. Exhibit GG2.

21 SBSA, October 2006, First Submission, p 56.

MasterCard and VISA and the specifications relating to formatting of electronic messages, etc, have also played a part. From a commercial perspective, the PCH agreements – in terms of which members agree to accept transactions initiated on competitors' ATMs – as well as the commercial arrangements associated with the carriage fee have also served to underpin interoperability.

Clearly, interoperability has always depended on an effective means of compensating the ATM service provider in off-us transactions. Historically, given the way the network developed, carriage has been the means of doing so. But carriage is not the only means by which the provider can be effectively compensated, or indeed incentivised to invest.

Given the strong association of carriage with interoperability, it is not surprising that the banks initially raised the threat to interoperability as a possible consequence of direct charging.[22] However, it is clear that carriage relates only to the pricing arrangements of the network, and any changes to this need do no violence to the technical arrangements, or the notion of accepting transactions acquired through the ATMs of competitors.

While it has been pointed out by the banks that carriage is a feature of many jurisdictions, it has become apparent through experience in the UK and elsewhere that is not a *necessary* condition for interoperability. Indeed, the claim that direct charging would undermine interoperability has not been sustained by the banks. For example, in a subsequent submission, one of the banks stated that one of the advantages of direct charging included "incentivisation for providers to further place ATMs".[23] The matter is taken up below.

5.3.1 Setting of the carriage fee

In its presentation to the hearing on ATMs on 3 April 2007, the Technical Team represented by Dr Hawkins indicated that to the best of its knowledge there was a uniform carriage fee currently in operation between the banks, namely R3.25 for the first R100 and a further 65c for each R100 thereafter.[24] The question which naturally arose was: if this was correct, then how did such a uniform fee come to be set? Getting to the truth on this was as difficult as pulling teeth.

FNB was the first bank to have to face the Panel's attempts at extraction. It had stated in its first submission to the Enquiry that:

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[22] See for example Absa, March 2007, Second Submission, Access and Interoperability, p 10: "The access [of other banks to the ATM network] is only provided because Absa receives compensation for some of its costs through the carriage" and without carriage, ATM operators may [restrict] access to their ATMs by rival banks", p 11.

[23] SBSA, August 2007, Impact of the proposed direct charging, Slide 5.

[24] Exhibit CC, slide 13; Transcript p 12 (Dr Hawkins); pp 45-46. More precisely, this means R3.25 for the first R100 or less, plus 65 cents for each additional R100 or part thereof. See further below.

> Historically, interchange has been set multilaterally by participants in the card PCH streams. After the introduction of Competition legislation FRB and the rest of the industry has viewed it as prudent to revert to bilateral negotiations to determine the fee.[25]

However, in its view such bilateral negotiations were "not sustainable".[26] Dealing with "Interchange on ATM transactions", FNB wrote that it would recommend the consideration of a number of alternative options to the current system, including:

> Moving away from bilateral to multilateral negotiations…[27]

We had interpreted these statements by FNB as at least implying that the current carriage fees had in fact been set through bilateral negotiations. But then the evident uniformity of the fee puzzled us.

At the hearing on 3 April 2007, FNB gave a presentation (Exhibit DD) which stated that the carriage fee for off-us transactions is "negotiated bilaterally" (slide 4) and that it is "subject to bilateral negotiations" (slide 5). Mr Jordaan repeated that the carriage fee "is subject to bilateral negotiations".[28] Ms Durbach stated that "since 2002/2003 as was indicated on our presentation any negotiations have to be conducted bilaterally."

The Chairperson of the Panel, chairing the hearing, asked whether the current fee was indeed the same for all four (major) banks.[29]

> MS DURBACH: If I can answer that. Historically it was negotiated as you know multilaterally. So for a period of time it would have been the same and that was the fee that Dr Hawkins put up. However, since 2002/2003 as was indicated on our presentation any negotiations have to be conducted bilaterally. So we can speak for FNB. However, what we cannot speak for is any other institution [that may] have negotiated different arrangements on the carriage fee between themselves, which may well have happened.[30]
>
> CHAIRPERSON: Right so you are not sure whether it is the same for all four [major] banks or not?
>
> MS DURBACH: We do not know. I can tell you what it is for FNB but I cannot comment on any bilateral arrangements between any of the other banks.
>
> CHAIRPERSON: OK.
>
> ADV PETERSEN (of the Panel) : … Ms Durbach, are we to understand that the carriage fee which exists by agreement between FNB and other banks is the result of the historical position or is it something that has been bilaterally negotiated? Currently?
>
> MS DURBACH: Currently? Yes, I just want to check one thing, sorry. I am happy to answer it but that answer would fall under the confidential part of our submission. We can answer it at a later point or would you like to hold it over? Would you like to ask the people to clear the room so we can answer that question? …

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25 FRB, 2006, First Submission, October, p 69.

26 *Id.*

27 *Id.,* p 72.

28 Transcript, p 52.

29 Transcript, 3 April 2007, p 63. In fact the carriage fee was said to be uniform between all the banks.

30 See also FRB, 2007, Second Submission, March, Section 2, p 1.

Before the room could be cleared, Ms Durbach continued:

MS DURBACH: Our position was negotiated multilaterally up until 2002/2003. What I can say is the majority of our current interchange arrangements are still pretty much at that level.

CHAIRPERSON: What do you mean by they are still at that level?

MS DURBACH: I mean that they have, the majority of them have not been re-negotiated bilaterally so still sit at the level as was explained by Dr Hawkins of the R3.25.

CHAIRPERSON: So they are still at that figure? I thought you said that was a historical figure, that things have changed?

MS DURBACH: Sorry, no. What I was referring to just to be, sorry. I obviously was not clear, is that the process of negotiating it had changed. The figure was set multilaterally until a couple of years ago. A couple of years ago we moved to only negotiating bilaterally and not multilaterally. And from an FNB perspective the fee has largely remained the same. What I cannot comment on though is what other banks have chosen to do amongst themselves. …

CHAIRPERSON: If I may ask, will it be possible for us to get the figures with regards to all the other agreements as to exactly what FNB charges in each of the agreements?

MS DURBACH: Yes. It will be possible for you to get that.

CHAIRPERSON: So that we can know exactly what is the fee in each of the agreements?

MS DURBACH: Yes.

CHAIRPERSON: OK.

ADV PETERSEN: There is no point then in [my pursuing] a line of questioning on the assumption that it is uniform. But you did hear Dr Hawkins report that as far as the Technical Team is concerned carriage is the same in the case of all banks, as far as we are aware. And if that is so, it would mean that to the extent that there had been bilateral negotiations – and you have reserved your position on that – we would have the extraordinary co-incidence that, down to the last cent, all the bilateral negotiations have arrived at the same figure. Would you accept logically that that is the implication of those facts presented to us?

MS DURBACH: The other thing I would just add to that is that I think what we could have also put forward in the submission is that some of the bilateral negotiations may not have occurred because of the difficulties in conducting a third party independent study which would assist us in determining what would be an appropriate rate.

CHAIRPERSON: What prompted the need to … move from a multilateral negotiating position to a bilateral negotiating position?

MS DURBACH: What prompted it was that at that time about four years ago we were made aware that there might be regulatory difficulties in terms of the current Competition Commission Act in terms of conducting multilateral negotiations or an industry third-party study. Until such time as we had obtained regulatory clarity we chose not to proceed in that way.

MR JORDAAN: If I may make a point. I think we are now at a tactical space now, but it can either be extraordinary that the interchange levels are the same – one can be completely logical depending on one's point of departure. In other words if one were to subscribe to the view that interchange should be set at the average cost of the industry, which is an approach taken in many countries in the world and for many interchange streams as determined for example by a third party, one would arrive at one set of interchange. Because it is based on the average cost for the industry. Or one could say no, it has got to be based on the cost of each individual provider separately which would be different prices and therefore different interchange. So it all depends on how one frames the question, how interchange should be set. This speaks to the difficulties around interchange and carriage fees and negotiations and multilaterals and bilaterals. Which is very difficult. Which is exactly why we put forward that if interchange has to be determined our proposal would be that we give it to an independent objective third party with some set of criteria of that structure, of the average cost of the

industry or the cost of each individual bank, however it should be. Or – and that is why the other two models or the direct charging model is so intuitively attractive – we can completely dispense with all of that by going to a direct [charging] model and you know, dispense with banks having to agree, or that third party having to get involved. And I am purely subjected to the competitive forces of the market.

CHAIRPERSON: I just wanted to say the questions were dealing with the issue of the carriage fee, which in my understanding represents compensation from the issuing bank to the acquiring bank for use of that infrastructure. That is my understanding. So if they end up being exactly the same, there is an issue about compensation as to how we arrive at the figure. That is all that we are sort of highlighting. But you have indicated that you will be letting us have the various amounts, so we will appreciate that.

MS DURBACH: Even though what I can say is that as I have indicated before that the majority of them would be at the same level, I just cannot comment on the detail. But that level that Dr Hawkins put up would be the broad level that would be applicable.

…

MR JORDAAN: The position in which we find ourselves … is one of uncertainty – whether bilateral, multilateral, what is the correct approach? If one has to live with the existing model that we have, we desperately need guidance from yourselves as to which one we should do. What we can tell you, though, is that bilateral negotiations have proven to be incredibly problematic in areas where we attempted [them].

We have examples where we are now performing transaction types without such agreement actually being in place. And it is the practical difficulties of going from multilateral to bilateral where we do not even know whether, what the position should be. Hence again a reason why we are putting up these other models that completely dispenses with either bilateral or multilateral models of the interchange setting.

FNB subsequently acknowledged in writing to the Technical Team that, in fact, it had no bilateral agreements in place regarding ATMs.[31] In our view the probability is that this was known to FNB at the time of its earlier submission, presentation and testimony at the hearing.

As appeared also from other evidence and questioning, Dr Hawkins was right. Despite talk of “bilaterals”, the truth is simply that carriage for off-us ATM transactions has all along been uniform between the banks. Since 1 March 1999 it has been R3.25 for the first R100 and a further 65c for each R100 thereafter.[32]

Capitec Bank was next up, appearing at the hearing on 4 April 2007. Mr Stassen stated frankly that the current basis on which ATM “interchange” (i.e. carriage) was set was far preferable to bilateral agreements, which could well lead to Capitec as a smaller player being “priced out of the market”.[33] Smaller players have “very little if any negotiating ability”.[34] However, he also said that “currently we negotiate the interchange with the other

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31 E-mail dated 28 May 2007. The message indicated that there are bilaterals in place for Mini-ATMs, but provided no detail. Cf also FRB, 2007, Second Submission, March, Section 2, p 4.

32 The only difference is with Mzansi withdrawals, where a flat carriage fee of R3.25 uniformly applies. See Transcript 11 April 2007, p 65.

33 Transcript 4 April 2007, p 3.

34 *Id.*, p 30. Nedbank (Mr Shuter) expressed a similar opinion, saying that in bilateral negotiations it would be at a disadvantage relative to the bigger banks: see Transcript 4 April 2007, p 60. Standard Bank also recognised that

Saswitch [participants,] or with the other banks".[35] But he did not pretend that the current level of carriage may vary as between different banks. When questioned by Mr Bodibe of the Panel, he simply stated that "the agreed interchange between ourselves and the issuing bank" was "currently R3.25 plus 65c per R100, exceeding the first R100" in all cases.[36] In an answer to Adv Petersen, he clarified this further by stating that it had not been bilaterally negotiated but was "the multilateral agreed fee".[37] Asked by the Chairperson when it had been agreed, he said that it had been in existence when Capitec joined the PCH "and has not been renegotiated at any time after that".[38] He rightly dismissed as "very unlikely" the notion that a carriage that was uniform down to the last cent could have been arrived at by bilateral negotiations.[39]

Nedbank, in its written submission in October 2006, had stated:

> ATM SASWITCH interchange has historically been set on a multilateral basis for the principles (ie how and for which transaction interchange will apply), but on a bilateral basis for the level (ie the actual price). The current interchange rate is R3,25 + 65c per/R100.[40]

As we now know, the statement that the actual price had been set on a bilateral basis was untrue.

When Nedbank appeared at the hearing on 4 April 2007, the question of carriage fees was addressed as follows:

> MR SHUTER: … Are they the same and how were they set? If I can say from Nedbank's perspective, through a variety of factors, the BOE acquisition, integration of People's Bank, management changes, we have not been able to establish the manner in which the current fee was set. We understand from the Absa submission that it was last reviewed in 1999, so we need to find people who were involved in that process eight years ago and generally those people no longer work for us. We are continuing to track them down, but I cannot say at the moment whether that fee was agreed multilaterally or bilaterally. Certainly our perspective is that it is the same fee. In our capacity as an acquiring bank we obviously have a relationship with all the issuing banks, and in our capacity as issuing bank we have relationships with all the acquiring banks, and the same carriage fee is being used – R3.25 plus 65c per hundred. … And we understand that to be common across the industry, and certainly it is common for all the arrangements that Nedbank has, both in its capacity as issuer and acquirer. …
>
> CHAIRPERSON: So as far as you are concerned that is common amongst the entire industry?
>
> MR SHUTER: Yes.
>
> CHAIRPERSON: There has not been any change?

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bilateral arrangements would be seen to promote unfair competition and create barriers to entry: SBSA, 2006, First Submission, pp 60-61. Likewise Absa: see First Submission, October 2006, Annex 3, p 67; Transcript 11 April 2007, pp 213.

35 *Id.*, p 6.

36 *Id.*, p 18.

37 *Id.*, p 31.

38 *Id.,* pp 31-32.

39 *Id.*, p 33.

40 Document 3, p 38. "Interchange" here refers to "carriage": see Transcript 4 April 2007, p 80.

> MR SHUTER: We would only know in respect of our own acquirer/issuer relationship, but because we have those relationships across all the players, our perspective is that it is identical across the industry.
>
> CHAIRPERSON: This was fixed on a multilateral negotiation?
>
> MR SHUTER: Our understanding from the Absa submission is that it was last reviewed in 1999.
>
> CHAIRPERSON: No, no, I do understand from the Absa submission. I am talking about your understanding about whether this was bilaterally or multilaterally ….
>
> MR SHUTER: Sir, I think, just to be absolutely clear on it, we have not been able to track down people who were working at Nedbank at that point in time, it is eight years ago. So the honest answer is I do not know. But I think if you have exactly the same fee across all players across the industry, it must strongly suggest that it was agreed multilaterally. I do not see how one gets to a different conclusion.[41]

When referred to the statement in Nedbank's submission of October 2006 that the actual level of interchange had been set "on a bilateral basis", Mr Shuter said that –

> at the time we submitted this particular submission our investigations had indicated to us that what is recorded here was how the fee had been set. In our subsequent investigations [we were not] able to confirm this, so you would have to take our current position as a change from this position. We have not been able to establish if these fees were bilaterally set.[42]

We do not consider either the original statement or this explanation satisfactory.

Standard Bank stated from the outset that "a multilateral implementation of the interbank interchange/carriage fee" is "the only workable approach".[43]

> "Interbank carriage" fee is the incumbent system whereby banks charge each other a per transaction interbank fee for the use of their ATM network by the other bank's customers.[44]
>
> …
>
> For both interchange and interbank carriage (and all other relevant payment streams), attempting to negotiate and implement interbank interchange/carriage fees on a bilateral basis would fundamentally compromise the comprehensive interoperability of the South African payment network. It is highly likely that given the complexity of bilateral negotiations, many pairs of banks would not reach agreement on interbank interchange/carriage for each other's customers. Consumer would potentially find themselves unable to use other banks' payment infrastructure (eg ATM or POS network) leading to significant losses in utility and convenience for the consumer.[45]

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41 Transcript 4 April 2007, pp 57-59.

42 *Id.*, p 73.

43 SBSA, 2006, First Submission, p 59.

44 *Id.*, p 60.

45 *Id.*, p 61.

To begin with, the ATM carriage fee was set at a relatively low level.[46] However as a consequence of actions initiated by Standard Bank, the fee was increased industry-wide in 1997 and again in 1999.[47]

The expression "multilateral implementation" used by Standard Bank in its first submission, quoted above, should not be thought to mean multilateral *negotiations*. This emerged on the last day of the ATM hearings, when Standard Bank revealed that,

> on the 16th January 1997 … Standard Bank unilaterally increased its carriage fee to other banks, and did this again on 18th December 1998. Standard Bank once again unilaterally increased its carriage fee to other banks.[48]

What in fact happened was that on 16 January 1997, a letter was sent by Standard Bank to the CEO of the South African Bankers Service Co Ltd (now commonly known as Bankserv), indicating that, with effect from 1 March 1997, Standard Bank would impose increased charges "for transactions on our machines by customers of other banks, processed through Saswitch".[49] A virtually identical letter was sent by Standard Bank on 18 December 1998, advising of a further such increase from 1 March 1999.[50] The fee to be applied from that date was "R3.25 for the first R100 or less, plus 65 cents for each additional R100 or part thereof."[51]

The letter of 18 December 1998 did contain the sentence:

> We understand that the price increase could be superseded through bilateral interbank negotiations but in the event that the negotiations are delayed or protracted feel it necessary to implement an increase from March 1999.

No evidence was given to suggest that such negotiations were initiated. In both 1997 and 1999 the other Saswitch participants simply adopted the same pricing (and evidently with effect from the same date), so that a uniform carriage fee was applied among them regardless of the issuing bank. According to Standard Bank, in 1997 "[t]he other banks accepted these increases and each independently increased their charges to the same level

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46 Belamont recalls that it was 50c in the 1980s. The FRB submission of March 2007, p 14, states that it was R1.00 + 50c/R100 prior to 1997, and that there were interim increases after 1997. This appears to be challenged by Exhibit GG2, presented at the hearings on 11 April 2007, which stated that the increase in March 1997 was the first since inception.

47 See Table 1 above.

48 Transcript 11 April 2007, p 62 (Mr Schlebusch).

49 Exhibit GG2. See also SBSA, 2007, ATM Submission, April, p 5. This letter also contained the first mention of which we are aware that carriage would be charged for balance enquiries and rejected transactions.

50 Exhibit GG1; SBSA, 2007, ATM Submission, April, p 6.

51 Exhibit GG1.

shortly after SBSA's announcement."[52] In 1999 "again the other banks implemented the same increase".[53]

Remarkably in the light of all this evidence, Absa still sought at the hearing on 11 April 2007 to convey that the current interchange fees came about through bilateral arrangement. It had stated in its first submission that interchange fees for the ATM payment mechanism "are determined on a bilateral basis".[54] At the hearing the Absa representatives were asked by the Chairperson whether Absa had been involved with any of the other banks in negotiating bilaterally or multilaterally.[55]

> MR VOLKER: Chairman, yes we have. I think historically going back to the late nineties, we had been, I think the current basis of the interchange rate on ATM's, I think is a result of a bilateral arrangement. So that goes to the nineties. I think that is where it is at the moment. Subsequent to that there have been a number of attempts to engage on this on a bilateral basis, but they have not resulted in any change to the current interchange rate, as we understand it today.
>
> CHAIRPERSON: So there are no bilateral agreements? Are there any bilaterals on the ATM ...?
>
> MR VOLKER: On the ATM, the historic… I think the last agreement that was, that set the current arrangement was set in 1998 and the current prevailing rate is still a consequence of that. So, I think that was the last arrangement which was on a bilateral basis. As I mentioned, subsequent to that we have had engagement with various banks on reviewing this on a bilateral basis but they have not resulted in any changes to the rate that was set in 1998.
>
> CHAIRPERSON: You must have been here when Standard Bank was presenting.
>
> MR VOLKER: I was not.
>
> CHAIRPERSON: You were not. Well, some of the [Absa] people here were present. There was a point made about a letter which went off and then subsequent to that, suggesting the increase in the carriage fees, and then subsequent to that, everybody else increased the carriage fees. You are aware of that?
>
> MR VOLKER: I am aware of that. I think I was responsible for ATMs at Absa at that stage. This was, as I said, I think the last increase was in 1998 and as far as I can remember the letter we received from Standard Bank was towards the end of 1998, we received a letter announcing their increase and obviously at that stage we had the choice of also doing the same to them, so we sent a subsequent letter to Standard Bank as well as to the other banks, to announce our increase which was of the same quantum.
>
> CHAIRPERSON: And also there was some evidence about subsequent negotiations between Standard Bank and yourselves which did not bear any fruit.
>
> MR VOLKER: That is correct.
>
> CHAIRPERSON: You are aware of those negotiations.
>
> MR VOLKER: Absolutely yes. I think it was a few years later. We engaged on a … It was not just confined to ATM's. It was a broad based discussion on reviewing the setting of interchange rates for all payment systems based on hopefully mutually accepted principles, but I think it was probably over a period of a year that we engaged with Standard Bank on

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52 SBSA, April 2007, Second Submission, ATM transactions, p 5.

53 *Id.*, p 6.

54 Absa, October 2006, First Submission, Annex 3 p 67.

55 Transcript 11 April 2007, p 164.

those discussions. The end result was that it did not change any of the rates.

MR ZEUNER: And we had similar sort of engagement also with FNB in 2005, and ...

ADV PETERSEN: Mr. Volker, if I can just clarify this with you and I am particularly concerned to do so, so that when we read the record later and the transcript of this, we do not draw unfair conclusions. As I understand it, carriage is uniform between all the participants.

MR VOLKER: Yes. That is correct.

ADV PETERSEN: R3.25 for the first R100 and 65c per hundred after that.

MR VOLKER: That is correct. That is my understanding.

ADV PETERSEN: Must I conclude from what you said before that those, that down to the last cent that was in every case arrived at through bilateral negotiations between the different ...(indistinct)?

MR VOLKER: Yes, I mean that is a reality. I think the way that it actually took place, … what triggered it off was a letter from Standard Bank who were really the leaders in the industry at that stage, fair to say. The letter arrived on my desk and I ...(indistinct) that this was the increase. I had one of two options. Obviously I could have declined the letter and said, look I am not interested in doing this, or I could have negotiated with them, but at that stage it seemed like, you know, an acceptable level of fees to ask, and so the result was that I sent a letter back answering it, and [announcing] exactly the same fee to Standard Bank. And at the same time I sent a letter to all the other banks that would be using my ATMs, making the same announcement. So, it was something that …, that is just the way it happened.

ADV PETERSEN: And that is what you meant when you spoke of bilateral arrangements?

MR VOLKER: Yes. That was how it transpired at the time. So, there were not discussions around the table, or actually negotiating and a bargaining process. You could maybe say it was unilaterally sent out, but obviously when the other party accepts it, there is effectively a bilateral agreement.[56]

We certainly do not see the matter that way. In our view it is evident that the two letters from Standard Bank, while on the face of them unilateral, were calculated to bring about and in each case did bring about a co-ordinated pricing response in respect of carriage from all the banks participating in the ATM network. The same would apply to consequential letters in response, of the kind written by Absa, as Mr Volker described them.[57]

It has been clearly established that the carriage fee implemented in March 1999 had not been revised subsequently. The implementation of the Competition Act, and legal advice that multilateral interbank agreement on carriage would be found to be in contravention of section 4(1)(*b*) of the Act, appears to have played a key part in this inertia.

According to the banks, the advice received by them has been that bilaterally agreed carriage would be permissible; however, negotiations would be time-consuming and repetitive. Moreover, the banks' interest in changing the carriage fee by bilateral negotiations does not appear to be intense. The only attempts at renegotiating the fee that have come to the Enquiry's attention are an effort by Standard Bank to enter into negotiations with Absa

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56 Transcript 11 April 2007, pp 165-169.

57 In response to questions from Mr Bodibe, Mr von Zeuner said: "If the panel so wishes, I mean, we can make available correspondence and information in that regard, which will sort of put on record our position and that is the best that we can disclose and I am prepared to do that." Mr Bodibe said "Thank you." (See Transcript 11 April 2007, pp 171-172.) The correspondence and information has not been forthcoming in this regard.

and FNB respectively in 2000 and 2001, and by ABSA with FNB in 2005.[58] According to SBSA, its attempts failed,[59] and “no party has succeeded in renegotiating the [1999] rates.” Absa confirmed this at the same hearing.[60]

Thus no bilateral agreement has superseded the fees which came into effect in March 1999, and all banks participating in the ATM PCH have continued the practice of charging each other the uniform carriage fee.

In its presentation of 11 April 2007, Standard Bank indicated that its reasons for requiring increased carriage were:

- Increased costs associated with handling cash, servicing and maintaining machines and soaring vandalism.
- Banks with a small ATM footprint “free-riding” on Standard Bank’s extensive ATM infrastructure.
- The value to other banks had increased as a result of Standard Bank’s increased ATM footprint.[61]

The behaviour of following the price set by Standard Bank, has been justified by way of suggesting that Bankserv could only accommodate one interchange rate per stream at the time.[62] We do not accept that explanation. The current management of Bankserv is of the view that multiple carriage fees could have been accommodated then, as is the case now, but believes that no one thought to ask.[63] It is more likely that no one (no bank, that is) was interested in asking. The incentive at that time was rather to follow uniformly the upward pricing signal given by Standard Bank.

It is difficult to predict where the carriage fee would be set today if it were to be multilaterally agreed or otherwise uniformly arrived at. While there has been inflation, the cost of technology has decreased and economies of scale through the Saswitch network have improved.[64] However, it would not be unreasonable to conclude that the existing arrangements around the carriage fee and pricing to customers – which typically includes both a cash withdrawal fee and a so-called Saswitch fee – continue to be comfortable and beneficial for the participants.

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58 *Id.*, p 64; SBSA April 2007, Second Submission, ATM transactions, p 6; Transcript 11 April 2007, p 167.

59 *Id.* Also, Transcript 11 April 2007, p 100.

60 See above.

61 Exhibit GG, slide 10.

62 SBSA, April 2007, Second Submission, ATM transactions, pp 5-6.

63 Correspondence from Bankserv, dated 3 September 2007.

64 See FRB, March 2007, Second Submission, ATM transactions, p 2.

Whether the conduct of the banks in arriving at the uniform carriage fees adopted in March 1997 and again in March 1999 was lawful or not is a moot point. Section 4 of the Competition Act 89 of 1998 only came into force on 1 September 1999. However, the effects of the earlier conduct – the practices followed by the banks as a result of the contact between them over the level of ATM carriage fees – have continued to the present day.[65]

In our view, the continuing effects of the earlier conduct are best addressed in the interests of competition and the consumer by going to the root of the problem – the very fact of interbank carriage as the method of compensating ATM service providers in off-us transactions when it has ceased to be necessary to effect such compensation in that way.

For reasons further developed below, carriage would remain objectionable even if levels of carriage were to be bilaterally agreed. Indeed, if carriage were to be regarded as a legitimate means of compensating ATM service providers in off-us transactions, then a uniform carriage, applicable to all participants, would seem preferable to levels bilaterally agreed.

This is not only because, in a complex network, multilateral or other uniform setting of terms and conditions is usually simpler, cheaper and more efficient. In interbank arrangements, bilateral agreements tend, if anything, to favour the bigger players over the smaller, potentially enabling the former to raise the barriers to entry and expansion by other participants and so enhance their own market power. Consumers are not protected in this way.

In our view the essential problem with present ATM pricing arrangements does not lie in the fact that carriage is uniform, or in the level at which carriage has been set. It lies in the very fact of carriage arrangements, which have the effect of allocating customers between banks when it comes to ATM services and of sheltering such services generally, to a significant degree, from price- and other aspects of competition between service providers which could otherwise quite feasibly operate.

If the recommendations which we make in this chapter regarding a change to a direct charging model for ATM transactions are not adopted by the banks within a reasonable time (see further below), then it would be appropriate in our view for the Competition Commissioner to begin a formal investigation into whether or not the continuing practices of the banks regarding interbank carriage fees contravene section 4 of the Competition Act.

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[65] Section 67(1) of the Competition Act provides that a complaint in respect of a prohibited practice may not be initiated more than three years *after the practice has ceased*. In this case, the effect of the practice has not ceased and so is accordingly open to different interpretation.

5.3.2 Carriage and indirect charging to the customer

It is not clear whether, prior to the carriage fee increases of 1997 and 1999, banks saw the carriage fee as a reason to charge their customers more for off-us ATM transactions than for on-us ATM transactions.

Indeed, in the early days of the network, it appears that some consumers, at least, were not charged additionally for off-us transactions. Standard Bank, for example, states:

> SBSA initially absorbed these charges (carriage fees), but in 1989 found that it was paying away what it considered to be excessive carriage fees to other institutions in the light of its own infrastructure. It therefore took a decision that with effect from 1 June 1989, it would levy a charge on customers at a flat rate of R0.75 in respect of Multinet withdrawals and R1.15 in respect of Saswitch withdrawals.[66]

The levying of the off-us fee did not necessarily make off-us ATM withdrawals more expensive than on-us withdrawals. For example, individual bank statements dating back to 1997 indicate that, while on-us transactions of R200 were priced to the customer at R1.69, off-us transactions of R200 and R300 were both priced to the customer at R1.50. The off-us transactions are listed on the statement as "Saswitch cash withdrawal at Absa", Boland, etc, and no other fee for the transaction is charged.[67] However, there may be an explanation for this that is peculiar to the account type concerned.

Absa states that "there has never been a time in South Africa when customers could access another bank's ATM without paying a higher fee" (2007, ATM Submission p 10), but we have not been able substantiate this with the information available.

Initially, banks would have had little reason to differentiate in the pricing of on-us and off-us ATM transactions having regard to the initially low level of the carriage charge; the cost saving made by the bank paying the charge by reason of its customer having used the other bank's ATM facility rather than its own; and the overall commercial benefit of being able to offer its customers the use of a more extensive ATM network than it had been able or had chosen itself to provide.

It is clear that, following the increases in the carriage fee in 1997 and 1999, banks have levied a substantial additional charge on their customers for choosing to use another bank's ATM. The increase in the fee to the customer for off-us transactions appears to have been driven primarily by the desire to curtail the extent to which clients were using the ATMs of other banks. This has been expressed as a situation where volumes were being lost on banks' own ATM networks and substantial fees were being paid to rivals so that their

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[66] SBSA, April 2007, Second Submission, ATM transactions, p 5. Note that in a later part of the submission (p 39), this fee is described as an "additional" charge to the consumer – over and above the standard cash withdrawal charge.

[67] Individual bank statement from SBSA dated 12 July 1997.

customers could use the infrastructure of other banks.[68] Standard Bank, for example, points out that before it instituted its "incentive pricing", 42 per cent of the total shared (off-us) transactions in the country emanated from Standard Bank customers.[69] For the year ending October 2007, this proportion had fallen to 26 per cent.[70]

Confidential: SBSA

The additional levy on off-us transactions appears to have been accompanied by a substantial increase in on-us fees as well. For example, in September 1999, a withdrawal of R1000 was priced to the customer at R8.50 per transaction with (in the case of an off-us transaction) an additional "Saswitch fee" of R4.00.[71] It is notable that the basic cash withdrawal fee of R8.50 had represented a substantial increase compared with previous years, and that it was identical whether transactions were made at the bank's own ATM or that of another bank. In the latter case, the so-called "Saswitch fee" is added.

However, neither of these fee categories bears any identifiable relationship to carriage or any other specific cost. The charge to the customer for off-us transactions was and is commonly referred to as a "Saswitch fee". This term has always been a misnomer considering that the processing charge by Saswitch to the banks has been a small fraction of the banks' additional charges to their customers.

It seems fair to conclude that:

- The increases in the carriage fee in 1997 and 1999 resulted in off-us withdrawals being priced substantially higher than on-us withdrawals
- The restriction of off-us withdrawals by this higher pricing provided an opportunity to increase on-us ATM transaction fees as well.

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68 SBSA, April 2007, Second Submission, ATM transactions, p 39.

69 *Id.*

70 SBSA, December 2007, The request for additional information dated 21 November refers, Annexure B.

71 SBSA Current account statement September 1999.

Figure 1 ATM Monthly transaction volumes[72]

Confidential: Bankserv

Source: Bankserv, 2007, Confidential additional submission

Confidential: Bankserv

The volumes through Saswitch, shown above, (which reflect all the off-us volumes for cash and balance enquiries) appear to indicate:

- The number of off-us ATM transactions had been increasing steadily from 1990, as consumer trust in ATMs increased and the network became more robust.
- In March 1997 the number of off-us transactions peaked at 14.6 million.
- Thereafter (apart from the annual December peak) the volumes progressively decreased, as consumers initiated fewer off-us transactions.
- Part of the gradual decline in volumes probably had something to do with the higher pricing not only for off-us cash withdrawals, but also the introduction of fees for balance enquiries and rejected transactions.

The probability is that the interbank arrangements regarding carriage in off-us transactions served to raise price and restrict output throughout the ATM network. It is probably fair to say that every off-us transaction avoided may not necessarily result in an on-us transaction. Instead, the discouragement of off-us ATM transactions may result in consumers making fewer, larger cash withdrawals at their own bank's ATMs.

72 This represents *all* ATM transactions such as balance enquiries.

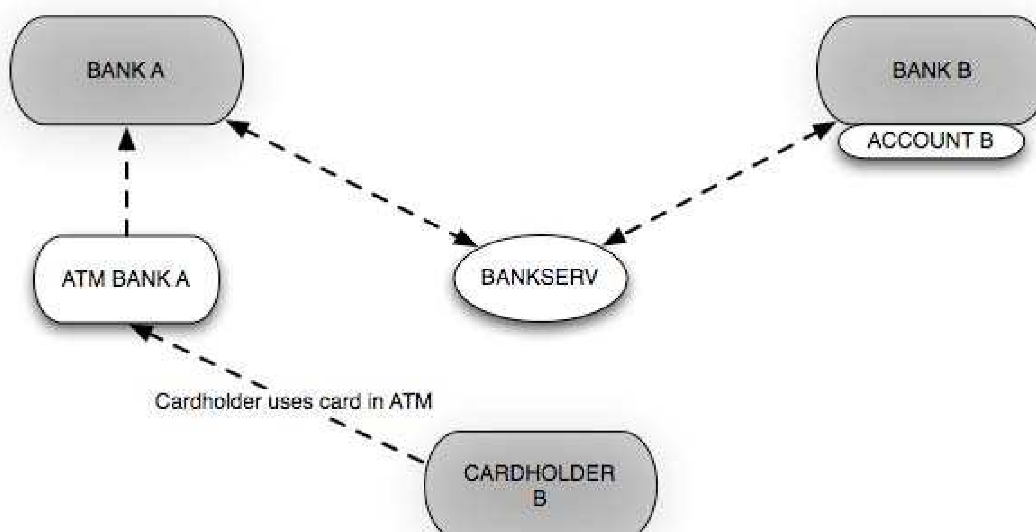
This is most clearly indicated in the statistics for off-us transactions themselves. Consumers responded to the successive price increases beginning in 1997 to 2000, so that by June 2000 only 11 million transactions a month were going through the switch. Discounting the December peaks, it was only in March 2006 that the volumes through Saswitch regularly exceeded their March 1997 levels.

5.4 Revenue and pricing in current ATM model

5.4.1 Authorisation and flow of funds

The current ATM model, applicable to the existing ATM arrangements in South Africa, is presented diagrammatically in Figure 2.

Figure 2 The flow of information for an off-us transaction



The flow of information depicts the authorisation process when a customer of Bank B requests cash at the ATM of another bank (Bank A). Bank A recognises automatically that this is an off-us transaction and seeks authorisation from Bank B, through Bankserv. If the amount requested is available, the transaction is authorised and the transaction is processed. This process shows the use of Saswitch as the network infrastructure through which electronic messages are switched from acquiring to issuing bank and back again.

If the transaction is authorised, the cash will be dispensed. The customer of Bank B is typically charged a composite fee, which has been described as a cash withdrawal fee,

together with a “Saswitch” premium or “interbank fee”[73]. These fees are not always separately disclosed and it may be that the consumer typically thinks that the whole fee is payable to the acquiring bank – or to Saswitch. The actual distribution of the total fee remains completely obscure.

As is now revealed a carriage fee, based on the formula of R3.25 for the first R100, plus R0.65 per R100 thereafter, is payable from Bank B to Bank A. Over and above the carriage fee, the switching costs of Saswitch are conventionally paid by the issuing bank, Bank B, and will vary according to the tiered pricing structure of Bankserv based on the volumes of transactions.[74] At settlement, the amount of the dispensed funds is transferred to Bank A, as well as the carriage fee.

Figure 3 The flow of funds for an off-us transaction

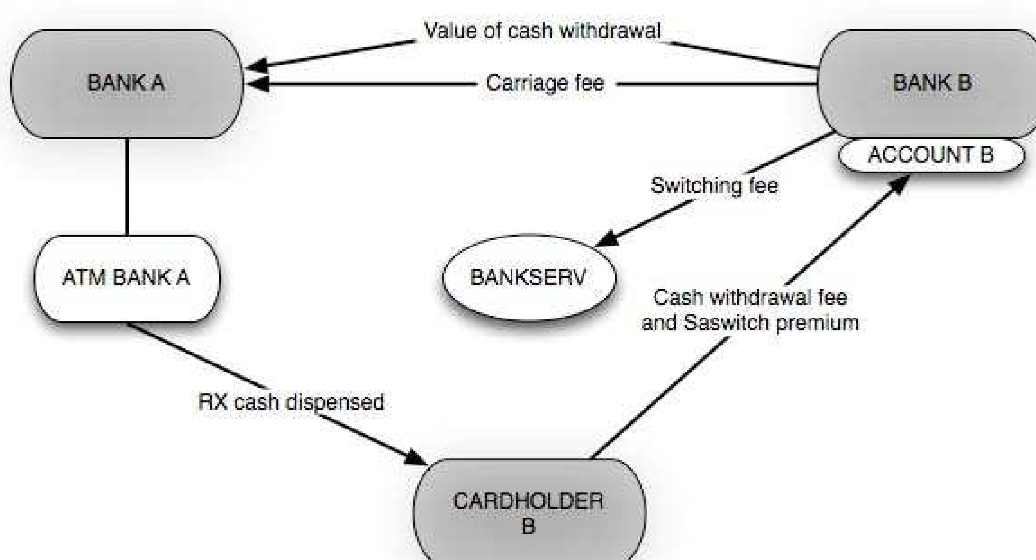


Table 2 sets out the shares of revenue from off-us ATM transactions accruing to the acquiring bank (which provides the ATM infrastructure and cash dispensing service); the issuing bank (where the customer has a bank account) and Bankserv (which provides the switching service known as Saswitch). It is clear that the issuing bank receives the majority of the total off-us fees charged to the customer.

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73 Both the terms are misnomers. The charge is levied by the issuer and does not correspond to the amount to Saswitch or to the other banks. The fee is termed a “convenience fee” by Nedbank (Slide 2 Exhibit EE). It is frankly referred to as a “disincentive fee” by FRB (Transcript 3 April p 110) and SBSA (2007, Annexure 10 p 1). Capitec referred to it as a “disloyalty fee” (Capitec, March 2007, Second Submission, Supplementary Submission to the Banking Enquiry, p 1).

74 Note that this is by convention. We have not been given any reason switching fees could not be paid instead by the acquiring institution, should this be a more logical allocation under a system of direct charging.

Table 2 Share of fee revenue for off-us transactions

Transaction value	R 100		R 242		R 500	
Total off-us fee	**R 9.79**		**R 10.75**		**R 13.74**	
Acquiring Bank A's share	R 3.25	33%	R 4.55	42%	R 5.85	43%
Issuing Bank B's share	R 6.41	65%	R 6.07	56%	R 7.76	56%
Bankserv's share	R 0.13	1%	R 0.13	1%	R 0.13	1%

Source: Banks submissions and banks' brochures.

5.4.2 ATM landscape

Only banks, mutual banks and branches of foreign banks may be participants of the ATM Payment Clearing House (PCH). The agreement (concluded in September 2000) which established the PCH also set out the additional requirements of:

- Membership of the PASA and the ATM Participant Group
- Maintenance of a settlement account at the SARB.

At present, the following 13 banks are members of the ATM PCH: Absa, African Bank, Albaraka Bank, Bidvest (formerly Rennies), Capitec, FirstRand, Investec, Mercantile, Nedbank, Standard Chartered, Teba, The South African Bank of Athens and Standard Bank.

Over and above these, the Postbank, which is excluded from the application of the Banks Act and Ithala Limited which has special exempted status, have access to the ATM network, by virtue of their sponsorship arrangements with members of the PCH – Standard Bank with Postbank, and Absa with Ithala. MEEG also has access to the ATM network by means of its sponsorship into the PCH by ABSA.

The bulk of the ATMs are owned or branded by the big four banks, with Capitec a relatively small fifth biggest provider. Some of the member banks have a small, or no, ATM infrastructure themselves, but their membership allows them to offer the network services to their customers – for which carriage is paid. Investec is an example of a bank with none of its own ATMs. There are also currently a number of non-bank service providers who have outsourcing arrangements with the banks (they provide ATM services on behalf of the banks). This includes, for example, ATM Solutions and Bytes Technology Group.

Table 3 sets out the number of ATMs owned or branded by each of the big four banks and Capitec. While this does not provide a complete view of the system – we believe it accounts for the vast majority of the ATMs in the country. Such numbers are regarded by the firms concerned as competitively sensitive information in respect of which confidentiality has been claimed, and there is no single source of such information.

Table 3 The number of ATMs by bank

Confidential: Absa Nedbank

End 2006	Absa	Standard Bank	Nedbank	FNB	Capitec
Number of Own ATMs	3,753	3,706[75]	1,276	3,148	280
Number of Other ATMs	3,300[76]	157	17[77]	0	170
Share of ATMs	44.6%	24.4%	8.2%	19.9%	2.8%
Mini – ATMs	81[78]	0[79]	0	1327	-
Total number of ATMs (incl. mini-ATMs)	7,134	3,863	1,293	4,475	4,50[80]
Share of Total	41.4%	22.4%	7.5%	26.0%	2.6%

Source: Banks' submissions, March and April 2007, Second Submissions, ATM transactions.

Given the PCH rules,[81] non-bank ATM providers need to have what is in effect an outsourcing arrangement with one of the PCH members to provide ATM services at all. It is these numbers that are captured under "Other ATMs" in the table above. In this case, the non-bank ATM provider is typically responsible for everything associated with the physical installation and maintenance of the ATM. This includes selecting the site, installing the machine, ensuring it is always on-line and stocked with cash, and so on. The bank with which the ATM provider has the contract will have its logo on the machine, and is the entity responsible for settlement through the PCH. The non-bank negotiates a fee with the participant bank. The latter receives the carriage to which it is entitled in terms of the PCH arrangements, and in effect passes on a share of this to the ATM provider, by way of the outsourcing fee.

Mini-ATMs on the other hand are effectively little more than Point-of-Sale (POS) devices, located as stand-alone devices in merchant stores.[82] Cash withdrawals through mini-ATMs

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75 Excluding AutoPlus and AutoDeposit machines which do not dispense cash, but allow only "other" ATM transactions like balance enquiries and deposits. (SBSA, April 2007, Second Submission, ATM transactions, p 21-22).

76 This is made up of 2,878 ATM Solutions ATMs supported by ABSA, 335 Bytes ATMs under Absa brand and 87 Bytes ATMs supported by ABSA. "Supported" ATMs are priced differentially to the customer. (Absa, March 2007, Second Submission, ATM transactions, p 3).

Confidential: Absa

77 Provided by ATM Solutions and Bytes. In contrast with ABSA, there is no differential pricing for "other" ATMs. (Nedbank, March 2007, Second Submission, ATM transactions, p 6.)

78 Provided by ATM Solutions. (Absa, March 2007, Second Submission, ATM transactions, p 4.)

79 SBSA do intend to roll-out mini-ATMs under their AutoMoney devices, of which 20 are currently on trial. (SBSA, April 2007, Second Submission, ATM transactions, p 23-24).

80 As stated in the hearings by Capitec CEO, Mr Riaan Stassen, Transcript, 4 April 2007, p 18.

81 The PCH agreement and clearing rules allow only participants in clearing, i.e. clearing banks, to deliver payment instructions to the system operator (Saswitch) – whether themselves or through their agents or customers. All terminals and other devices used for the purpose, must be owned by, or contracted to, the collecting participant, which is the acquiring bank. (See PCH agreement, Sections 2.2.3, 2.2.9.)

82 FRB, March 2007, Second Submission, ATM transactions, p 4 makes something of the fact that their mini-ATMs have a housing to provide privacy. But other mini-ATM models such as counter-top models appear to fulfil the same function.

are initiated as self-service transactions, but have to be fulfilled through the assistance of the merchant. Once the consumer has requested a withdrawal through such a device, a printed slip from the machine is presented to the merchant who then dispenses the cash from his or her till to the customer. These slips are later reconciled through the system. The carriage payable in this case is considerably smaller.

Absa, FNB, Nedbank, Standard Bank and Capitec account for some 17,215 ATM terminals around the country. If one takes only cash dispensing machines into account (i.e. excluding mini-ATMs), Absa's brand appears on 45 per cent of all ATMs in the country, and Standard and FNB's on 24 per cent and 20 per cent respectively. Nedbank has the smallest number of ATMs of the big four banks with around 8 per cent of the total. Capitec, the next biggest player, has around 3 per cent of the country's ATMs.

Confidential: Absa

If one takes into account mini-ATMs, however, then FNB is the second biggest ATM provider in the country, with a 26 per cent share.

5.4.3 Carriage fees on other ATM transactions

The carriage fees for "other" ATM transactions came into force over a period of time. While balance enquiry fees appeared to have come into existence some time earlier, fees for rejected transactions came into force in March 1997, and both sets were increased to their present levels in March 1999.

Carriage for cash-back at point of sale – with and without purchases – and for mini-ATM transactions are more recent phenomena. These cash withdrawal options only came about after the PCH agreement – which set out "the principle of bilateral negotiation of fees and charges in relation to all matters other than error rectification".[83]

[83] SBSA, April 2007. Second submission, ATM transactions, p 6.

Table 4 Carriage fees for "other" ATM transactions[84]

	Absa	Standard Bank	Nedbank	FNB
Balance enquiries	R 1.65	R 1.65	R 1.65	R 1.25*
Mzansi	R 0.65	R 0.65	R1.62*	-
Rejected ATM withdrawals	-	-	-	-
Card ejected	R 1.10	-	R 1.10	-
Card captured	R 3.30	-	R 3.30	-
Cash-back POS with a purchase[85]	R0.70	Varies from R0.00 to R0.84	-	Between R0.65 and R0.75
Pure cash-back POS[86]	R0.90	-	Flat fee but set at rate lower than ATM Interbank fee (Figure not supplied)	R0.90
Mini-ATMs	R0.90 to FRB R0.25 default	R0.90 to FRB R0.25 default	R2.50 to FRB R0.25 default	R2.50 or R0.90 or R0.25, depending on the bank

Confidential
Absa
FRB
SBSA
Nedbank

Source: Banks' submissions, March and April 2007, Second Submission, ATM transactions, q 1.

*Possible reporting error in these two values. We believe the ATM carriage fees to be uniform across banks.

While there is missing data in Table 4, it appears that there is standardisation of carriage for balance enquires, but some variation, and evidence of bilateral negotiations or unilateral imposition of different interbank fees in the case of cash-back and mini-ATM transactions. Note that cash-back at POS is a facility restricted to debit cards, and the carriage shown here excludes the interchange fee of 0.55 per cent of the value of the transaction flowing from acquirer to issuer. In the case of mini-ATMs, where a bilateral negotiation between banks has not been concluded, a default rate of R0.25 applies – which was the default fee for Postbank stand-alone counter-top devices. (See more in section 5.7)

5.4.4 Pricing to customers

While there are uniform carriage fees on cash withdrawal transactions in the ATM stream, pricing to customers varies by bank and type of account, and in one case, by type of provider. Table 5 indicates the different variable fees for the big four banks and Capitec.

In the data, various fees are set out for a savings account, a current account and a credit card account. (Note that in the case of the credit card, an annual, not monthly, fee typically applies.) Each of these accounts allows for a debit or credit card to be issued, which can be used to withdraw cash at the Saswitch ATM network.

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[84] Note all of these are carriage fees – and hence flow from issuer to acquirer. A dash in the table indicates information not received.

[85] This excludes the interchange flow of 0.55 per cent flowing from acquirer to issuers for all debit card purchases.

[86] Note that this is still only accepted by some banks. SBSA state that the MasterCard and VISA rules prohibit pure cash-back (SBSA, April 2007, Second Submission, ATM transactions, p 23). ABSA, however, states that "This prohibition is overwritten by PASA rules which permit pure cash-back transactions at POS" (Absa, March 2007, Second Submission, ATM transactions, p 7).

Table 5 ATM prices per bank

	Absa	Standard Bank	Nedbank	FRB	Capitec
Dates Accessed and Applicable to charges	1 April 2006 -	2007	1 July 2006 -	May 2008	2007
Cash withdrawal savings account (SA)	R2.70 plus R1.00 per R100 or part thereof (FlexiSave)	R5.05 (E-Plan)	R2.85 plus R0.90 per R100 or part thereof (Savings Deposit Account)	• R5.00 for R0.01 – R500 • R10.00 for R501 – R1000 • R15.00 for R1001 > (Smart account)	R2.00 (One Global Account)
Monthly fee (SA)	R5.90	R6.65	R11.50	R7.50	R3.50
Cash withdrawal current account (CA)	R3.00 plus R0.90 per R100 (Silver Current Account)	R3.10 plus R0.90 per R100 (Current Account)	R2.85 plus R0.90 per R100 (Basic Current Account)	• R5.00 for R0.01 – R500 • R10.00 for R501 – R1000 • R15.00 for R1001 > (Personal Cheque)	
Monthly fee (CA)	R30.00	R17.50	R42.00	R10.00	-
Credit cards (CC)	R3.00 plus R0.90 for each additional R100 or part there of.	R3.00 plus R1.00 per R100 of the total withdrawal amount	R2.85/R0.90	• R5.30 for R0.01 – R500 • R10.60 for R501 – R1000 • R15.90 for R1001 >	-
Annual fee (CC)[87]	R146.65 p.a.	R400 to R132 p.a.	R400 to R110 p.a. (excluding garage card options)	R225 p.a. (R132 p.a. for the Smart CC Charged at R11 per month)	-
Other Bank's ATM	R9.00/R0.90[88]	Above mentioned plus R6.70	Above mentioned plus R5.95	R5.75 + ATM fee above for the CC and • R10.75[89] for R0.01 – R500 • R15.75 for R501 – R1000 • R20.75 for R1001 > on SA and CC	R6.50

Source: Banks' submissions, March and April 2007, Second submissions, ATM transactions and 2007 fee Brochures.

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87 The indicated annual fees are not necessarily all inclusive. Some banks may well charge additional annual fees such as a so-called "Loyalty fee" of a substantial amount.

88 The ATM cash withdrawal fee applicable to ABSA-supported ATMs (ATM Solution ATMs and Bytes ATMs) is R5.80 plus R0.90 for each additional R100 or part thereof (i.e. Absa has three tiers of fees: on-us, almost on-us – for Absa branded ATMs – and off-us).

89 This is R10.50 for SA.

In general, most banks charge an *ad valorem* fee for ATM cash withdrawals. The main reasons given for the *ad valorem* fee is that the costs and risks for the bank increase with the value drawn from the ATM, because of cash handling, the risk of stocking the device and insurance.[90] In addition, one bank has argued that *ad valorem* pricing allows them to charge lower rates to customers withdrawing small amounts.[91] By contrast, non-cash ATM transactions tend to be charged as a flat fee, as the costs and risk of the transactions do not vary by value.[92]

Confidential: Absa

There are a few exceptions. In the case of the Mzansi account, for example, which has neither *ad valorem* carriage nor pricing for cash withdrawals,[93] the flat fee pricing structure is a consequence of the banks attempting to meet their commitments under the Financial Sector Charter to service low-income clientele.[94] For FNB, however, the banded fee structure – which is an *ad valorem* fee structure of sorts – for on-us and off-us ATM transactions is instituted to allow greater simplicity.[95] Capitec charges the simplest fee structure of all – R2 for on-us and R6.50 for off-us transactions.

In all cases, a customer will be charged the stated cash withdrawal fee, unless a bundled option is chosen, for each on-us transaction. In addition, there is a premium fee charged for an off-us ATM transaction. (See the *Other Bank's ATM* row in Table 5.) In the case of Standard and Nedbank, off-us transactions attract a cash withdrawal fee plus a premium. Absa and FNB employ a higher fee structure for off-us transactions. There are different arguments for charging consumers the premium, which are explored in the next section. At least one of the major banks associates the premium with funding the carriage fee.[96] Conceptually at least, this implies that the cash withdrawal fee is charged regardless of whether the customer uses his or her own bank's ATM or not.

5.4.5 Revenue and ATMs

In Table 6, the revenue earned by banks per off-us transaction, the carriage to be paid away and the net revenue for the issuing bank for an average value off-us ATM transaction, are

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90 Also see the chapter on Costing and Pricing.

91 Absa, March 2007, Second Submission, ATM transactions, p 8.

92 Nedbank, March 2007, Second Submission, ATM transactions, p 3.

93 For example, after one free deposit and withdrawal a month, the Mzansi account holder pays R4.20 per transaction for up to five transactions (withdrawals or deposits) and thereafter R8.40 per transaction. SBSA, April 2007, Second Submission, ATM transactions, p 10.

94 Nedbank's Transactor account was launched under the Peoples Bank brand and exists as an inherited pricing structure for the same reasons. Nedbank, March 2007, Second Submission, ATM transactions, p 5.

95 Also see the chapter on Costing and Pricing.

96 FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 2.

shown. The net revenue is larger than that paid away in carriage in every case, except in the case of Capitec, where only a small portion of the fee is retained.

The retention of the larger part of the fee by the issuing bank when the acquiring bank bears the costs of locating and maintaining the ATM, keeping the machine filled with cash, and so on, suggests the profitability of the ATM stream.

Table 6 Revenue from average transaction value (R380[97])

(Average Transaction Value – R380)	Off-us revenue R	Carriage fee R	Net Revenue R
Absa	11.52	5.20	6.32
Standard Bank	13.12	5.20	7.92
Nedbank	12.22	5.20	7.02
FRB	10.75	5.20	5.55
Capitec	6.50	5.20	1.30

Source: Calculated from fee brochures.

The banks have argued that the direct costs of providing an off-us ATM transaction consist of the carriage fees (payable to the ATM provider) and additional costs incurred at the issuing bank (including authorisation, transactions record keeping and the costs associated with card fraud risks).[98]

In addition, indirect costs have to be covered, too. Issuing banks have argued that common costs and other costs related to account holding should be taken into account as well. The common costs include branch costs, ATM infrastructure, IT infrastructure, head office infrastructure and legislative compliance costs.[99] Other services for which they do not directly charge include the costs of providing face-to-face client service,[100] costs of providing the account[101] and the costs associated with change of address.[102] In some cases it was more generally stated, such as by Mr Jordaan of FNB:

> The… banks' withdrawal fees, cash withdrawal fees, are important for us in recovering the costs of providing for the overall product. Again this is a trap one can easily fall into, to think the cash withdrawal fee is only for cash withdrawal. I know it is termed like that but it also serves to recover some of the many other costs we as a bank have.[103]

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97 Note that in its information furnished to FEASibility in 2006, Bankserv maintained that R242 was the average transaction value for off-us transactions. In response to a query raised, given the disparity between this value and the R500 often quoted by banks, Bankserv restated the value as R380 – see correspondence dated 23 August 2007.

98 SBSA, April 2007, Second Submission, ATM transactions, p 18.

99 SBSA, April 2007, Second Submission, ATM transactions, p 12-13.

100 Transcript 4 April 2007 p 105.

101 Transcript 3 April 2007, p 15.

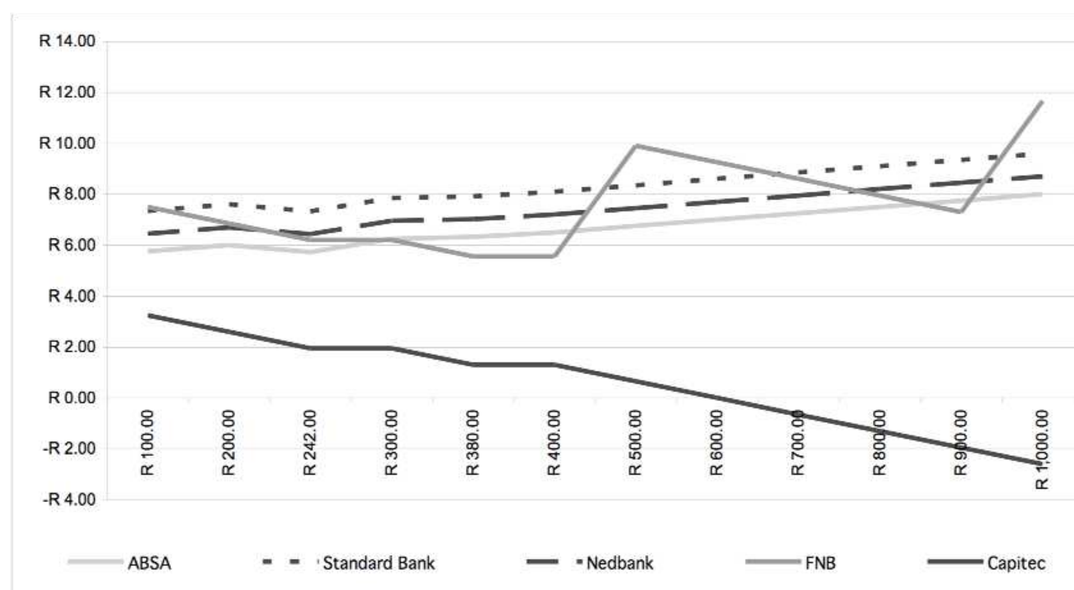
102 Transcript 4 April 2007, p 105.

103 Transcript 3 April, pp 53-54.

It is questionable whether, in the case of an off-us ATM withdrawal, the issuing bank should be able to recover from the cardholder who has elected not to use that bank's ATM but rather to use that of another, a fee which includes the recovery of the cost of having its own ATM infrastructure available. This ability derives to a significant extent from the banks' market power and from the arrangements whereby the customer is treated as "belonging" to the issuer for all ATM transactions and the issuing bank's own ATM service provision is accordingly sheltered from direct competition.

Figure 4 shows the net revenues accruing to the issuing bank, as the value of the transaction increases. In each case, except for Capitec – which has a flat fee regardless of the size of the transaction – revenue increases with the value of the transaction.

Figure 4 Net off-us revenue as the value of the transaction increases



Source: Fee Brochures and Bankserv

Capitec's pricing method is clearly very different from the big four. Capitec has targeted a particular cohort of customers given that their business has its origins in micro-lending where – up until the recent past – loans were exempt from a usury cap. Once Capitec gained a banking licence it gradually started opening deposit accounts for its clientele, who are typically low-middle income earners in the public and private sector.[104] For this reason, while it appears from the figure above that Capitec would be heavily subsidising their clients for larger off-us transactions, it may be that there are few such instances and that the average size of a withdrawal is somewhat smaller than for customers of other banks.

As has been noted above, consumers have responded to the big banks' higher pricing for off-us transactions by avoiding such transactions. In the data requested from the big four

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104 They have consistently pursued this customer niche and have a number of features which reinforce this such as higher interest rates for deposits *up to* R10 000, and so on.

banks and presented in Table 7, it appears that there were close to 1 billion ATM transactions in 2006, but only around 15 per cent went through Saswitch (which only deals with off-us transactions). This does not signify that there is little demand for off-us ATM withdrawals, but rather that there is restricted demand for such withdrawals at the high prices which the big banks have been able to impose.

Table 7 Off-us transactions as a share of banks' own total

2006 – Volume	Absa	Standard Bank	Nedbank	FNB*	Total for big four
On us	320,461,000	204,712,704	80,457,426	177,670,917	783,302,047
Off us	46,252,000	30 723 167	29,360,261	32,739,513	139,074,941
Total	366,713,000	235,435,871	109,817,687	210,410,430	922,376,988
Off us share of total	12.6%	13.0%	26.7%	15.6%	15.1%

Confidential: Absa FRB SBSA Nedbank

Source: Banks' submissions, March and April 2007, Second Submissions, ATM Transactions, q 21.

In Tables 7-9, the data are for *all* ATM transactions, including cash withdrawals and balance enquires, and where applicable, mini-ATM transactions. From Table 7, it appears that Absa, Standard Bank and FNB have been particularly effective in reducing the number of off-us transactions – both as a consequence of the high number of ATMs bearing their respective brands, and because of what are referred to as the relative "price incentives" associated with using one's own bank's ATMs.[105] Once a bank has invested in ATM infrastructure, it makes sense to provide price incentives to customers to use the bank's own ATMs, since the infrastructure becomes more viable, or more profitable, as more transactions are acquired through it. Typically, each ATM transaction will attract a fee. (It is perhaps worth pointing out that the price incentives to customers are sometime perverse – customers will travel some way to avoid paying off-us fees, discounting their travel costs in doing so.) Nedbank's relatively small ATM infrastructure was bound to lead to a higher proportion of off-us transactions – which now make up around 27 per cent of the ATM transactions initiated by Nedbank clients.

Confidential: FRB

In our view the expression "price incentives" in this context is self-serving and misleading. What is really happening is that price disincentives are applied to off-us transactions – enabling the on-us price itself to be raised to a supra-competitive level.[106]

At least 75 per cent of the off-us transactions are initiated at the ATMs of the big four banks, (i.e. more than three-quarters of all off-us transactions go through their terminals). This would include, for example, the clients of Investec, who by virtue of Investec's membership

105 SBSA, April 2007, Second Submission, ATM transactions, p 19.

106 The discussion of market power of the big four banks and their ability to price without reference to cost is dealt with in chapters 2 and 3.

of the ATM PCH can access the ATM network, even though Investec has no ATMs itself.[107] Around 23 per cent[108] of off-us transactions are initiated at the ATMs of the other nine participants of the ATM PCH.

Table 8 Carriage revenue

2006 – R	Absa	Standard Bank	Nedbank	FNB
Carriage fee paid	169,160,000	190,416,314	116,951,566	133,599,765
Carriage fee received	267,240,000	171,339,214	67,495,945	202,372,706
Net Carriage Revenue	98,080,000	-19,077,100	-49,455,621	68,772,941

Confidential: Absa FRB SBSA Nedbank

Source: Banks' submissions, March and April 2007, Second Submissions, ATM Transactions.

In the data presented in the Table 8, the 2006 data for each of the big four banks is shown. The rows show respectively, the carriage paid away (when their customers use the ATMs of another bank), the carriage received, (when the customers of other banks use their ATMs) and the net carriage received. Two of the banks, Absa and FRB, are net receivers of carriage. This is not surprising in the case of Absa, which owns and brands almost twice as many ATMs as any other competitor. FNB's case is rather more interesting, however. Ignoring mini-ATMs for now (which attract a far lower carriage), one might expect Standard Bank to receive the next highest value carriage fees, given that it is the second largest ATM provider.

While the carriage earned on mini-ATMs will make some difference, the extent to which FNB's carriage earnings exceed those of Standard Bank suggests that FNB may have been more successful in identifying commercial locations for its machines than Standard Bank. The location of ATMs was raised by FNB as a critical factor in predicting winners and losers to any change in the existing model.[109]

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107 Investec did not take part in the Enquiry. We have not ascertained their reasons for not deploying their own ATMs. It may well be that their high net worth customer base is less likely to make numerous small cash withdrawals and hence they would be unlikely to be able to attract a sufficient number of transactions to enjoy economies of scale.

108 Bankserv, email correspondence of 3 September 2007 .

109 For example in their February 2007 submission, Answers to the questions for discussion on ATMs/Saswitch.

Table 9 Gross ATM fee revenue from banks' own customers

R	Absa	Standard Bank[110]	Nedbank	FNB	Total Big four
On us	1,112,180,000	995,040,976	244,653,558	739,030,828	3,090,905,362
Off us	303,000,000	262,446,313	213,732,164	255,904,913	1,035,083,390
Total	1,415,180,000	1,257,487,290	458,385,722	994,935,741	4,125,988,753
Off us share of total	21.4%	20.9%	46.6%	25.7%	25.1%
Share of ATM revenue	34.3%	30.5%	11.1%	24.1%	100.0%

Confidential: Absa FRB SBSA Nedbank

Source: Banks' submissions, March and April 2007, Second Submissions, ATM Transactions, q 20 and q 22.

The data in Table 9 above show that between them, the big four earned a total gross ATM fee revenue from customers of R4.1 billion in 2006, with Absa and Standard Bank the biggest earners (see last row of table). (Bankserv fees would need to be deducted and net carriage would need to be deducted or added as the case may be, in order to arrive at each bank's own fee revenue. However, Bankserv fees were not supplied in every case.)

Confidential: FRB SBSA Nedbank

While we have seen that Nedbank and Standard Bank are net payers of carriage, it is apparent that the quantum of the on-us and off-us fees eclipses net carriage. Nedbank, with its small ATM infrastructure, earned close to R214 million in off-us fees from its own customers – only a little less than its total on-us fee revenue of R245 million over the same period. Banks' current ability to earn this revenue while not directly providing the cash dispensing service probably explains why Nedbank, in particular, placed such emphasis on possible negative consequences should the proposed change to direct charging be adopted.[111] With 46 per cent of its gross ATM fee revenue originating from off-us transactions by its customers, Nedbank would be more sensitive to a change to direct charging than the other banks with between 20-25 per cent coming from such off-us transactions.

Confidential: SBSA

Confidential: Nedbank

Confidential: Nedbank

[110] The Standard Bank figures are derived estimates supplied by SBSA in a separate data submission dated 14 September 2007.

[111] The list of "cons" on the direct charging model indicates their deep suspicion of the model. See Slide 12 of the Nedbank presentation at the hearings, 4 April 2007. Exhibit EE.

5.5 The argument for direct charging

The current Saswitch ATM network appears to have developed naturally as a result of each bank's desire to provide its account holders with a convenient and easily accessible cash dispensing service. In terms of cost and risk sharing and enhancing one's competitive offering, each of the banks has an incentive to share infrastructure and participate in a network arrangement that allows them to offer ATM functionality.

However the continued carriage arrangements and the indirect pricing to consumers raise a number of competitive concerns. These include the fact that it:

- Prevents competition between banks for the provision of ATM services to each other's cardholders.
- Precludes the development of a cash dispensing market for non-bank providers.
- Entrenches each bank's hold over its own customers in respect of its own ATM services, thus providing a shelter for uncompetitive on-us ATM pricing as well.

This section sets out the key arguments for direct charging. To begin, the justification of carriage on the basis of two-sided market theory is challenged. (The theory of two-sided markets is discussed more fully in the next chapter, on Payment cards and Interchange.) The argument for separating carriage fee arrangements from other interbank arrangements like the interchange fee on card transactions is set out. Thereafter, the competitive concerns associated with carriage are discussed.

The possibility of a two-sided market emerging, should direct charging be adopted and access for non-bank ATM providers be opened up, is then explored and finally some of the competition considerations associated with direct charging are examined.

5.5.1 Inapplicability of two-sided market theory to ATMs

The ability to draw cash from ATM facilities is usually provided as part of a bundle of services linked to an account at the bank. The bundle of services attached to the account generally includes the following transaction services:

- Receiving deposits to the credit of the customer (whether by cash, cheque, or electronic transfer)
- Enabling withdrawals by the customer whether directly or as a result of payments made by the bank on the customer's behalf.

In terms of the arrangement between the account holder and the bank, a payment card is issued which allows the customer to perform various transactions electronically on his or her

account.[112] This could be through the facility of an ATM (for purposes of a cash withdrawal) or through a point of sale device (for purposes of a debit or credit card purchase), or the internet.

In terms of transactional function there is no intrinsic difference between the merchant in the payment card purchase and the owner of the ATM cash dispenser. In both cases the cardholder has purchased a good or service, the issuing bank having transferred value to the merchant or the ATM provider, from the customer's account.

So while the bank allows the transfer of value, there is a distinct transaction (in both the ATM and the payment card example) where the bank is not necessarily a party to the underlying transaction itself. In the ATM case, it is the cash dispensing service and in the payment card case, it is the sale of the item.

If the costs of providing the service at the point of sale are included this will not change the fact that the cardholder must participate in two distinct economic transactions. In this regard, the ATM cash dispenser could add by way of a charge (or deduct from the cash amount dispensed) an amount sufficient to cover the cost of dispensing the cash to the card holder. Similarly, the merchant recovers the cost of its service at the point-of-sale by raising the price of the item purchased (or conceivably by levying a separate charge). This is altogether separate from the service performed by the issuing bank in processing the payment necessitated by the purchase. For that service the issuing bank charges its account holder customer.

Currently in off-us transactions, as a result of the interbank arrangements and certain regulatory provisions which sustain them, the ATM service provider functions always as agent, or at least as mandatory,[113] of the issuing bank. This applies both where the ATM owner is a bank and where the ATM owner is a non-bank whose terminals are contracted to a bank or banks.[114]

Where only the issuing bank charges a customer for the ATM withdrawal, irrespective of whether the owner of the ATM is a bank or non-bank, the situation for off-us transactions is that, legally and commercially, the ATM owner supplies the issuing bank and the issuing bank supplies the customer. The issuing bank is thus involved as purchaser of the service in the one transaction and seller of the service in the other. This kind of matching of supply with demand occurs in any outsourcing arrangement and is not indicative of a two-sided market.

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112 Even a consumer who only transacts through the internet will typically be issued with a card, as the card number provides access to the internet banking facility.

113 "A contract of mandate is a consensual contract between one party, the mandator, and another, the mandatory, in terms of which the mandatory undertakes to perform a mandate or commission for the mandator." The Law of South Africa, First Reissue, Vol 17, para 2, sv "Mandate and Negotiorum Gestio" by DJ Joubert and DH van Zyl. In our law "agency" implies in addition an authority given by the principal to represent him or her in concluding a juristic act.

114 For example, ATM Solutions or Bytes Technology Group.

A two-sided market involves two independent suppliers *each* transacting directly with a customer in respect of its own supply to that customer, in circumstances where the two separate supplies and the two demands need to coincide for either transaction to occur.

The carriage fee paid by the issuing bank to the ATM service provider is thus not in truth a species of interchange. It is simply a payment to that provider for the service which it provides to the issuing bank. All it has in common with interchange is that it is paid interbank. Interchange in contrast is not a payment for service provided. It is a balancing payment, which serves to overcome unavoidable imbalances between the costs and revenues on the two sides of a two-sided market where, but for the redistribution so effected, there would inevitably be a mismatch of supply or demand.

The current arrangement between the banks in respect of off-us ATM transactions is structured so as to eliminate all elements of two-sidedness in the market. The arrangement is one of reciprocal agency or mandate. This reciprocity is all-encompassing. The customer always belongs to the issuing bank. It is as customer of the issuing bank, and not as customer of the ATM service provider, that the customer receives and pays for the off-us service.

5.5.2 Competition concerns relating to carriage

Competition concerns related to carriage include several interrelated aspects that are discussed below. These are that carriage:

- Involves customer allocation, preventing competition between banks for the provision of ATM services to each other's cardholders
- Precludes the development of a cash dispensing market for non-bank providers
- Entrenches each bank's hold over its own customers in respect of its own ATM services, thus providing a shelter for uncompetitive on-us ATM pricing as well.

We have shown above that cash dispensing is capable of being carried on as a service comparable to other services which are or can be performed by merchants, in respect of which payment cards are routinely used to effect settlement of the price between the customer and the merchant. Furthermore, there is no necessary connection between the cash dispensing service and deposit-taking: there is no need for the provider of the service to be a bank.

Why has the independent provision of ATM services to the consumer not been developed as a distinct market, standing on its own feet, and to that extent independent of the market in which banks provide deposit-taking and related payment services, including payment card facilities, to consumers?

Obviously, in this country, banks as deposit-takers were the first to appreciate the need for and advantages in automating the dispensing of cash which otherwise had to be dispensed to their account-holders by bank tellers. They were thus naturally placed to pioneer the development of the network recounted in section 5.2 and 5.3 above. However this initial development itself brought into being the *potential* for a further development of a different kind: the *separation* of cash dispensing as a commercial activity from deposit-taking, so that a distinct competitive market in (for example) ATM cash dispensing services became feasible.

In our view that potentiality has existed for some time, but has been prevented from bearing fruit by the historically established arrangements between the banks – together with certain regulatory provisions crafted by banks and their representatives in order to sustain and validate such arrangements.

We refer here not simply to the terms of the PCH agreement and clearing rules, as such, but also to the accompanying industry practice and agreed technical protocols which do not allow for the alternative. There is no provision either in the PCH agreement or in the corresponding clearing rules which expressly bars the collecting participant (the ATM service provider) from charging directly for transactions, and from recovering that charge from the paying participant (the issuer) by way of the customer's payment instruction(s). However, it is clear that both documents are premised on the carriage model, in which the ATM service provider in off-us transactions provides that service to the cardholder on behalf of the issuing bank. Thus, Schedule 5 (par 1) of the PCH agreement states: "It is recognised that the parties will in the normal course of business conducted in terms of this agreement be obliged to process transactions on behalf of the other party and as such are entitled to mutually agreed upon compensation in respect of such services rendered."[115] The clearing rules document specifically "supports" the PCH agreement and states that, "[s]hould it happen that these rules differ from the agreement, the agreement takes precedence." [116]

The interbank arrangements which do not enable the off-us ATM service provider to charge the cardholder directly for the use of its machine have come to constitute, in our opinion, a form of customer allocation which restricts competition contrary to the objects of our competition law.[117] Whether they also contravene the letter of the law is a matter discussed below.

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115 PASA, April 2007, Payments Association of South Africa Banking Sector Enquiry Payments Clearing House Agreements, Shedule 5, Fees and Charges.

116 PASA, April 2007, Payments Association of South Africa Banking Sector Enquiry Clearing Rules, Rules governing the clearing of ATM and related debit payment instructions, Section 2.2, p 9.

117 These objects include *inter alia* the promotion of competition in order to provide consumers with competitive prices and product choices. Section 2 of the Competition Act 89 of 1998.

"An agreement to divide markets is a classic method of cartelization," writes the American appellate judge and antitrust author, Posner.[118] In our Competition Act, section 4(1)(*b*)(ii) prohibits parties in a horizontal relationship (i.e. competitors) from agreeing or engaging in a concerted practice to divide a market and so restrict competition "by allocating customers, suppliers, territories or specific types of goods or services".

It is enough that the firms be potential competitors. As was held in *Nedschroef Johannesburg (Pty) Ltd v Teamcor Ltd and others* [2006] 1 CPLR 98 (CT):

> [M]arket division does not require that both firms be competitors prior to the act of division. If they are potential competitors this will suffice. Frequently firms will divide a market before they become de facto competitors precisely to avoid that outcome. Anticompetitive outcomes are no less serious as a result…[119]

Usually when markets are divided, this is done by allocating territories to different suppliers[120] who would otherwise be competing with each other.[121] But other forms of allocation may be just as effective in avoiding competition. Potentially competing suppliers may divide between themselves the products that each may manufacture.[122] "In a horizontal customer division scheme, firms divide the market by classifications of customers – e.g., one chemical manufacturer will sell only to hospitals, another only to schools, and another only to factories, etc".[123] This is only one example of dividing a market by customer allocation.

Any agreement between or concerted practice by firms in a horizontal relationship which, by its nature, treats a particular class of customers as *belongin*g to a particular firm or group of the firms for the purposes of a particular kind of supply – so that the other firms in that relationship, being potential competitors for that supply to the same customer or customers, are prevented from doing so – amounts in our view to a division of the market by means of customer allocation.

The particular agreement or practice must be *characterised* as restrictive of competition before it can be held to fall within the prohibition provided by section 4(1)(*b*). In *American Natural Soda Ash Corporation and another v Competition Commission and others* 2005 (6) SA 158 (SCA) the Court held that the essential enquiry is:

> to establish whether the character of the conduct complained of coincides with the character

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118 *Antitrust Law*, 2nd edition, p 183. See also Brassey (ed.) *Competition Law,* "Restrictive Horizontal Practices" by Campbell, pp 148-149.

119 Para 44. Cf also *Palmer v BRG of Georgia, Inc.* 498 U.S. 46, 49-50, 111 S.Ct. 401, 112 L.Ed.2d 349 (1990).

120 In *Palmer* (*supra*) the U.S. Supreme Court declined to overrule *United States v Topco Associates, Inc.* 405 U.S. 596, 92 S.Ct. 1126, 31 L.Ed.2d 515 (1972), reaffirming that "agreements between competitors to allocate territories to minimize competition are illegal" and are one of the classic examples of a *per se* violation.

121 It is implicit in the requirement of a "horizontal relationship" that the parties could and probably would compete but for the restrictive agreement. See Neuhoff (ed.) *A Practical Guide to the South African Competition Act*, p 74.

122 See *Nedschroef* (*supra*) para 14.

123 Hovenkamp, *Antitrust*, 4th edition, p 97.

> of the prohibited conduct: and this process necessarily embodies two elements. One is the scope of the prohibition: a matter of statutory construction. The other is the nature of the conduct complained of: this is a factual enquiry. In ordinary language this can be termed 'characterising' the conduct… [124]

While the judgment, which concerned alleged prohibited price-fixing contrary to section 4(1)(*b*)(i), left the question of the proper construction of section 4(1)(*b*) open, it suggested that conduct which is not designed to avoid competition but which "merely has that incidental effect" may not fall within the prohibition.[125] As Sullivan and Grimes point out, "market division" is more than just a choice about what markets to serve. "The concept implies an effort to stifle or at least reduce competition in order to reduce output and increase price."[126]

How should the current interbank arrangements in South Africa for off-us ATM transactions – and in particular the arrangements concerning carriage – be characterised?

An arrangement whereby payment cards can only be used for ATM cash dispensing if the cash is dispensed *by or on behalf of the issuing bank*, is an arrangement that effectively prevents the service provider from having a direct commercial relationship with the customer in respect of that transaction where a payment card issued by another bank is used. The arrangement thus prevents the off-us provider from competing directly with the issuing bank for that piece of business with that customer.

The all-encompassing arrangement whereby the acquiring bank or the non-bank provider always acts *on behalf of the issuing bank* in off-us ATM transactions, *and the concomitant absence of any arrangement to enable interoperability between the banks on the basis of direct charging for ATM services*, amounts in our view, to an agreement (or at least a concerted practice) whereby the customer is effectively allocated, for purposes of off-us transactions, to the bank which issued the card. The customer is treated as "belonging" to the issuing bank.[127]

If (to illustrate the point), banks were to decide to take in laundry and were then to arrange among themselves that payment cards issued by them could only be used to pay for laundry services supplied by the issuer or by a firm contracted to, or acting on behalf of, the issuer,

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124 Para [47].

125 See e.g. para [49].

126 *The Law of Antitrust: An Integrated Handbook,* 2nd edition, p 255. In our law and in other comparable jurisdictions, there are of course legitimate restraints of trade which involve temporary market division. "Thus [in the United States], one that sells a business can agree not to compete with the purchaser within a territory and for a time reasonably necessary to protect the capital value of the assets sold from undue erosion. The rule enables sellers to cash out the reasonable value of the good will in a business and protects buyers from the risk of paying for something that soon disappears." Sullivan and Grimes, *op. cit.,* p 231. Our law is similar. For our current common law approach to reasonable restraints of trade, see generally *Reddy v Siemens Telecommunications (Pty) Ltd* 2007 (2) SA 486 (SCA); *Automotive Tooling Systems (Pty) Ltd v Wilkens and others* 2007 (2) SA 271 (SCA); also e.g. *Prism Holdings Ltd and another v Liversage and others* 2004 (2) SA 478 (W); and see further *Botha and another v Carapax Shadeports (Pty) Ltd* 1992 (1) SA 202 (A).

127 The notion that the customer "belongs" to the issuing bank was in fact the very terminology used by SBSA at the Enquiry hearing in Cape Town on 13 November 2006. (Transcript 13 November p 117.)

would anybody doubt that this constituted unacceptable customer allocation (quite apart from other possible categories of restrictive conduct)?

Because the consumer is not free to shop around directly for the cheapest and most convenient ATM services but is treated as belonging to the issuing bank in all ATM transactions, banks' own ATM services to their customers are also significantly sheltered from competition.

The customer is obliged to receive her or his ATM service as a service tied together with the issue of the payment card and the related bank account holding. In this way, banks' customers are subjected to an unnecessary degree of captivity. To change ATM service provider – to enter into a direct transactional relationship with another ATM service provider – the consumer is obliged to change her or his bank. This is clearly inimical to competition in conditions where the potential for an independent market in ATM cash dispensing services exists.[128]

Currently in the ATM network, each bank is a service provider to each other bank in the arrangement. It may be thought that, as suppliers to each other, the banks are simply in a vertical relationship where off-us ATM transactions are concerned. However, that approach fails to recognise that parties stand in a horizontal relationship to each other not only where they are actual competitors in respect of the same supply but where they are potential competitors as well. In other words: could and would these firms compete with each other for the same ultimate customers in respect of the service supplied but for the existence of arrangements between them to the contrary? In our view the answer to this question is yes – in respect of those banks engaged in supplying ATM services interoperably under the present PCH arrangements.[129]

The arrangement between them whereby they are suppliers of ATM services to each other is at the same time an arrangement to the effect that that they will not supply each other's cardholders with ATM services independently when the card is used. As potentially

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128 This does not imply that ATM services necessarily constitute a distinct market for purposes of measuring market power. ATM services are nevertheless a distinct service, and section 4(1)(*b*) does not require that the whole market including that for substitute products or services has to be divided by the competitors before the section is contravened. Even where only two competitors among many allocate their own customers between themselves there may be a contravention if their conduct is properly to be characterised as such.

129 There is a further distinct aspect to the question whether the banks are in a horizontal relationship in regard to off-us ATM transactions. As we have seen, *under current arrangements*, when Bank A provides its ATM service in an off-us transaction, it provides that service commercially to Bank B, albeit that the actual use of the ATM is by Bank B's customer. There is a supply arrangement between Bank A and Bank B, and Bank A charges its fee to Bank B for that supply. In each particular ATM transaction, therefore, the two banks involved are in a *vertical* relationship (the one supplying the other). But that does not mean that the two banks are not also in a *horizontal* relationship with each other in the market for the supply of such services by a bank to other banks. Inasmuch as each bank, in a number of transactions, will find itself in the position of Bank A, all of them are potential competitors, at least in the sense that the supplier could agree with the purchaser of the supply to make the supply at a different price, or not make it at all. The fact that they have agreed a common price means that the question properly arises as to whether there is an agreement between them, or a concerted practice by them, which ought to be characterised as prohibited price-fixing in contravention of section 4(1)(*b*) of the Competition Act. Similarly the question arises as to whether the effect of their agreement or concerted practice brings it into conflict with section 4(1)(*a*).

competing suppliers to the end consumer in off-us ATM transactions, all agree to make their supply only to each other, and at the same price. It could be argued that this entails price-fixing by firms in a horizontal relationship.[130] At the very least they fix a trading condition.[131] Both in this respect and in respect of customer allocation, *to the extent that it cannot be shown to be necessary* it objectively serves a restrictive purpose either in actual contravention of, or at least at odds with the policy underlying, section 4(1)(*b*) of the Competition Act.

In its earlier development, the arrangements entered into between banks and other financial institutions, whereby the ATMs of the one were made available to the customers of the other, could not properly be characterised as the kind of conduct prohibited by section 4(1)(*b*). It may well have been necessary to develop the network that way. At least initially, it is unlikely that its purpose was conceived as anti-competitive. Nor is it likely that the arrangement would, in the sense now contemplated by section 4(1)(*a*), have initially had anti-competitive effects outweighing the pro-competitive gains inherent in the establishment and extension of the network. But a highly developed ATM network now exists, and the anti-competitive implications of the all-encompassing arrangements between the banks in this regard are now apparent.

As is dealt with more fully in our discussion of the feasibility of a direct-charging model for ATM services, interoperability can no longer be said to depend on carriage. No practical necessity now exists to justify the continuation of the present off-us ATM charging arrangements between banks. Nevertheless, there is a view that the banks could currently have a defence to a complaint brought against them for having contravened section 4 of the Competition Act by virtue of these arrangements.

This is not because we accept the argument advanced during the hearings that "concurrent jurisdiction" as contemplated by the Competition Act justifies the arrangements notwithstanding anything to the contrary in section 4. In an Appendix to this report, we consider the general principles likely to apply to a defence of "concurrent jurisdiction" – principles comparable to those which apply to the defence of "state action" (in the United

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130 See footnote above. Cf also *Brennan et al v Concord EFS Inc. et al* 369 F.Supp.2d 1127 (N.D. Cal), discussed below.

131 We note the interpretation given by the Competition Tribunal to "trading condition" in the context of section 4(1)(*b*)(ii) of the Competition Act, in *Competition Commission v Patensie Sitrus Beherend Bpk* (Case No. 37/CR/Jun01), decided on 8 April 2002. There the Tribunal concluded that the rules of a producer co-operative which required each producer/ member to deliver his crop to the co-op was not a "trading condition" the fixing of which is prohibited under section 4(1)(*b*). In reasoning its way to this conclusion (*per* D. Lewis, F. Fourie and D. Maponya concurring), the Tribunal maintained the view that all that is required to sustain a complaint under section 4(1)(*b*)(i) is proof that parties in a horizontal relationship "have agreed to fix a price or any other trading condition." However – without the benefit of the subsequent judgment of the Supreme Court of Appeal in *American Natural Soda Ash* (*supra*) – it approached the matter as if no characterisation of the conduct as restrictive of competition was called for. But it realised that this approach would make the prohibition too wide, so it cut down the meaning of "any other trading condition" so as to refer only to trading conditions which are "part of the price-quantity-quality nexus of the concerned transactions/trade" (para 35). This aspect was not addressed in the appeal to the Competition Appeal Court. In our view, even on the Tribunal's version, setting uniform carriage would involve the setting of a uniform trading condition intimately related to the price and output of ATM transactions with end customers.

States) and "state compulsion" (in Europe). If the banks' defence to a complaint, say, of market division by way of customer allocation in relation to off-us ATM transactions were to rest solely on the current PCH arrangements having been approved by PASA and ultimately the SARB, we would not be deterred from recommending the initiation and investigation of the complaint – leaving the defence to be tested in referral proceedings in due course.

The legal point we have in mind is a different one. For reasons set out in section 5.6.6 of this chapter, we have concluded that the regulations in force under the Financial Intelligence Centre Act 38 of 2001 ("FICA") could present a challenge to the necessary change to a direct charging model for ATM transactions without a small technical amendment attainable by way of exemption. Notwithstanding the above mentioned view, there is another opinion submitted by the National Treasury[132] which concludes that FICA does not create such an obstacle.

The point to be made here is that the current situation is one which needs to be changed. This chapter proceeds on the assumption that the slight difficulty which may be presented by FICA regulations can be and will be ironed out. We are firmly of the view that only a change to a direct charging model for ATM transactions would overcome the serious competition concerns that we have identified above. The fact that a direct charging model is accepted to be feasible, technically and commercially, shows that any necessity for the present arrangement – if we assume necessity once existed – has now fallen away.

Assuming that the necessary exemption is given, or the slight complication is otherwise cleared away, if the banks then fail to make all reasonable efforts to replace the current carriage model for off-us ATM transactions with a direct charging model, it would be difficult to avoid the conclusion that their arrangements have the purpose of restricting competition in contravention of section 4(1)(*b*). It could also, in our view, be shown that the anti-competitive effect of the arrangements is substantial, thus justifying a complaint in the alternative in terms of section 4(1)(*a*).

We therefore recommend that the Competition Commissioner should initiate and investigate such complaints in the event that a change to direct charging for off-us ATM services has not been made *within one year* of this possible regulatory complication having ceased to exist.

5.5.3 Two-sided markets and direct charging

We have indicated above that carriage fees are not justified by two-sided market theory.

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[132] The National Treasury submitted this opinion by Adv MD Kuper SC, entitled Legal nature of inter-bank charging relationships – Section 21 of the Financial Intelligence Centre Act, 38 of 2001, on 30 November 2007.

Should a change to direct charging be made, then ATM cash dispensing would more clearly reveal the characteristics it has in common with the provision by merchants of other goods and services directly in exchange for payment by means of payment cards. The question then arises whether, in this altered context of direct charging, two-sided market theory would apply.

If customer B, who banks with Bank B, uses the ATM of Bank A, a payment card is being used to effect the transaction and its acceptance is necessary to complete the transaction.

So long as the cardholder is dealing simply here with two banks, as the other transacting parties, it is difficult to see that the market can properly be characterised as two-sided. This is because, while two independent suppliers exist, two independent demands, which have to be reconciled, do not exist.

When, however, non-bank providers are able to enter the market for cash dispensing services, independent of an ATM agency relationship with a bank, there would be a further party, whose willingness to accept the payment card has to be taken into consideration.

In principle, if the costs and the demand elasticities on the issuing side were to be out of balance with the costs and the demand elasticities on the acquiring side in regard to such use of payment cards, there could in principle be redistribution by way of interchange to enable the two-sided market to function. But, as in the case of other merchandise and service provision, that would be confined to addressing any imbalance in the costs and revenues.

The cost of the actual service of cash dispensing is a different matter. Irrespective of whose ATM is used, the same customer will end up bearing this cost. There is thus no "two-sidedness" needing to be or capable of being balanced by interchange in relation to this aspect of the transaction.

One can readily envisage a situation where the cardholding customer making the off-us transaction is charged a fee to compensate the ATM provider for the cash dispensing service, and a fee to compensate the issuing bank for its service in processing the payment for the cardholder.

So far, no-one has suggested that interchange would in fact be necessary to enable a market for ATM service provision to function effectively on the basis of the direct charging model. As we explain in the chapter on Payment Cards and Interchange, where interchange is not necessary to the viability of a payment stream, it should not be allowed. Further reasons why interchange would be inappropriate in the ATM context are addressed below.

5.5.4 Competition considerations of the direct charging model

For the shift to direct charging to be a sustainable and beneficial change for the consumer, a number of issues need to be considered.

These include:

- Acceptable reciprocal arrangements between issuers or ATM providers
- Discriminatory pricing to customers of different issuers or ATM providers
- The compensation of the issuing bank.

Acceptable reciprocal arrangements between issuers or ATM providers.

It is not suggested that an ATM service provider (including a bank) should be precluded from offering its services to customers by way of, or with the assistance of, outsourcing arrangements or a joint venture with another actual or potential provider. The assessment of each such arrangement from a competition standpoint would depend upon its own facts.

Quite different in principle, however, would be a reciprocal arrangement of agency or mandate, whereby an issuing bank agrees with another issuing bank that each will service the other's cardholders on the basis that the customer remains, for purposes of the transaction, simply the customer of the issuer. For reasons previously explained, this might well be considered as amounting to a prohibited agreement between actual or potential competitors not to compete in respect of each other's cardholders for cash-dispensing business (i.e., for example, as customer allocation prohibited in terms of section 4(1)(*b*) of the Competition Act).

Discriminatory pricing to customers of different issuers

The possibility for price discrimination between different issuers or providers has been raised as a concern both by smaller banks that are part of the existing ATM network and by non-bank providers which have existing arrangements with a registered bank.

They envisage the possibility of, say, two large banks agreeing with each other a lower direct charge for dispensing cash to each other's cardholders than the fee charged to the cardholders of other issuers. This would have the potential to seriously distort and retard the development of an independent market for ATM services. Such an agreement, if not ruled out by the terms upon which interoperability is established for purposes of the direct charging model, would have to be evaluated on its particular facts in the light of the Competition Act. It might warrant investigation in connection with possible anti-competitive effects (section 4(1)(*a*)), or indeed as constituting price-fixing (section 4(1)(*b*)). It might serve

to create or enhance the degree of market power[133] on the part of one or more of the participants over its own customers or in the market more generally, and might, on that basis, give rise to a finding of exclusionary conduct amounting to an abuse of dominance (section 8 of the Competition Act). It might likewise constitute prohibited price discrimination if it is likely to have substantial anti-competitive effects (section 9).

The advantages of incumbency are so great, and the development of an independent market for ATM service provision is so important, that we are persuaded of the need to remove uncertainties by addressing the above problem on a regulatory basis before it rears its head.

Our recommendation is that the change to a direct charging model should be accompanied by a regulatory prohibition – whether by way of PCH clearing rules or otherwise – against any ATM service provider discriminating in price between customers using cards issued by other firms.

On the other hand, unilateral discrimination in price between a bank's own cardholders and other customers in the provision of its ATM services should not, we think, be prohibited. From a competition perspective, it appears to make sense to allow issuing banks to incentivise their clients (thereby offering the clients lower fees) to use their infrastructure. If an abuse of market power arises in such cases this can be addressed in terms of section 9, and possibly also section 8, of the Competition Act.[134]

The compensation of the issuing bank

While the bulk of the costs for a cash withdrawal fall on the acquiring side, and include the installation of the machine, the cost of cash distribution, maintenance of the ATM, etc, there is clearly a basis for the issuing bank to charge a fee of its own, apart from the direct charge that flows to the acquiring institution. The issuing bank processes the transaction and performs other functions related to the transaction such as making the necessary payment on the customer's behalf to the ATM service provider. Moreover, the current convention is that it is the issuing bank that pays Bankserv for the processing of the instructions from the ATM of another bank to the issuing bank and back again, and it is also the issuing bank that deals with customer queries.[135] In principle, the issuing bank should be compensated for the work it does in ensuring a completed ATM transaction.

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133 Our Competition Act does not recognise "collective dominance": the position of each firm has to be assessed individually. However, arrangements between firms, while they might not affect the market share of each participant, might enable one or more "to behave to an appreciable extent independently of its … customers…" and thus provide a basis for a finding of market power. (See Competition Act, section 7, read with the Appendix of this report).

134 Although the direct charging model has the potential for discrimination in that it allows a bank to offer a discount to its own customers in terms of on-us ATM transactions, this may occur in any ATM model. Currently, for example, Absa charges its customers more when they use the ATMs of ATM Solutions – which are branded and sponsored by Absa itself.

135 Although both of these conventions could presumably be changed.

There are two obvious possibilities in terms of facilitating this compensation:

- A direct charge by the ATM service provider, with a separate issuer fee by the issuer
- A direct charge with an "interchange fee" flowing from acquirer to issuer.

The direct charge with a separate issuer fee allows for both the acquiring institution or other firm that provides the cash dispensing and the issuer that processes the transaction to charge an explicit fee to the consumer. The key advantages of this model are that it potentially allows for price competition on both the acquiring and issuing sides, and avoids an interbank fee of any sort being set. In addition, there is transparency regarding the distribution of the relative fees, so the consumer knows what the ATM service provider charges relative to the issuer of the card.

This appears to be the approach proposed by the Australian banking industry which aims to have this model in operation by October 2008.

The key disadvantage is that the consumer may be only partially informed about the full charge at the time of the transaction – the direct charge by the ATM service provider will be known, but the issuing bank may charge a fee that is only appreciated by the customer later (as it appears on a statement). However, if customers are adequately advised generally in advance by their banks of applicable ATM transaction charges, and given ongoing consumer education, this disadvantage can be minimised.

A direct charge with an "interchange fee" would entail the ATM service provider collecting and transferring to the issuer the latter's compensation for processing the transaction. The ATM service provider would charge an aggregate fee sufficient to cover not only its own costs plus profit, but also those of the issuer. The ATM service provider would then pay the agreed amount of "interchange" to the issuer for its share of the work.[136] The direct charge displayed on the ATM screen would be all-inclusive.

The "interchange" in question would presumably need to be set on a multilateral basis, based on a study *inter alia* of relevant issuing costs and the extent to which these could not reasonably be recovered from issuers' direct revenues. (See the approach to interchange discussed and recommended in the chapter on Payment Cards and Interchange.) A submission of Absa lists the possible basis for the calculation of the ATM "interchange" to include transaction processing costs, general overheads, fraud losses, disputes and system errors.[137]

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136 In practice, of course, the issuer would deduct and retain this portion as the payment due to it when remitting to the acquirer the amounts appropriately debited from the cardholder's account.

137 WWB, for Absa, September 2007, Direct charging models for ATM's, p 10.

The key advantage of this alternative for the consumer appears to lie primarily in the nature of the all-encompassing charge for the ATM transaction. From the consumer's point of view this allows for a simple "what you see is what you pay" system.

However, there are a number of concerns with this proposed model which make it inappropriate in our opinion.

First, as a matter of principle in competition policy, if agreement between parties in a horizontal relationship – i.e., between actual or potential competitors – goes beyond what is reasonably necessary for the proper functioning of a payment network, it ought not to be entertained. This must apply *a fortiori* to agreements involving price uniformity instead of competitive pricing. As has already been explained, we find no reason to conclude that any element of interchange would be necessary to enable a direct charging ATM network to operate effectively. There is no reason to allow the elimination of price competition on the issuing side.

Second, there is a significant danger that the use of ATM "interchange" in the context of a direct charging model would tilt the competitive playing field against non-banks, and indeed also to a lesser extent against smaller banks in the provision of ATM services directly to the public. This is for a combination of reasons.

The ATM provider would have to charge an aggregate fee high enough to include the "interchange" component to compensate the issuer as well as its own remuneration as acquirer. The impression may well be created among consumers that the off-us provider is the cause and beneficiary of the entire charge. That would tend to chill off- us transactions.

Even where interchange is legitimate, the difficulties in arriving at an appropriate level of interchange are acknowledged to be considerable. In this case, where banks are themselves ATM service providers and may have a continuing interest in discouraging off-us transactions, there could well be a heightened incentive to inflate interchange. Given that "interchange" is not necessary in the ATM context, this serves as an additional reason to avoid it.

For these reasons, in our view, "interchange" as a means of compensating issuers for their processing and related functions in off-us ATM transactions should not be permitted.

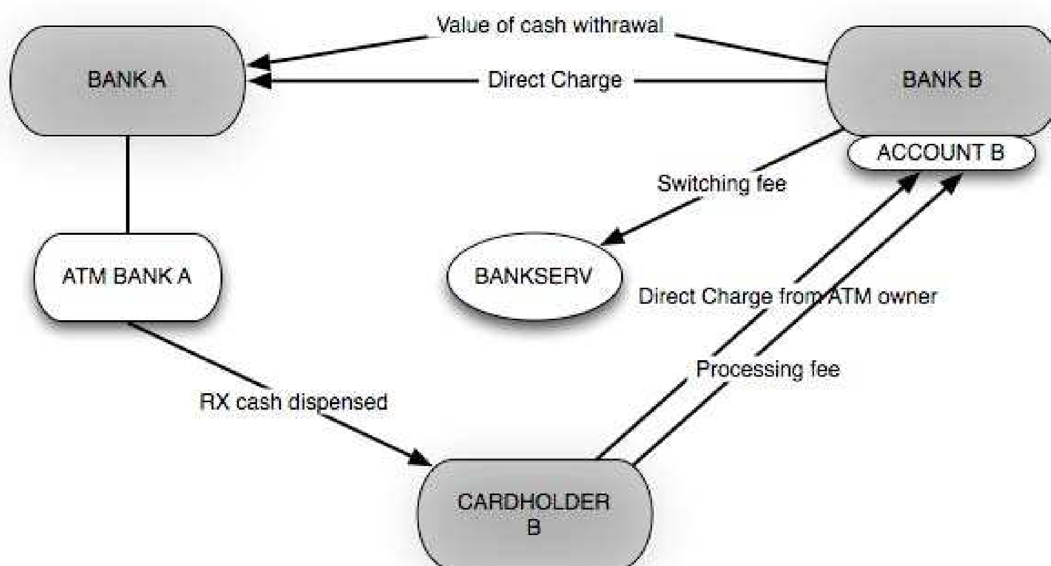
Our recommendation accordingly is that the necessary compensation to the issuer for the work that it does in connection with an off-us ATM transaction be obtained through the issuer levying its own charge directly on its customer, whether as a separate charge or in any other manner.

5.6 Implications of the direct charging model

5.6.1 Flow of funds in direct charging model

For the direct charging model, the carriage fee would be replaced by a direct charge, set by the ATM service provider. Instead of recovering costs from the issuing bank through a carriage fee, the ATM service provider would be recovering costs directly from the customer (who uses the payment card). The basic obligation to pay the ATM service provider would shift from the issuing bank to the customer, and so carriage would altogether fall away. In this instance – i.e. an off-us transaction – any existing basis for a “cash withdrawal fee” charged by the issuing bank would also fall away. It would remain simply for the issuing bank, if it wishes, to charge a fee in respect of its own processing and related service to its customer for using the payment card. A description of the model is set out below.

Figure 5 Proposed direct charging model



In the figure above, Cardholder B uses the ATM of Bank A, and agrees explicitly, by using the ATM key pad, to the direct charge. The request for funds will be processed through Bankserv (Saswitch), and if funds are available, authorisation will be given and the cash dispensed. The direct charge is recovered, together with the value of the cash dispensed, at settlement and the customers’ account will reflect both of these deductions. To be more specific, Cardholder B instructs Bank B to pay the direct charge plus the value of the cash dispensed over to Bank A on her or his behalf.

In this model, the issuing bank remains responsible for the small switching fee to Bankserv. Over and above this, the issuing bank may charge the customer for the work it has done,

and so the customer may be liable for a processing fee. All fees must be transparently recorded on the cardholder's statement.

While this model does not necessarily reduce the number of charges, the consumer ought to face lower charges, as ATM providers are able to compete on the direct charge. The fees charged by the issuing bank will also become more transparent.[138]

Whether in fact ATM charges do come down will depend upon whether the banks engage in effective price competition; whether there is entry by new ATM providers; and whether consumers are responsive to the new opportunities to shop around.

Direct charging undermines a fundamental source of power for the banks – that of control over customers in terms of the provision of payment services. In the case of off-us transactions, this has allowed banks to charge their customers for the services provided by others. This practice has served to obscure what each participant receives. This lack of transparency, together with the industry-wide setting of carriage, has ensured that the provision of ATM services has largely been sheltered from competition. Direct charging eliminates the need for any price setting or industry agreement relating to carriage, as the customer will be charged directly by the cash dispenser.

The elimination of the need to agree on the level of a carriage fee has been mentioned as an advantage of the direct charging model by most of the banks during the course of the Enquiry. This has much to do with the apparently widely held view that only bilateral negotiations of interbank fees would be deemed acceptable by the Competition authorities. In both the first and second round of hearings, banks also pointed to the logistical burden of having to conduct such negotiations on a bilateral basis for each of the payment streams.

There are a number of possible areas of concern associated with the implementation of the direct charging model. Among them is the possibility of discriminatory pricing with regard to areas, different times of day and the clients of different banks. We have given consideration to some aspects of this issue above, and will explore it further below.

5.6.2 Direct charging and interoperability

Direct charging has a number of potentially positive outcomes from the perspective of competition, but for it to be recommended in place of the existing carriage based model, we have needed to be sure that it would do no harm to the interoperability of the system.

Banks rightly regard interoperability as a basic requirement of a functional payment system:

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[138] The Reserve Bank of Australia expects that the move to direct charging in Australia will ultimately lead to substantial reductions in the issuer's off-us processing fee and – even to the abolition thereof. Media release, 13 August 2007.

> The ATM network is not like a normal consumer market where e.g. retailer A is under no obligation to stock the branded goods of retailer B, or if a price cannot be agreed upon, they do not have to accept the goods. In the payments industry, banks are obliged to provide service to the customers of other banks in the name of interoperability.[139]

The interoperability of the system relates to the ability of consumers (from any issuing bank) to use any ATM. Technically, this has been achieved in large part by the central switching hub - Saswitch, but also through the technical specifications of ATMs, including the standards implicit in the use of MasterCard and VISA.[140] Historically, the PCH agreements (in terms of which members agree to accept the transactions initiated on competitors' ATMs) and the commercial arrangements associated with the carriage fee have served to underpin interoperability.

While the direct charging model proposed here would entail a change only in regard to carriage, some banks' initial responses appeared to associate the model with the unravelling of all the existing arrangements. We believe the use of the central switching hub, the existing standards, and the ATM PCH agreement need to be retained. Since the PCH agreement has certain restrictive clauses,' it would presumably have to be amended.

There was some suggestion that the carriage fee is required to cover unavoidable costs and provide an incentive to invest in ATM infrastructure. However, in our view it is clear from the submissions as a whole that direct charging provides an alternative model by which these unavoidable costs would be covered, with interoperability being maintained, and with incentives to invest being, if anything, strengthened.

From the outset FNB acknowledged "that there are a number of ways that ATM charges and fees can be charged and this is reflected in a number of different regimes across the world."[141] It went on to propose that, among alternatives to the current system, consideration should be given to:

> The move to a model of elimination of interchange[142] with ATM owners charging customers directly. This would involve dropping interchange altogether on ATM withdrawals, and so would be a significant change for the industry requiring careful investigation and consideration.[143]

FNB later stated specifically, in answer to the Enquiry's question whether "the carriage fees associated with ATM transactions [are] … essential for interoperability in the system":

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139 SBSA, October 2006, First Submission, p 56.

140 See for example, the rules stated in the VISA international operating regulations Ch 2, 4 and 8.

141 FRB, October 2006, First Submission, p 72.

142 The expression "interchange" is being used here, as in other quotations, to refer to carriage. That is also a way in which it was referred to in (e.g.) the Enquiry's questionnaire to the banks on ATM transactions. We have subsequently clarified our thinking on the correct and incorrect use of the expression "interchange".

143 *Id.*, p 73.

> Although cost recovery is essential to support interoperability, this does not necessarily need to occur via interchange fees.[144]

Nedbank agreed:

> It is Nedbank's view that the current carriage fee is not essential for interoperability in the provision of a shared ATM network, as an alternative surcharge model could be adopted with an equal ability to support interoperability.[145]

And further:

> It is Nedbank's view that the surcharge model is equally capable of addressing the critical success factors for offering ATM cash withdrawal services.[146]

(The term "surcharging" is sometimes used by the banks to refer to direct charging, but we prefer to avoid it. It can lead to confusion with the US model where there is surcharging over and above carriage. For this reason, "direct charging" is preferred throughout this report.)

Although Standard Bank did not directly answer the question whether carriage was essential to interoperability, it implied that carriage is not in fact essential when it acknowledged:

> For ATMs, "surcharging" [is an] alternative system of recovering network costs whereby the bank that owns the ATM (acquirer) surcharges the other bank's (the issuing bank) customer directly on the use of the ATM, with no interbank fees paid.[147]

Absa, too, did not directly answer the question about interoperability. It concentrated on expounding the historical role that carriage fees have played in the development of the ATM network and in its own investment in an extensive ATM infrastructure. It has been the existence of carriage that has made Absa willing to allow other banks the use of its ATMs.

> This access is only provided because Absa receives compensation for some of their costs through the carriage fee.[148]

While the ability of a direct charging model to ensure interoperability and the recovery of adequate compensation was not specifically addressed, it was implicitly conceded by Absa when it said that without carriage fees, one of the choices facing ATM operators would be "recovering the costs of network access by rivals' customers through surcharges at the ATM".[149]

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144 FRB, March 2007, Second Submission, Access and Interoperability, p 10.

145 Nedbank, March 2007, Second Submission, Access and Interoperability, p 63.

146 Nedbank, March 2007, Second Submission, ATM transactions, p 3.

147 SBSA, October 2006, First Submission, p 58.

148 Absa, March 2007, Second Submission, Access and Interoperability, p 10.

149 *Id,* p 11.

It went on to develop arguments concerning "negative consequences that could arise if the current system of interbank fees was altered in any material respect", which we address further below,[150] and concluded that:

> Absa believes that carriage fees are essential for consumer welfare benefits relating to ATM networks.[151]

In a similar way, Standard Bank initially argued against a direct charging model (calling it surcharging) on the following lines:

> We do not believe that a surcharging model would have any pro-competitive effect and would, in fact, have a negative social impact on the market for ATM services in South Africa.[152]

The implication was that the carriage model is essential to avoid these negative social consequences. However, by March 2007, Standard Bank was prepared to concede that:

> SBSA believes that the ATM infrastructure in South Africa may be sufficiently developed to eliminate the carriage fee and replace it with a model of direct charging…[153]

Subsequently Absa, having performed some additional analysis in anticipation of the possibility that a change to a direct charging model might be recommended, provided the Enquiry with constructive views on various ways in which such a change could in fact be implemented.[154] This was in September 2007, after FNB (in May 2007) and Standard Bank (in August 2007) had themselves undertaken preliminary studies and independently confirmed to the Enquiry's Technical Team the feasibility of the envisaged change.

The responses, considered together, lead us to conclude that the elimination of carriage and replacement with direct charging will not undermine interoperability, taking fully into account the continued need for high standards of technical reliability. At the same time, certain rules will be required to ensure accessibility and affordability.[155] Such rules are explored below.

5.6.3 Direct charging, accessibility and affordability

As indicated, some banks have raised concerns regarding the extent to which consumers may be placed at a disadvantage by a shift to direct charging.

Some of these arguments appear to link a shift to direct charging with other changes – such as the demise of the PCH agreement, for example. Standard Bank pointed to the complexity

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150 *Id.,,* p 10.

151 *Id.,,* p 12.

152 SBSA, October 2006, First Submission, p 58.

153 SBSA, April 2007, Second Submission, ATM transactions, p 9.

154 Absa, September 2007, Direct charging models for ATM's.

155 It is our view that balance enquiries could also be charged for directly, as well as the service of cash deposits at ATMs, although the latter would require some kind of agency arrangement with the issuing bank.

and large number of required negotiations that would pose a significant barrier to the entry of small banks[156]. In a similar vein, Absa talked of how smaller banks would need to invest in their own ATM network as they would be "unable to access the existing ATMs of other banks".[157] As has been stated before, the proposed change has to do with pricing, not with disrupting the other technical and commercial arrangements.

The key arguments raised against shifting to a direct charging model relate to the extent to which consumers will be assured an accessible and affordable ATM service from the network and the possible confusion arising from such a change. These are discussed below:

- **Accessibility**

  A number of the banks, including FNB, Nedbank and Standard Bank, acknowledged that direct charging would provide incentives to acquiring banks to deploy ATMs. This suggests that investment in the ATM infrastructure will not be adversely affected and that the accessibility of the ATM network for consumers will not be negatively affected, should such a change be made. In our view, the model creates incentives for banks to compete for ATM transactions and opens the possibility of non-banks to independently deploy ATMs. Hence we would anticipate more, rather than less, ATMs in the direct charging environment.

  We are not persuaded by the contrary argument advanced initially by Absa.[158] In particular, we reject the contention that, "[i]n the absence of carriage fees, banks will make decisions about the investment in ATMs on the basis of only their own customer base", and such investment would not be justified in rural areas where "banks may have insufficient customers of their own to justify investing in an ATM because transaction volumes will be too low."

  The assumption of the direct charging model is that ATM service providers (whether banks or non-banks) will serve all card-holding customers within a continuing interoperable network. The pricing flexibility that will accompany direct charging is, we believe, *more* likely to encourage ATM service provision in areas currently under-served, and where poor people often have to incur enormous additional costs and difficulties – including having to take taxis to other villages or towns – in order to get access to cash.

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156 SBSA, October 2006, First Submission, p 59.

157 Absa, March 2007, Second Submission, Access and Interoperability, p 12. A bank which refused to make its ATMs available on a direct charging basis to the cardholding customers of smaller banks while making them available to the bigger ones would likely face investigation for exclusionary conduct – quite apart from having to explain to its shareholders why it was foregoing the extra revenue.

158 *Id.*, pp 10-12.

- **Affordability of ATM transactions**

The banks hold different views regarding the effect a shift to direct charging would have on affordability. In its March 2007 submission, Absa pointed out that there was no certainty that consumer prices would be lower,[159] and reiterated this at the hearings.[160]

FNB associated direct charging with price competition among acquirers which would encourage "entry, competition and innovation".[161] FNB also noted that "Acquirers would have to offer transactions at market-accepted levels".[162]

Standard Bank were Nedbank are concerned that a shift to direct charging may lead to less affordability for those in remote areas. Nedbank stated that:

> In areas with lower population density, the impact of the increase in pricing to the card holder outweighs the benefit of access to more ATMs.[163]

We are not persuaded that the banks' weighing of the relative costs and benefits will correspond with that of consumers who are currently seriously deprived of cash dispensing services.

The possibility that an ATM provider could exploit its dominant position as a sole provider of ATM services by charging significantly more for the remote service than in an urban area, (price gouging) was raised by both Standard Bank[164] and Nedbank.[165] A higher charge may well be justified in a remote area – given the associated costs - as the banks themselves have pointed out.

Should a particular ATM provider make super profits in a remote location, it is likely that other service providers will enter and introduce competition. This is all the more to be expected if access to the market is opened up, under appropriate regulation to non-banks. Nedbank indicates that market forces may be undermined, however, as the viability of maintaining an ATM is highly dependent on the number of transactions initiated, and two ATMs may not be viable in such areas. (Note that research

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159 Absa, March 2007, Second Submission, Access and Interoperability, p 12.

160 Transcript 11 April 2007, p 7.

161 FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 5. Here one can logically take "acquirers" to be intended to refer to both bank- and non-bank ATM service providers.

162 FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 5.

163 Nedbank, March 2007, Second Submission, ATM transactions, p 21. Nedbank appears to be taking this view directly from the US literature on surcharging, which may not be strictly comparable with direct charging in South Africa.

164 SBSA, October 2006, First Submission, Standard Bank Voluntary submission to the Competition Commission Enquiry into Competition in Banking, p 58.

165 Nedbank, March 2007, Second Submission, Access and Interoperability, p 64.

suggests that a few hundred transactions a month can still ensure viability[166] – but of course such calculations depend on the actual price of such infrastructure, information which was not made available to the Enquiry.) It appears that Nedbank is discounting the likelihood that the costs will not be standard across all acquirers – which may well work in the favour of consumers. Price competition in remote areas may well be more vigorous should non-bank ATM providers be permitted to operate independently of a sponsoring bank.

With regard to the compensation banks would receive from direct charging, we do not see any reason why they would be unable to fulfil their ATM commitments in terms of the Financial Sector Charter.[167]

- **Uncertainty for customers resulting from differentiated pricing**

  The banks have pointed out that currently, within a particular market segment, their customer prices are standardised, regardless of when or where a transaction is initiated at an ATM. They have accordingly raised the possibility that under direct charging arrangements, cash providers may charge differentially, depending on the location, time of day and issuer.[168]

  The last can perhaps be most easily dealt with: It appears to be commonplace that where direct charging (as opposed to surcharging) is adopted elsewhere in the world, a rule of non-discrimination on the basis of issuer holds. Such a rule would prohibit price discrimination on the basis of the issuing institution in off-us transactions, something that has been raised as a concern by smaller banks.[169]

Should this rule be instituted as we have recommended above, then the other possible variations of differentiating in price for peak hours, or remote areas remains. Such differentiation would not necessarily be anti-competitive, and could indeed serve to increase output and ultimately lower price. At the same time it is worth noting that differentiated ATM pricing for time and place is unprecedented in South Africa – although clearly possible under the current arrangements – and banks would have to consider the possible consumer backlash should they make such a move. The only differentiated pricing that currently may have geographical implications is Absa's higher pricing structure for ATM Solutions ATMs, which are sponsored and branded

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166 See for instance, data from the US which suggests that technology has advanced so that a mere 300 transactions per month make an ATM viable (*ATM Cash Machines*, 2007) and data on cash machines in the UK, which suggest that non-bank owned ATMs typically attract 550 withdrawals a month (www.apacs.org.uk).

167 These commitments are listed, for example by Absa, October 2006, First Submission, p 19.

168 SBSA, October 2006, First Submission, p 58, Absa, March 2007, Second Submission, ATM transactions, p 9.

169 See e.g. Capitec, March 2007, Second Submission, Supplementary Submission to the Banking Enquiry, p 2.

by Absa.[170] These ATMs look distinct from Absa ATMs, although they carry the Absa brand, and are more likely to be located in remote areas. Hence customers in remote areas that currently bank with Absa are probably paying more for their ATM transactions than Absa's city-dwelling customer base.[171]

While bank customers may have a feel for the pricing of their own bank's ATMs and even the pricing structure for off-us transactions, the ability to state these precisely is highly unusual.[172] Direct charging would have the advantage that at the time of the transaction, the consumer would be told the amount of the direct charge.[173] If the bank charges a processing fee over and above this, the consumer would probably only know the value later. While this falls short of full disclosure, it is at least much more information than is currently presented to the consumer at the time of making the cash withdrawal. In spite of this, banks have made much of the customer uncertainty that will result with direct charging.

Capitec, for example raised the following:

> The introduction of a surcharge in South Africa will create uncertainty among users of ATMs. It is not a concept we are used to and it may take a long time before it is fully understood …. One concern is that there may be factors that are used in setting surcharge fees that may discriminate against smaller banks, individuals or service areas …. It is therefore possible that every ATM may charge a different fee; some ATMs may be free, at others it may vary from town to town or even suburbs … Unsophisticated and illiterate users of ATMs may not be aware of the cost implications when using the ATM. Illiterate persons may not comprehend the effect of the surcharge with the transactions, paying more than [they] expected.[174]

The uncertainty that consumers will have to deal with is of course associated with the extent to which banks themselves institute price differentiation for time and place. Hence while they make much of this, it will be entirely in the hands of the banks individually how much price uncertainty is generated, as they currently have exclusive right to acquire ATM transactions from consumers and hence levy fees. It is perhaps worth noting that the current fee structures are not necessarily comprehensible to even sophisticated customers.

Of course it is possible that, should independent non-bank ATM providers be permitted to acquire ATM transactions, they could have highly differentiated pricing, based on time and location. The extent to which this would generate consumer resistance would have to be weighed up by the service provider against the possible benefits of such an approach.

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170 A premium of R2.80 is charged for each ATM transaction from an ATM Solutions machine. Absa, October 2006, First Submission, p 8.

171 This was confirmed by ATM Solutions in the hearing on 11 April 2007, in which Mr Kark confirmed that "a significant proportion of the machines provided and serviced by ATM Solutions are in rural and otherwise underserved areas", p 27.

172 Kaufman Levin Associates, July 2007, Research Presentation.

173 And we recommend that the consumer must have the option to cancel the transaction free of charge, should the disclosed price be unacceptably high.

174 Capitec, March 2007, Second Submission, Supplementary Submission to the Banking Enquiry, p 2.

5.6.4 Direct charging and the smaller banks

A possible negative outcome of the model is that smaller banks might be less able to attract new customers, as their smaller ATM infrastructure will militate against their offering a meaningful discount to their customers for on-us transactions. Nedbank, for example, has stated that direct charging will lead to customers being attracted to banks with bigger ATM market shares.[175]

There are two parts to this argument.

First, while it is impossible to predict the extent to which banks will offer their customers on-us discounts, it is a feature of the current model that customers of smaller banks already experience the disadvantage of a smaller ATM infrastructure, since they would be paying the disincentive fee over and above the standard cash withdrawal fee in more instances. Such customers must thus have reasons for signing up with smaller banks that outweigh the disadvantage of a small on-us ATM infrastructure.

Second, while direct charging will create a new dynamic, the assumption that appears to be implicit here is that banks will use the off-us revenue of the direct charge, as well as other customer account fees, to discount – or apparently discount – on-us ATM transactions. This will attract those customers who typically rely on many cash withdrawals. If this amounts to an abuse of dominance, it will need to be tackled as such.

However, if lower prices on the part of bigger banks are simply the result of competitive efficiency brought about by economies of scale, this should be seen as a positive competitive outcome for consumers. Although the adoption of a direct charging model will remove the shelter from relative inefficiencies, this is not an adequate basis to resist the change. As in other markets, when competitive forces prevail, smaller players have to rely on advantages such as flexibility, innovation and entrepreneurial drive in order to out-compete larger incumbents.

Some banks impress upon consumers the benefits of other electronic transactions, which avoid the need for multiple cash withdrawals. Hence one cannot assume that all customers will switch merely for the benefit of cheaper on-us transactions.

At the same time, each bank's price for the direct charge for off-us transactions – which we assume will be standard for all card holders[176] – will have to be pitched so as to maximise the usage of their ATM infrastructure, whether by their own or other bank's cardholders. Hence there is a good prospect that competitive forces will bring ATM prices down.

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175 Nedbank, March 2007, Second Submission, ATM transactions, p 21.

176 If a rule of non-discrimination on the basis of issuing institution is put in place, as we recommend.

5.6.5 Conditions for success of the model

There are two possible phases associated with a switch to direct charging: the first relates to the adoption of the direct charging pricing model and the second relates to allowing non-bank providers into the network. As noted before, the latter is not a foregone conclusion, but is a possibility that may arise – and in our view ought to be allowed – when the direct charging model is introduced.

The following appear to be necessary requirements should the direct charging model be adopted:

- **Industry-wide education**

  The shift to direct charging will require consumer education, the cost burden of which would fall to the banks.[177] FNB has pointed out that changes to transaction processing are high risk in terms of customer knowledge and understanding etc.[178]

  Since this would amount to a substantial change, there would be a need for education through different media and the process may require personal interaction in less sophisticated client cohorts.[179]

- **Disclosure standards**

  Disclosure standards should include requirements for disclosure on ATM screens and the option for consumers to opt out free of charge once the direct charge has been shown. It would also need to be designed to minimise confusion for consumers resulting from changes to their previous ATM experience. Lessons from the UK indicate that these standards need to be agreed upon prior to implementation.

- **Agreed clearing and settlement procedures**

  Such procedures should allow the acquiring bank – or non-bank provider whether directly or through a clearing bank – to recoup its direct charge at settlement, along with the value of the cash dispensed, from the customer's (i.e. the issuing) bank.

- **Software and possible hardware upgrades**

  Both banks and Saswitch (Bankserv) would need to make some changes. For example, banks would have to allow for direct charging disclosure screens on ATMs. Saswitch would have to be able to facilitate two claims for each off-us transaction – the amount of the cash dispensed and the amount of the direct charge. Moreover,

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177 See, for example, Grim and Balto, 1992.

178 FRB, March 2007, Second Submission, ATM transactions (Initial Questions), p 5. However, it should be pointed out that the banks do change their ATM interface from time to time, but do not necessarily re-educate consumers in this regard. Hence they may be overstating the case.

179 Absa, September 2007, Direct charging models for ATM's, pp 21-22 for example sets out a number of media and formats in which this education could take place.

the calculation of carriage would have to be eliminated. The facility to be able to track transactions would also be necessary.

- **The establishment of dispute resolution mechanisms**
  These mechanisms would form part of the arrangements associated with the PCH agreements between network providers. They would deal with matters such as which institution would be the first port of call for the consumer should there be a false transaction, or insufficient funds dispensed. Up until now, the consumer had no commercial relationship with the off-us cash dispenser, and would have automatically consulted his or her issuing bank should such queries have arisen. If direct charging comes into force, it is possible that the issuing bank may feel it has no incentive to sort out queries on behalf of the customer. Experience elsewhere suggests this is unlikely.

- **The establishment of network rules**
  This would include rules identified here as necessary for the success of the model, such as:
  - no discrimination between issuers in off-us transactions
  - arrangements to accommodate Mzansi cardholders (who are currently not charged an extra fee for off-us transactions)
  - arrangements for holders of payment cards issued abroad.

Should the adoption of the direct charging model be followed with a move to allow direct participation by non-bank providers, additional measures and concerns would have to be addressed. This would include changes to the ATM PCH agreement and the clearing rules. (This matter is dealt with at length in the chapter on Access to the Payment System, and only a few brief points are raised here.)

Participation by non-banks could take the form taken in the UK (through the establishment of a separate scheme such as LINK) to manage such an arrangement. This route would require a change to the PASA constitution to allow for a combined bank and non-bank scheme to be established under its auspices, and hence a change to the NPS Act. The establishment of an ATM scheme would require criteria for entry that would be objectively applied by the executives of such a scheme. This is further discussed in the chapter on Access to the Payments System.

As discussed in the chapter on Access to the Payments System, we consider that duly qualified non-banks should be able to become full participants in the clearing and settlement process of appropriate payments streams. While not necessarily becoming settlement participants, non-banks could alternatively acquire transactions, and present them to the switching operator, Saswitch, while still having a banker that would settle on its behalf. Should such a route be followed, provisions of the NPS Act would have to be clarified as

would certain clauses in the PCH agreement which relate to restrictions on the nature of the relationship between banks and non-banks in the ATM PCH.

5.6.6 Direct charging and FICA implications

It has been pointed out that the Financial Intelligence Centre Act, 38 of 2001 ("FICA") may pose a challenge to a change to direct charging for ATM services.[180] However, there is also a view to the contrary.[181] In our view, any possible challenge is no more than a technical anomaly which serves no policy objective, and can be overcome by a simple regulatory intervention on the part of the Minister of Finance.

In Mr Grobler's (of the Banking Association) opinion, the challenge can be cured by a special exemption from the National Treasury. In our view it would be a simple matter for such an exemption to be promulgated,[182] so as to exempt accountable institutions from compliance with the provisions of FICA in respect of a category of transactions[183] – namely single transactions[184] – in which the accountable institution provides an ATM service to a client using for the purpose of the transaction a card not issued by or on behalf of that accountable institution itself.[185]

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180 Memorandum by Stuart Grobler of the Banking Association, dated 23 April 2007 (File Ref: 35265), furnished to the Enquiry on 11 May 2007. He explained that "All 'accountable institutions' (which includes banks) are under statutory obligation to identify and know-the-client whether they are in an ongoing business relationship together, or whether the institution performs a "single transaction" that is not part of such an ongoing relationship…[W]ith the proposed direct charge model, the ATM owning (or acquiring) bank will be charging the client of the other (issuing) bank a direct fee, presumably recovered from his/her bank account via the switch network. In this case, the acquiring bank is no longer the agent of the issuing bank, but there is a direct banker-client relationship between the acquiring bank and the ATM-using client, for the single transaction. There is therefore an obligation under FICA…." (pp 1-2). The view that there may well be an obligation under FICA and reasons for such a view are considered in the Appendix to this report on FICA and Direct Charging.

181 Opinion by Adv. MD Kuper SC, in which he writes "The purpose of FICA is to combat money laundering activities and terrorist activities by establishing a Financial Intelligence Centre which can identify the proceeds of unlawful activities and make information available to the relevant authorities. An effective method of advancing these objectives is to require banks to verify the identity of their clients or those who act for their clients. This, no doubt, facilitates investigations into money laundering and the financing of terrorist activities. However no purpose can be served by requiring another bank which does not do banking business with the person concerned to undertake a like verification exercise. The Financial Intelligence Centre by definition already has the necessary information, or access to the necessary information, from the verifying bank which does have a banking relationship with the relevant individual. How can this purpose be further served by requiring duplicate or triplicate information from other banking institutions which are not involved in any banking business with that person?" (Submitted by the National Treasury, November 2007, *Legal nature of inter-bank charging relationships. Section 21 of the Financial Intelligence Centre Act, no 38 of 2001,* p 12.*)* Having regard to this context, Mr Kuper concludes that the customer in an off-us ATM transaction is not a "client" of the bank providing the ATM service in the sense contemplated by FICA, and that FICA therefore would not apply to the transaction so far as that bank is concerned.

182 As is pointed out in paragraph 3 of the Financial Intelligence Centre's guidance note issued by way of Government Notice 715 in *Government Gazette* 27803 of 18 July 2005, FICA and the regulations "require that banks identify all clients with whom they do business unless an exemption applies in a given circumstance."

183 See section 74(1)(*b*) of FICA.

184 A "single transaction" is defined in section 1 of FICA as meaning "a transaction other than a transaction concluded in the course of a business relationship".

185 A qualification as to the maximum value of such exempted transactions would, we think, serve no useful purpose – having regard to the fact that the issuing institution would or could in any case impose its own limits on ATM transaction values, and would in each instance authorise (or decline to authorise) electronically the amount of cash to be dispensed or other payment undertaken through the ATM.

It should be noted that the opinion submitted to the Enquiry on behalf of the National Treasury dated 30 November 2007, concludes that an exemption would not be necessary. Absa also appears to share this opinion when it states "We are of the view that there will not be any FICA implications as a result of the introduction of a direct charging ATM model".[186] Should the National Treasury issue a statement to this effect on which banks could firmly rely, the need for a special exemption may be avoided.[187] Either way, certainty needs to be created for the industry in this regard.

An exemption – or statement of clarity by the National Treasury – would not undermine the anti-money laundering objects of FICA, inasmuch as, whenever an ATM is used to effect a withdrawal, transfer or addition of funds held on deposit to the credit of a cardholder, the accountable institution which issued the card and which keeps the customer's account would have been obliged in terms of FICA – and would remain obliged – to establish and verify *inter alia* the client's identity, and to maintain the prescribed records of the transaction.[188] Each ATM transaction, even when carried out off-us, involves at the same time a transaction between the issuer and the cardholder as its account-holder in connection with the use of the card. An exemption for off-us ATM transactions of the kind suggested would thus not reduce the intended effectiveness of FICA in bringing about the proper detection and reporting of suspicious transactions.

5.7 Direct charging, mini-ATMs and cash-back

While we do not believe that the case for direct charging stands or falls on its ability to also deal with mini-ATM cash withdrawals and cash-back at point of sale, they are frequently touted as alternatives to ATM cash withdrawals. Accordingly, the existence of carriage needs to be examined here as well.

5.7.1 Direct pricing and mini-ATMs

A mini-ATM is a cashless device that is initiated as if it is a self-service activity, but requires the assistance of the merchant to fulfil the transaction. It is supported by the cash floats of merchants.

As in the case of ATMs, the mini-ATM carriage that flows from the issuer (who issues the card and charges the customer) to the acquirer (who provides the service and negotiates the

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186 Absa, September 2007, *Direct Charging models for ATMs*, p 19.

187 It should also be noted that the Financial Intelligence Centre Amendment Bill (B18 of 2008) has recently been published. If enacted, it would make provision (under a new section 43A of the principal Act) for the Financial Intelligence Centre or a supervisory body (after consultation with the Centre), where a category of accountable institutions is concerned, to issue by notice in the *Gazette* directives regarding the application of the Act. This may itself provide a basis for resolving any uncertainty. In terms of Schedule 2 of FICA, the SARB would appear to be the relevant supervisory body in this case.

188 Unless exempted, for example in terms of the above-mentioned paragraph 17.

placement of the mini-ATM in the merchant's store), appears to be a compensation from the issuing bank to the acquiring bank for the use of infrastructure by the issuing bank's customer.[189] Once again, this is not a balancing payment between two sides of a market, in other words it is not a form of interchange, but merely the payment for an outsourced facility, that happens to have been agreed upon within the interbank space.

For these reasons, the direct charging approach appears applicable to mini-ATM transactions as well. Nevertheless, we do not consider it advisable to recommend such a change for mini-ATMs at this stage.

The submissions of the banks have raised aspects regarding mini-ATMs that need to be considered. These include the fact that:

- Mini-ATMs are in their infancy and the existing model of carriage provides appropriate incentives for the roll-out of these machines – while taking into account the risk associated therein[190]
- Merchants are not regulated and hence cannot be trusted in imposing a direct charge[191]
- The implications are not fully understood.[192]

Confidential: Absa

Various submissions confirmed the view that mini-ATMs are in their infancy. While no bank appeared to accept the notion that ATM themselves now represent a mature market, it is fair to say that the mini-ATM cash dispensing mode is new. However, there is some contention as to whether or not the existing model of carriage provides appropriate incentives for the roll-out of these machines and whether or not it takes into account the risk associated therein.

Standard Bank's view on mini-ATMs was ambiguous[193] and involved pointing out how the clearing rules in the ATM PCH are *not* adequate to deal with the possible additional risks introduced by merchants. Moreover, MasterCard and Visa have not certified mini-ATM devices. In addition, Standard maintains that some central banks have banned mini-ATMs. However, Standard is itself experimenting with AutoMoney devices, which are mini-ATMs. Hence, while it appears that Standard does not believe the current arrangements deal with the possible risks, it appears to be arguing for the status quo with a slight tweak (for instance

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189 There is, of course, no reason why suitably qualified non-banks couldn't directly offer mini-ATM services, just as they could offer ATM services.

190 SBSA, April 2007, Second Submission, ATM transactions, p 37.

191 *Id.*

192 Absa, September 2007, Direct charging models for ATM's, p 23.

193 Contained in SBSA, April 2007, Second Submission, ATM transactions, pp 22-25 and pp 37-38.

by placing mini-ATMs in a separate PCH, or with that of debit cards).[194] It also maintains that due to technical limitations, no participants in the ATM PCH can distinguish between mini-ATM and ATM transactions,[195] and so while cheaper carriage fees have been negotiated with mini-ATM providers, customers are charged the same as for the full ATM service.[196]

FNB, on the other hand, having rolled out more than 1300 Mini-ATMs, is emphatic as to their positive benefits. It sees this as a substitute channel for full ATMs in areas where remoteness and low density population cannot support the more expensive infrastructure. Mini-ATMs have played an important role in ensuring that FNB is able to meet its FSC obligations.[197] FNB also claims that the current arrangements have *not* led to the appropriate carriage being set:

Confidential: FRB

> FRB's competitors have been reluctant to pay what FRB sees as a fair carriage fee, covering at least the costs of service provision. Due to FSC commitments and its aim to provide access to low-income customers, FRB made the strategic decision to continue to provide off-us withdrawals, rather than risk the service not being available to large numbers of consumers who would benefit from these facilities. The level of carriage fee negotiated is not sufficient to allow the mini-ATM network to fully cover its costs, although off-us transactions do make a positive contribution.[198]

The irony is that the mini-ATM carriage fee that FNB has negotiated with its larger competitors (in one case as high as R2.50) is substantially greater than the default fee (of 25 cents) that a smaller bank would receive should it roll-out mini-ATM devices. Indeed, one of the non-bank providers, Smart ATM, is in such a position, where the smaller bank through which it operates by way of an outsourcing relationship has been unable to negotiate a carriage fee above the default for Non ATM Devices (NADs). The NAD default carriage fee of R0.25 was imposed sometime after Smart ATM had been operating under the auspices of the ATM PCH through its sponsoring bank. At the time, Smart ATM had negotiated an 80 per cent share of the ATM carriage fee, which was subsequently massively reduced to the default NAD fee after mini-ATMS were reclassified as such by PASA.[199] If it is true that most banks in the ATM PCH cannot distinguish between ATM and Mini-ATM transactions, then while a carriage of R0,25 is paid away to the acquirer, the issuing bank charges the customer the full fee for an off-us transaction (on average in excess of R11).

While this bears out the concerns that are discussed more fully elsewhere about the problems of leaving interbank fees to be negotiated on a bilateral basis, it also raises the question as to why such a fee needs to be determined within the interbank space at all.

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194 SBSA, April 2007, Second Submission, ATM transactions, p 22.

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

196 SBSA say they will be getting this soon. FRB appears to have it as they do mention lower customer fees for mini-ATMs.

197 FRB, March 2007, Second Submission, ATM transactions, p 4.

198 FRB, March 2007, Second Submission, ATM transactions, p 4.

199 Smart ATM, May 2006, The National Payment System and Competition in the Banking Sector, p 1.

As for the conduct of merchants, the concern is that it would be "difficult to monitor, detect and act against instances of customer abuse by literally thousands of merchants".[200] In the case of banks or registered ATM providers – so the argument goes – ensuring good conduct is far simpler. While this may be true, it is a frequent theme of the banks to presume that they alone have some kind of commitment to protecting consumers – while all other purveyors are to be considered suspect. However, the evidence does not support such a view. The potential dangers of a merchant in an outlying area abusing his or her dominance in the provision of mini-ATM cash dispensing is probably not very different from such abuse in the provision of any other good or service. There may be some abuse, but consumers are themselves reasonably savvy and abuse of cash dispensing services may lead to the loss of considerably more business than the merchant had bargained for. It is also unclear precisely what is meant by this abuse. Higher pricing by a sole trader in an outlying area may well occur – but is this necessarily abuse of the customer? The banks themselves have argued that they will feel at liberty to charge different prices for ATM services in more remote areas.

The point regarding the possibility of fundamental changes with financial consequences for a number of players is well made. The implications of having direct charging for mini-ATMs have not been fully considered by this study and there may be other issues which require further consideration. If carriage is to be retained in relation to mini-ATMs, then the appropriate carriage fee should be determined through an independent process, comparable with that which is proposed for the setting of interchange. This is outlined in the chapter on Payment Cards and Interchange.

However, the mini-ATM payment channel remains an example of how poorly the existing interbank and accompanying regulatory arrangements operate – arrangements that is, with regard to rule-setting in the PCH, process management dealing with banks and non-bank operators and both interbank and customer pricing. While banks say that mini-ATMs can improve the cash dispensing services to many of those currently underserved by branch and ATM facilities, they do not generally appear to have played as constructive a role as possible in ensuring this.

5.7.2 Direct charging and cash-back at POS

One of the anomalies of the South African retail payments system, which is highly sophisticated and interoperable, is the apparent delay in the facilitation of cash-back at point-of-sale. In less sophisticated payments environments, this feature became available more-or-less in line with ATM rollout as an attempt to provide consumers with alternative cash-dispensing services.

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200 SBSA, April 2007, Second Submission, ATM transactions, p 38.

In the UK for example, this was a widely used feature from the mid 1990s. In South Africa, this functionality is still in its infancy and hardly marketed at all. Indeed, only two large retailers (Pick n Pay and Shoprite Checkers) have instituted the facility, and it applies only to debit card transactions.

There are various reasons for this – including resistance to rolling-out a substitute for the ATM network which might undermine its profitability. Another must have to do with the uncertain application of the MasterCard and VISA rules prohibiting pure cash-back transactions (those not accompanied by a purchase). The VISA and MasterCard rules in this respect, and the extent to which they are observed in South Africa, are discussed in the chapter on Payment cards and Interchange.

As appears to be the case with mini-ATMs, there is little to support the view that those involved have done all that they might have done to support the development of this service.

However, adoption of direct pricing for cash-back at POS is complicated by a number of realities. As the banks are quick to point out, the POS device exists for a different reason – primarily to allow the processing of debit and credit card transactions – which clearly affects the economics and viability thereof. Hence, while dispensing of cash at a till may be highly effective, ultimately such cash dispensing would need, for the most part, to be accompanied by a purchase for it to make sense for the retailer.

The carriage for cash-back takes into account the following considerations:

- The retailer has cash at its premises (hence cash does not have to be supplied from elsewhere)
- The retailer adds to its revenue and reduces its overall cash handling costs by dispensing cash-back to customers as a service
- The investments in POS devices have already been made (typically by the retailer) and so no new investment is required.

These considerations have led to a far lower carriage fee in the case of cash-back at POS than in the case of a typical ATM withdrawal. (See Table 5.)

Given the infancy of cash-back at POS, and the dearth of information available to us in this regard, we are not in a position to draw conclusions as to whether carriage could effectively be replaced by a direct charging model in these contexts. We therefore recommend that the Competition Commission revisit this question once adequate experience has been obtained of direct charging in ATM services and consider at that stage the case for and against extending the direct charging model.

In the meanwhile, we recommend that the independent process of carriage setting referred to in connection with mini-ATMs above, be adopted for cash-back at POS.

5.8 International precedent and learning

Two countries – the UK and Australia - provide recent international precedent for the adoption of the direct charging model.

5.8.1 ATM pricing models in the UK

In the UK, direct charging was implemented as a dual alternate system in 1999. ATM providers have a choice of charging carriage, through interbank arrangements, or imposing a direct charge on the customer. The key reason given for the dual approach has to do with the historical adoption of the so-called “free banking” model, where customers are typically not charged by their banks for payment services if they have positive balances in their accounts (on which no or low interest is earned).[201] There has been considerable consumer resistance to any moves away from this model.

The implementation of direct charging in the UK was associated with non-bank ATM providers gaining access to the network. This also dates back to 1999.

A scheme to allow for non-bank membership, known as LINK, was set up to manage arrangements. LINK has allowed for two pricing alternatives – one where carriage is retained (used by almost all of the banks in the network) and another where a direct charge is imposed on the consumer (used by non-banks). Where carriage is retained, the consumer experiences the cash dispensing service as “free-to-use”. This makes the ATM service provided by non-banks, for which a direct charge is levied, seem more expensive even if it isn’t – a situation far from ideal for competition.

The carriage fee model is dominant. Of some 60,000 ATMs in the UK, 35,000 are “free-to-use” and 25,000 charge a direct fee. Not surprisingly, 96 per cent of all ATM transactions are carried out through the “free-to-use” ATMs while only 4 per cent of the transactions are facilitated through the charging ATMs (the 25,000). Each ATM operator has a choice as to which of these two models it wants to apply. Most banks have only “free-to-use” ATMs, while the independent operators use the direct charging model. One of the banks does have pay-to-use ATMs, but these ATMs are deployed under another brand.[202] In most cases there would be no charge to the consumer if they used a bank-branded ATM, whether it was an

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201 This was confirmed by the Office of Fair Trading in a tele-conference with the Enquiry’s Technical Team on 17 May 2007. The description of the current situation given in this section is our understanding of the situation at the time the information was received.

202 PayStrat, 2007. Notes on the conference call held with BASA and LINK, 6 June 2007.

on-us or off-us transaction; however, if the consumer used the ATM of a non-bank, he or she would be charged a fee, as shown on the ATM screen, prior to the transaction.

Non-banks employ the direct charging model, as they find carriage levels too low. Double charging is prohibited, so a choice needs to be made between direct charging and carriage. A non-bank typically sets its direct charge at around GBP1.50 to GBP1.75 per transaction. This is a flat fee, and *ad valorem* rates are uncommon. The non-bank ATMs tend to be deployed in convenience areas, within pubs and stores rather than in the high street. While only 4 per cent of all ATM transactions are made through these direct charging non-bank machines, the non-banks still find the business profitable.

Almost all of the banks' ATMs are "free-to-use" for customers of other banks;[203] however, the issuing bank will be obliged to pay the acquiring bank the applicable "interchange" (i.e. carriage fee). One bank currently employs the direct charging method for other banks' customers, but this is unusual. This particular pricing structure has led to most banks expanding their ATM network so that they can avoid having to pay the carriage. There may accordingly be over-extension of ATMs in some areas, while in other areas, the lack of viability of the "free-to-use" model has meant that there are relatively few bank ATMs. Commercially, banks have found the entry of non-banks to be acceptable. When a customer uses a non-bank ATM, the interchange is saved and the customer is charged directly.

LINK

There are currently 49 members of the LINK Scheme. New members are required to meet certain criteria, such as an evaluation of the business, the ability to ensure data protection and a viable business plan, which is discussed only with the Director of the Scheme. Existing incumbents are not consulted on the applications of new entrants, the decision rests with the Scheme's executive.

LINK is divided into two distinct entities – the Scheme and the Company. The Scheme deals with inter-member trading issues and the rules of the game. There are three categories of membership: issuer only, acquirer only and issuer and acquirer.[204] The Company is owned by 23 member banks and is a for-profit company that provides services to LINK scheme members under the rules set by the scheme.[205] Like Bankserv, the LINK Company competes for switching business against VISA and MasterCard, and is currently cheaper.

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203 Prior to 1999, it appears a "foreign fee" of around GBP 1 was charged. Barclays, for example scrapped this on 5 July 1999, for most customers. Press release available on http://www.prnewswire.co.uk/cgi/news/release?id=42580.

204 This could be likened to the PASA Payments Clearing House for ATMs and its associated PCH Participant Group.

205 This could be likened to the Saswitch processing capability owned by Bankserv.

The carriage fees are set to recover acquiring costs, and the costing method employed includes items such as the cost of cash, rental space, IT costs, maintenance, telecoms and hardware costs. The data for both banks and non-banks are included in the annual costing study and four carriage levels are set: branch and non-branch cash withdrawals and branch and non-branch balance enquiries and reject fees.

The carriage for branch ATM cash withdrawals is currently set at around 20 pence and that for non-branch cash withdrawals at 31 pence. Balance enquiries or rejection fees at a branch ATM are around 10 pence and balance enquiries or rejection fees at a non-branch ATM are just under 20 pence.[206] KPMG is currently the consultant commissioned by LINK to undertake the costing study.

In a tele-conference with the Office of Fair Trading (OFT) and the Enquiry's Technical Team, the OFT pointed out that the carriage fee approach was allowed to be retained only because of the so-called "free-banking" model in the UK and consumer resistance to a change in this regard. The trade-off imposed on the industry for maintaining the carriage fee was that it would be set on the basis of an independent study, as described above. It was also pointed out that since the costing studies have been conducted, the carriage fee has been set at progressively lower levels.

We are advised that lessons relating to the adoption of the direct charging model in the UK include:[207]

- With better handling and enforcement in the early stages of the expansion of the LINK membership, the reputational risk brought about by a few non-banks could have been avoided. The risk resulted from failure to disclose the direct charging approach adequately, while charging the client. This has now been addressed by setting requirements for disclosure to clients – such as minimum font size on the screen – and an opt-out choice for the consumer should he or she not accept the direct charge, and so on.
- In retrospect, the criteria for non-bank entry should perhaps have included safeguards on the probity of the business. While no non-bank has failed since membership has been extended to them, capital requirements would give the executive of the LINK scheme greater comfort.

The following is an extract from the Banking Association of South Africa (BASA) submission to this Enquiry relating to the implementation of the direct charging model. In the course of

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206 These data have been confirmed by Mr. Edwin Latter of LINK and Mr. Paul Smee of APACS, in interview on 11 June 2007.

207 As raised by Mr. Edwin Latter of LINK , in interview on 11 June 2007.

its own investigation, BASA posed certain questions to LINK, and received answers as follows:[208]

How easy / difficult was it for the banks to change agreements & rules to incorporate carriage fees and direct charging?
Issuing banks have been fairly relaxed regarding the implementation of surcharging [direct charging] as it saved them the carriage that they would pay in the alternative.

Was the establishment of a set of minimum criteria with regard to direct charging not viewed as anti-competitive?
No, the establishment of minimum criteria was not a problem.

Who set the criteria?
The scheme facilitated sessions between the banks and independent operators, who jointly agreed the rules.

Why has the OFT prohibited double charging? Was it ever allowed or was it uncommon?
Double charging was initially allowed. However, as a result of the political pressure relating to this practice, it was later discontinued.

How were the Association rules (Visa & MasterCard) prohibiting ATM surcharging addressed?
The Association rules were ignored as the transactions are facilitated via Link and not through the Associations.

Are there any agreements between the Issuers and the Acquirers as to the level of direct charging that the Acquirers may apply?
No.

Can the Acquirer apply different direct charges in terms of:

Different Issuers, e.g. having preferential agreements with large Issuers versus small Issuers? If so, what was the impact of this on the smaller Issuers?
Scheme rules do not allow for differentiation between Issuers.

Different times of the day, e.g. charging a higher surcharge during peak periods?
There is no restriction to such differentiation. It is however not something that is done.

Different locations, e.g. having higher surcharge in rural areas which have low transaction volumes?

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208 In their telecom of 6 June 2007. Note that the terms carriage and direct charging have replaced the terms interchange and surcharging, for consistency.

> Direct charging does differ per location as mentioned earlier. In exclusive locations, the fee may be higher. However, in low income areas free-to-use ATMs are being deployed due to political pressure.

In contrast to South Africa, where each existing PCH member has to provide written permission for a new entrant to operate in the payment stream, in the UK the LINK executive applies the criteria for entry into the scheme objectively. The decision to permit entry is not referred to existing members.

5.8.2 Direct charging in Australia

From 1 October 2008, the direct charging model will be adopted in the Australian ATM networks. This is a consequence of an industry agreement reached in August 2007.[209]

The stimulus for change arose from the concerns expressed in a 2000 review, and reiterated in 2005, by the Reserve Bank of Australia and the Australian Competition and Consumer Commission, regarding the bilaterally negotiated carriage fees at the time. In particular, a substantial mark-up on off-us fees was seen to persist owing to a lack of competitive pressure in the setting of the fee.[210]

The length of time that the Australian industry took to consider the move to the direct charging model led some to suggest that they must be having doubts about such a move. For instance, both Nedbank and Absa cast doubt during the hearings in April that the direct charging model would ever be adopted across the Australian industry.[211] Within a few months, they were contradicted.

The changes agreed to by the Australian industry include liberalising access to the ATM network.

The key elements of the proposed system are:

- The development of objective and transparent entry requirements, and the obligation of incumbents in dealing with new entrants
- The clear disclosure of any charges levied by the ATM owner before a customer proceeds with a transaction

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209 RBA, 2007, Reform of the ATM System in Australia. Media Release, 31 August.

210 CRA, 2007. Implementation of direct charging in Australia. Submitted by ABSA.

211 See Transcript 4 April 2007, p 64 and Transcript 11 April 2007, p 211-212, respectively. For example, Mr Norton (for Absa) stated: “I think the industry has moved away from that proposal and the current proposal as I understand it, that is on the table in Australia, is the retention of bilaterally negotiated interchange fees but with oversight by the Reserve Bank in Australia to ensure that those fees are at the appropriate level. That seems to us to be the position in Australia after sort of lengthy and careful consideration of the very similar issues that you are looking at today, and it might be helpful for the panel maybe to have regard to the Australian experience because it may have some bearing on your deliberations”.

- The abolition of bilateral interchange (read carriage) fees paid by banks and other financial institutions to ATM owners for the provision of such services.

The carriage fee in Australia is typically around Aus$1, and as elsewhere is seen to be objectionable as the fees are:

> ... neither transparent to customers nor subject to the normal forces of competition. With these fees abolished, ATM owners are free to charge customers who use their ATMs, but must disclose the fee, increasing the overall transparency of pricing.[212]

At the time of writing, the self-regulatory code for the new model had yet to be finalised by APCA (the Australian Payments Clearing Association). It is expected that the code will forbid discrimination by issuer. APCA currently has 80 members including the Reserve Bank of Australia, building societies, credit unions and banks.

In addition, it is expected that issuers will be able to charge a fee to their customers for the processing work they have done. Currently, issuing banks pass on the carriage fee to customers when they make use of another institution's ATM, with a fee that is typically between AUS $1.25 to AUS $2. This is considerably higher than the on-us fees imposed on customers, ranging from 20 AUS cents to 50 AUS cents.[213]

The lessons from the Australian case are that:

- Other jurisdictions are uncomfortable, as we are, with interbank fees that are sheltered from competition. Moreover, competition does not appear to be advanced by the bilateral negotiation of such fees
- The direct charging model clearly appears to be entirely feasible
- Access to the network by non-deposit-taking institutions is both conceivable and supported by the shift to direct charging.

5.8.3 Surcharging in the United States

The discussion above has excluded any examples from the US, where a system combining surcharging and carriage exists.[214] In our view, this is not a particularly functional model, nor

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[212] RBA, 31 August 2007, Reform of the ATM system in Australia, Media release.

[213] CRA, 2007. Implementation of direct charging in Australia. Submitted by Absa.

[214] The element of carriage faces ongoing legal challenge. In *Brennan et al v Concord EFS Inc. et al* 369 F.Supp.2d 1127 (N.D. Cal), plaintiffs claimed that banks and others owning ATMs in the Star ATM network committed violations of section 1 of the Sherman Act by setting fixed "interchange" (i.e. carriage) fees in off-us transactions. This constituted – so it was alleged – horizontal price-fixing. The plaintiffs relied purely on the defendants' conduct being condemned *per se*, and disclaimed any intention of proceeding on a "rule of reason" theory. The defendants moved to dismiss the action before trial on the ground that Star was a pro-competitive cooperative joint venture subject only to rule of reason analysis. This contention was rejected, and the motion to dismiss on this ground failed. Walker, Chief Judge, after an extensive review of the US authorities, held that horizontal restraints in the context of a pro-competitive joint venture "remain unlawful per se unless they are necessary to (or, in certain formulations, 'reasonably ancillary to') the achievement of the joint venture's pro-competitive benefits." (At 1135.) The question whether "interchange" (i.e.

does it have any particular redeeming features. It is set out here merely to bring out the differences between it and the direct charging model proposed.

ATMs were introduced into the US in the 1960s. Initially customers were only able to withdraw cash from their own branded ATMs but banks soon realised that unit transaction costs declined with an increase in volume. The US, unlike SA, has many networks and this led to the formation of shared ATM networks which could link machines from regional and national networks to one another and thereby increase the volume of transactions by increasing the access to the customer through off-us transactions.

In the mid-1980s banks introduced a service fee for off-us transactions for ATM withdrawals. "Interchange" (carriage) fees were established to compensate ATM owners for the costs of handling network transactions that were not their own. A uniform fixed "interchange fee" was set collectively by network operators and rules against surcharging by ATM service providers were initially adopted. This restriction did not survive legal attack. The ATM service provider became free to charge a surcharge over and above the carriage applicable within the network.

In the surcharging model, a carriage fee is still payable by the cardholder's bank to the ATM owner. A direct surcharge may also be levied on the cardholder by the ATM owner. In this case, the ATM owner receives the proceeds of the carriage, the direct surcharge, and the cash dispensed at settlement. The carriage is an interbank fee, which is set by the network participants and would not be subject to competition. The surcharge on the other hand is set by the ATM owner and is an additional charge to the normal carriage fee. To the extent that the surcharge fee is disclosed, before the transaction is initiated, this fee would then be transparent.

Surcharging provides ATM owners with the opportunity of generating direct fee revenue and may even act as a strategic tool for potentially attracting account holders who wish to avoid surcharging by making on-us transactions. The probability of surcharging increases with a bank's market share of ATMs. The average level of surcharging in the US has reached an all-time high in 2007 to its current level of USD1.64.

In a direct charging model, in contrast, carriage is not charged. A direct charge is simply levied by the ATM owner (or acquirer) to customers using cards issued by other banks. This

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carriage) was necessary, or whether the network could viably rely on "surcharging" (i.e. direct charging) alone, was a question of fact which could only be determined by a trial. The latest information which we have been able to obtain at the time of writing indicates that the case is proceeding to trial.

While one of the authorities relied on in the analysis was *Dagher v Saudi Refining Inc.* 369 F.3d, 1108 (9th Cir.2004) – subsequently reversed in *Texaco Inc. v. Dagher*, 547 U.S. 1, 126 S.Ct. 1276, 164 L.Ed.2d 1 (2006) – it should be noted that the reversal turned on the fact that the Supreme Court, in contrast with the view of the Court *a quo*, considered the price in question in that case to be simply an integrated joint venture's own price to its customers, and that accordingly no price-fixing between competitors had taken place.

In *Brennan*, the Chief Judge noted incidentally that "interchange" (i.e. carriage) in the ATM context is structurally different from interchange in the context of payment card schemes.

charge is recouped, together with the cash dispensed, at settlement. In addition, a processing fee covering the switching fee for routing transactions through the network, and other processing costs, may be charged by the issuing bank. Fees in the direct charging model are set unilaterally in each case by the institution offering the service. These fees can promote transparency to the customer. Competition is enhanced as off-us pricing will be done on a competitive basis between banks.

5.9 Other pricing models

In this section, two models other than direct charging are briefly reviewed. The lesson to be learnt from them is that each one is likely to provide a different competitive dynamic – with different winners and losers.

The two models are:

- Elimination of "Saswitch" premium or "convenience" fee to the customer
- Setting of carriage by an independent third party.

5.9.1 Elimination of the "Saswitch" premium or "convenience" fee

FNB proposed an elimination of the so-called "Saswitch" premium fee (also known as the convenience fee, the interbank fee and the disloyalty fee[215]). As a result customers would have the benefit of experiencing the same price for ATM withdrawals whether they are made at their own bank's ATM or that of another service provider or bank. However, the carriage fee – the amount which is paid over by the issuing bank to the acquiring bank – remains intact. Hence, while reducing the price to the consumer, the banks within the network continue to pay the carriage fee over to each other if their consumers use another bank's ATM terminal.

FNB argued that this proposal has the benefit that "from day one there will be a reduced direct cost to customers of at least R500 million".[216] The proposal grabbed media attention, but closer scrutiny shows that the proposal in this one-sided form is far from adequate and would in any event tend to distort competition and thus not ultimately benefit the consumer.

As we have shown earlier in this chapter,[217] the aggregate amount of carriage that Bank B, in its role as card-issuer, pays away to Bank A and other banks in their role as ATM service providers to Bank B's cardholders, depends on factors such as the relative extent and

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215 So-named, for example, by Capitec, March 2007, Second Submission, Supplementary Submission to the Banking Enquiry, p 1.

216 Transcripts of 9 November 2006, p 33 and 3 April 2007, p 55.

217 See section 5.4.5 above and especially Table 7 and Table 8.

convenience of Bank B's own ATM infrastructure made available to its customers. Conversely, the amount of revenue that Bank B will receive by way of carriage from other banks will depend on its provision of ATM infrastructure relative to theirs, and to their ability themselves to meet their cardholders' ATM needs. The relationship between the size of a bank's card-issuing base and the size of its ATM infrastructure will clearly play an important part in whether it is a net payer or net receiver of carriage.

The fact is that some banks are net payers of carriage and others net receivers. The simple abolition of a fee category which serves (whether in whole or in part, or in excess) to recover carriage paid away, can only disadvantage the net payers of carriage relative to those which are net receivers. In other words, it is not neutral in the competition stakes between banks that are simultaneously issuers of cards and providers of ATM services.

Since the customer would have no incentive to seek out her or his own bank's ATMs – given that there is no longer a pricing differential – it is likely that a bank with a small acquiring but relatively large issuing base would find that a disproportionate number of withdrawals are off-us, resulting in considerable value (in the form of carriage) being paid away to competitors. Only a bank with a relatively large acquiring base, reinforced by confidence in the location of its ATMs, would be likely to find the proposal sustainable and attractive.

Table 10 The number of ATMs and cards issued for each bank

	Absa	Standard	Nedbank	FNB
Total number of ATMs (incl. mini-ATMs)	7,134	3,863	1,293	4,475
Number of cards issued (debit and credit)	10,442,655	21,605,659	3,347,067	5,513,634
Ratio of card issued to ATMs	1,463.8	5,593.0	2,588.6	1,232.1

Confidential: Absa FRB Nedbank

Source: Banks' submissions, March and April 2007, Second Submissions, ATM Transactions.

The ratio of the number of cards issued relative to the number of ATMs deployed is indicated in the last row of Table 10. The higher this ratio, the worse off the bank tends to be with the forgoing of the "Saswitch premium", while still having to honour the carriage fee payable to the acquiring bank.

A large issuing base is likely to result in a higher number of Saswitch transactions. Unless balanced with a large acquiring base and the ability to generate a large number of off-us transactions from customers of other banks, this is likely to result in higher carriage fee payments to other acquiring banks. Based on the data submitted, it appears that FNB would lose the least, and be most likely to benefit ultimately, from its proposed change.

Confidential: FRB

As was revealed in the hearings, the key constraint to the implementation of such a change would be that all banks within the ATM PCH would need to agree to implement the abolition of the Saswitch premium together. If one bank were to implement this unilaterally, the

savings to the consumer would not be guaranteed and it is unlikely that this would be sustainable. In the words of FNB, its proponent,

> … in the process we would lose a lot of volume from our own devices that would go to competitive devices, rendering our devices far less economical. And what would simply happen is that we would shoulder the load on our own and our devices would become less efficient. …it would be extremely naive from a commercial perspective if we were to do something like that.[218]

In addition,

> ... the possibility of us attracting enough customers by dropping that fee (the “Saswitch” premium) to cover the very significant loss we would take, in our assessment is probably unlikely.[219.]
>
> Part of [the] reason for this is that the Saswitch fee (“Saswitch” premium) is ultimately different to other prices in the sense that if you drop it you do not get additional business, you lose carriage…[220]

The hearings revealed that none of the banks, apart from FNB, was in favour of the proposal of dropping the “Saswitch” premium while carriage remained. Nedbank said bluntly:

> We do not believe we should spend a lot of time on the FRB proposal. By their own admission they would be mad to do it.[221]

In fact FNB admitted only that they would be “mad” (not their expression) to do it *alone.* If it were implemented across the board, they would stand eventually to gain.

However, we do not believe that the proposal, even if so implemented, has merit. As this chapter has explained, the source of the problem lies in the system of carriage as the means of compensating the off-us ATM service provider. This system has complex anti-competitive effects, including the sheltering of issuing banks’ prices for both off-us and on-us transactions from effective competition. Nominally eliminating one fee category would not prevent one or more other fee categories from creeping up to recover the lost revenue. The present problem would thus not be tackled at root, but merely be obscured in a way calculated to impress and lull the paying public while disadvantaging other banks relative to the bank that has made the proposal.

In our opinion, it is not an acceptable alternative to the change to a direct charging model which we recommend.

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218 Transcript 3 April 2007, pp 108 and 109.

219 *Id.*, p 110.

220 *Id.,* p 120.

221 Transcript 4 April 2007, p 94.

5.9.2 Independent third party to set carriage fee

The notion of an independent third party to set the carriage fee may be influenced not only by the UK example, but also by the approach emerging in various jurisdictions as far as the interchange for card payments is concerned. The justification for this approach is that where there is a two-sided market and a four-party model, it may be necessary to balance the revenue generated in a way that is commensurate with the costs in order to ensure participation on both sides of the market.

While this would be a departure from the process by which carriage has been set, the argument is that if this approach can provide assistance in the case where debit and credit cards are used in other transactions, then why not in the case of ATM transactions?

Essentially, acquiring banks would provide details of their costs to a third party. The third party would then, using an agreed methodology, arrive at the uniform level of the carriage fee payable by the issuing bank to the acquiring bank.

In the UK, the LINK ATM network has a dual system in which both banks and non-banks are involved in providing cash dispensing services. Both a carriage fee system and a direct charging model are employed – although never together. Where the carriage fee applies (typically between banks that do not charge their consumers an explicit ATM withdrawal fee), it is calculated by an independent third party, in this case KPMG, on the basis of the costs of both issuers and acquirers including those that do both. Hence the use of an independent third party has a precedent.

It is our view, however, that there is no justification in South Africa for carriage to continue to exist in regard to ATM transactions. The submissions made to the Enquiry do not point to the need for carriage to continue – in fact all of the banks which engaged in the argument have admitted that carriage is not essential to interoperability. While the banks raise social concerns that might arise should carriage be abolished and a direct charging model be introduced, none of their concerns appears insurmountable if sensible rules are implemented. The benefits of a pricing structure that is transparent and subject to forces of competition outweighs any appeals to the retention of the existing model on the basis that in the eyes of the banks “it ain’t broke, don’t fix it”.

Chapter 6

Payment Cards and Interchange

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6.1 Introduction and synopsis

6.1.1 Evolution of means of payment and arrangements between banks

In the historical progress of trade from barter, through local monetary exchanges and paper systems, to the global division of labour and the electronic transfers and settlements of the present day, security, reliability and efficiency in the means of payment (or payment instruments like credit and debit cards) have been fundamental requirements for development.

In *The Virtuous Circle: Electronic Payments and Economic Growth*,[1] it is observed that the development of money has depended on the actions of the people using it:

> Ultimately, consumers determine what form of money is most desirable – people simply substitute cheaper and more convenient forms of money for expensive and inconvenient forms. It is ultimately through this substitution in use that new money forms embed themselves in the marketplace.[2]

Nonetheless, in the development of means of payment from the earliest standard coinage, the state or public power has always played a necessary role.

> History demonstrates a compelling need to standardise payment forms to enhance their utility. Examples are as ancient as the Qin Dynasty in China (221-207 B.C.), when the Emperor unified three or four forms of currency into one coin, and as contemporary as the creation of the euro in the 21st Century.[3]

Also crucial to the development of means of payment and payment systems has been the role of banks, and the arrangements which they make with each other in this regard, in order that such forms of money or payment instruments are mutually acceptable.

Regulatory authorities around the world have been paying increased attention to interbank arrangements. Central among these arrangements is “interchange”. This obscure but important subject has long exercised, and continues to exercise, competition authorities in many countries. In the United States in the 1980s it became a focus of antitrust scrutiny by the courts. The European Commission has been concerned with interchange since at least 1992, and continues to wrestle with the issue. It has led to successive rounds of litigation in Britain involving the Office of Fair Trading. It has become a matter of contention in competition enforcement in Spain, Portugal, Austria, Poland and elsewhere. In Australia it has led to an extensive regulatory intervention by the Reserve Bank. It is a subject central to

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1 Visa International and Global Insight, June 2003. This document is publicly available on the internet. The same document (with only a few trivial differences in presentation) was submitted as document V in Visa’s Second Submission, June 2007, under cover of a claim of confidentiality! It also appears within Annexure M of Visa’s First Submission, October 2006, without such a claim. Our references to and quotations from the document are derived from the public source.

2 *Id.*, p 6.

3 *Id.*

this Enquiry.

6.1.2 What is interchange?

Although interchange in some contexts may involve institutions other than banks, it is best understood initially as a particular transfer of value between banks. In contrast with payments in cash, where the payer pays the payee (the beneficiary) directly, every other mode of payment in South Africa currently requires in the ordinary course the assistance of one or more banks. For this service, a charge is made. It is when two banks are involved, each needing to levy a charge for its service to its customer, that interchange comes, or may come, into play.

Interchange, as we know it locally, is a transfer made by interbank arrangement whereby, in the context of a payment made by the customer of one bank to the customer of another bank, one of the two banks contributes a part of its revenue to the other bank. At present interchange is to be found in some form in the great majority of instances where one person makes a payment to another person other than in cash, and where the payee has his or her bank account at a bank other than that of the payer.

Classically, the need for interchange has arisen in connection with the development of payments by card.[4] Typically, such payments are made by a cardholder buying goods or services from a retailer (or "merchant"). It is in the context of payment by card that we shall first analyse interchange, and then consider its applicability to other modes of payment (payment streams).

"Issuing" and "acquiring"

The cardholder making payment to the merchant will have obtained the payment card from an "issuer", and the merchant accepting the card will have contracted with an "acquirer" in order to accept the cards of the relevant card scheme. In some cases the issuer and the acquirer will be the same institution, but in other cases the two institutions will be different. Where issuer and acquirer are the same institution, the transaction is referred to as *on-us*; where they are different institutions, the transaction is referred to as *off-us*.

The EC Interim Report of April 2006 dealing with payment cards defines *interchange fee* as the "fee paid by an acquiring institution to an issuing institution for each payment card transaction at the point of sale of a merchant."[5] This definition assumes, of course, that the

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[4] It could conceivably have arisen much earlier, with the development of payments by cheque, but evidently the need for it then was not such as to bring it into existence.

[5] European Commission, Competition DG, Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, "Interim Report I: Payment Cards", 12 April 2006, Glossary. Under the rules of the MasterCard scheme, "financial institutions" which are regulated as such and supervised by government authorities may issue cards and acquire card transactions. Such institutions are not necessarily limited to banks. In the case of Visa, the institutions must ordinarily be authorised to take deposits. In South Africa, only banks are currently able to issue cards and acquire card transactions within the

transaction is off-us. An acquiring institution is defined as a "credit institution or other undertaking, and member of a card scheme that has a contractual relation with a merchant."[6] An issuing institution is a "credit institution, and member of a card scheme, that has a contractual relation with a card holder for the provision and use of a card of that card scheme. In a closed system, the card issuer is the scheme owner, while in open systems several credit institutions act as card issuers."[7]

The distinction between "closed" and "open" card systems has relevance to our understanding of the dynamics of interchange. We now turn to this.

6.1.3 Three-party ("closed") and four-party ("open") card schemes

In a "closed" system,[8] the card scheme owner – examples are American Express and Diners Club[9] – is not only the issuer of the card but also the acquirer of the merchant's transaction. It may licence banks or other financial institutions, or utilise franchisees, to issue its cards to customers, or to contract its acquiring services to merchants, but they do so on its behalf.[10] To analyse such a scheme we must therefore look through the licensee to the principal (the scheme owner). We can identify, in essence, *three parties* to each payment transaction using the card of such a scheme: (i) the cardholder, (ii) the merchant and (iii) the scheme owner.[11] Hence such a scheme is conventionally referred to as a "three-party" scheme.

Here there is no possibility of a transfer of revenue from acquirer to issuer (or *vice versa*), since issuer and acquirer are one and the same. All transactions are on-us. Interchange thus does not arise as such in a three-party scheme. At most there may be an *internal* transfer of revenue in a notional or accounting sense – an "intrachange" (to coin an expression) – from the acquiring side to the issuing side of the scheme owner's business.[12] No arrangement between different firms is required to bring this about.

Visa and MasterCard schemes (see further below).

6 *Id.*

7 *Id.*

8 Also referred to as a "closed loop" system: see Transcript 19 April 2007, p 13 (Nedbank, Mr Shuter). Closed or closed loop systems are also sometimes referred to as "proprietary" card schemes: see e.g. American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking, p 4.

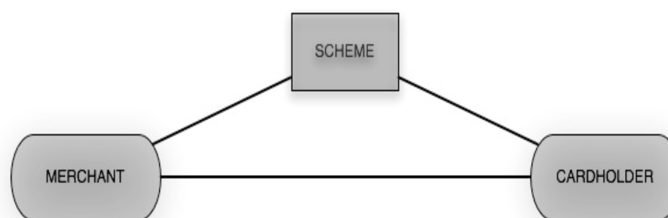
9 Transcript 17 April 2007, p 15. Private or proprietary "white label" cards (including buy-aid society cards such as those issued by Pretorium Trust) also function as closed systems.

10 American Express stated in its Submission, October 2006, p 2: "Amex itself operates the network and typically acts as both the issuer and acquirer of cards. … Amex's merchant agreements are bilateral agreements between the merchant and Amex as acquirer." Describing the essential characteristics of a "closed" system, it says that the scheme itself "acts as issuer and acquirer" and "[o]wns the direct relationship between scheme and end-users, namely cardholders and merchants. … No legal or contractual relations exist between or amongst the various licensees of the proprietary system." *Id.*, p 4.

11 Transcript 17 April 2007, p 15.

12 *Id.*, p 16; *id.*18 April 2007, p 35; *id.* 19 April 2007, p 13, p 16. "Notionally Amex is a discreet business unit and we have everything all together." Nedbank (American Express's licensee in South Africa), id. 19 April 2007, p 17. American Express confirmed that there are no interchange fees between its licensees: "[T]here is no fee – in particular an interchange fee – and no settlement between these licencees." (American Express, October 2006, p 2.)

Figure 1 The parties in a “closed” or three-party card scheme



The matter is different with the card schemes which dominate the payment card scene in South Africa. MasterCard and Visa are “open” systems,[13] conventionally referred to as “four-party” schemes.[14]

The four-party model evolved from the three-party model. It was a natural progression for banks which had acted as mere licensees for the issuing of a scheme owner’s cards, to become direct issuers to customers in their own right, albeit within the governing framework and under the logo of the particular card scheme. Likewise on the acquiring side, banks could contract directly with merchants. Recruitment of tens of thousands of banks and other financial institutions around the world as issuers and acquirers has greatly expanded the reach of these card schemes. With this change, the triangle of relationships in a payment transaction under the three-party model becomes replaced by a rectangle.[15]

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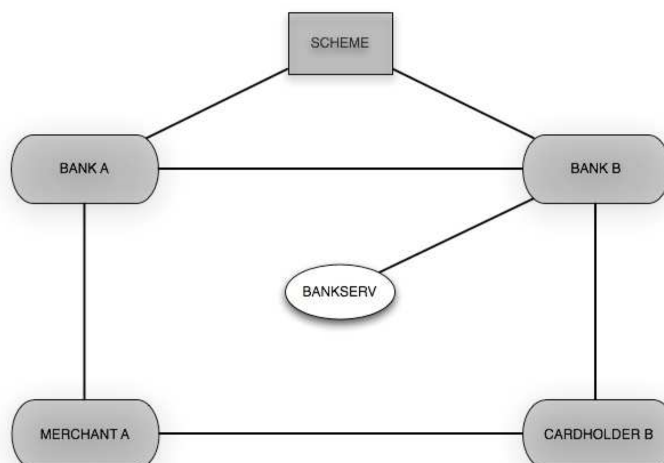
[13] Also referred to as “open loop” systems: see e.g. Visa, June 2007, Second Submission, document B (third part) p 5 and pp 13-15.

[14] Transcript 17 April 2007, p 15.

[15] See Transcript 17 April 2007, p 16. It has been pointed out that, strictly-speaking, the “four-party scheme” involves *five* parties including the scheme owner. However since, in such a scheme, the scheme owner does not participate directly in each payment transaction, the “four-party” label seems quite appropriate for basic analytical purposes.

Figure 2 The parties in an "open" or four-party card scheme



Standard Bank has correctly defined card interchange as "the fee paid by acquirers to issuers in a card purchase transaction within a four-party payment system."[16] However, as is discussed further below, interchange should not be seen as a fee for service.

However, it should be noted that, where the payer (the cardholder) and the payee (the merchant, for example) are served by the same bank or financial institution as issuer and acquirer – in other words where the payment transaction is on-us – only three parties are involved in the payment transaction notwithstanding that the scheme itself is an open one. A triangular diagram (comparable to the depiction of the three-party schemes above), and not a rectangular or four-party diagram, would thus illustrate the relationship in that transaction.

Nevertheless, the whole point of the open scheme is that it greatly expands the scope and flexibility of card-issuing, acquiring and use precisely by allowing for off-us transactions, in which it is unnecessary for either the user or the acceptor of the card to be concerned with the institution that has provided the necessary services to the other party. It is thus appropriate to describe and analyse open schemes essentially in terms of an off-us, four-party model.

6.1.4 Necessity of interchange in principle

Whenever a payment card is used to buy goods or services, or otherwise to effect a payment, two independent demands have to be matched. This applies to both three-party and four-party schemes. Just as a wedding requires two people to say "I do", a payment by payment card requires one person (the payer) to choose to use the card as the means of payment, and another person (the payee, usually a merchant) voluntarily to accept it. If the

16 SBSA, October 2006, First Submission, p 53.

cost to the one or to the other – the charge levied for the use or acceptance of the card respectively – is such as to deter either of them, then the card will not come to be used to effect payment.[17]

In the case of a “closed” or three-party scheme, the scheme owner itself must be able to match – to bring into effective correspondence – the two independent demands, by way of its own pricing of its issuing service[18] to cardholders on the one hand, and of its acquiring service[19] to merchants on the other hand. The scheme owner’s issuing and acquiring costs are aggregated in its own hands, and so are its issuing and acquiring revenues. Within the constraints set by its aggregate actual and potential costs, and by its aggregate actual and potential revenues, it can maximise output (and profit) in terms of card usage by effectively cross-subsidising the one side of the business with the help of the other. It can, for example, price below cost on the issuing side (i.e. in its price to cardholders) to the extent that it can recover the shortfall by pricing above cost on the acquiring side (i.e. in its price to merchants). The different price elasticities of demand[20] relative to cost on the different sides of the market for its card payment services can thus be reconciled by way of a balancing exercise, performed by the single supplier matching two supplies in a way that brings into effective correspondence the two independent demands.

While the market in this case may be characterised as two-sided insofar as two separate demands are met by two different supplies, the fact that there is only *one supplier* to these two demands in respect of any particular payment transaction means that no special balancing mechanism is needed.

Where an open or four-party scheme is concerned, however, a special balancing mechanism has been shown to be necessary in principle. Here, in off-us transactions, there are two separate suppliers to the two independent demands. Costs and revenues in respect of issuing and acquiring are thus no longer aggregated in the hands of a single supplier. The balancing exercise, to the extent needed to match the two demands with each other and the two supplies with them, can now only be performed effectively by a transfer of revenue between the two suppliers. In our view interchange is, at least in principle, a reasonably necessary and thus legitimate means of bringing this balance about.

In arriving at this conclusion we have had to consider in some detail the nature of the joint

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17 Whether a particular purchase-and-sale transaction will also fall away will depend, of course, on whether there is a substitute means of payment (cash, for example) that is adequate and acceptable to both parties. The theory of “two-sided” markets is discussed in the section of this chapter dealing with the necessity of interchange in principle.

18 We use this simplified terminology to include card-issuing, transaction processing and related services on the issuing side.

19 Likewise here we use a simplified expression for something with complex elements.

20 “Price elasticity of demand” refers to the responsiveness of consumers, through quantity demanded, to changes in price. For example, cardholders may be very responsive to changes in price – meaning that demand on the issuing side would be more “price elastic”. On the other hand, merchants may be far less responsive to changes in price – meaning that demand on the acquiring side would be “price inelastic”.

venture in open card schemes and various arguments advanced concerning their need for interchange. We have given attention to the true nature of interchange as a means of revenue allocation between financial institutions participating in a card scheme, rather than as a price for a service by one such participant to another. We have addressed the question whether the necessity of interchange in principle is refuted by the success achieved by card schemes in some countries without interchange, or refuted by evidence that payment card issuing may be profitable even when interchange is left out of account.

Our theoretical analysis is preceded by a compilation and analysis of the data on card issuing, merchant acquiring, revenues and profitability which the participants in the Enquiry furnished voluntarily, and is based further on questions and answers aired at the hearings on this subject.

6.1.5 Danger of abuse and how best to prevent it

In our view, the necessity of interchange in principle as a balancing mechanism (and thus its legitimacy in principle also) does not serve to justify the methodologies currently employed by the card schemes, and by their participating banks, in arriving at the actual levels of interchange which are applicable to the various types of payment card transactions. Unsatisfactory aspects and implications of these methodologies are considered in detail in the course of this chapter. Here the broadest outline must suffice.

Interchange enters invisibly into the merchant service charges levied by acquirers. As a common component in acquirers' costs, it sets a floor for their merchant service charges which cannot be competed away. In turn, it enters invisibly into consumer prices. If interchange is necessary, it has nonetheless the nature of a necessary *evil* — and should be kept as low as reasonably possible. In fact, as our investigation shows, the art in interchange setting has been for the schemes or their participants to assess the maximum share of issuing costs which merchants are likely at any time to be willing to bear by way of merchant service charges, and to keep interchange at this level or just a little below it.

As a subsidy from the acquiring to the issuing side, interchange obviously facilitates card issuing. Competition between schemes for issuers has the paradoxical tendency to drive interchange upwards rather than downwards. Where, as in South Africa, the major issuers are also the major acquirers, the interests in maximising interchange are generally far more powerful than any that might tend to bring it down. Where interchange has come down, the likelihood is that issuing costs have come down even faster, or some immediate purpose of overcoming merchant resistance to card acceptance has been the aim.[21] The true constraint on interchange, and on merchant service charges, is ultimately the "competition" of increasingly archaic substitute means of payment. Little comfort can be taken from this.

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[21] The bargaining power of larger merchants allows them to negotiate more favourable merchant service charges. This can, however, not be seen as an effective constraint on the level of interchange fees set between participating banks.

Even a monopolist in the payment card business would not be able to price beyond the level at which the merchant would rather refuse cards and elect to accept only cash or cheques.

Interchange revenue (more broadly the interchange component concealed in the merchant service charge) can be applied by issuers so as to increase cardholder demand – which then, by way of network effects, increases the degree of economic "captivity" of merchants. The more cardholders there are wanting to use cards to make purchases, the less can merchants really afford to refuse them. Thus the elasticity of merchant demand for acquiring services can be reduced, and their willingness to endure above-competitive prices for the benefits that go with acceptance of payment cards can be increased. Interchange setting can therefore serve as a means of market manipulation, by the schemes themselves or collectively by their participating banks.

Moreover, by including in credit card interchange a contribution by the merchant to the issuer's costs of extending credit, the current interchange methodologies of the schemes and their participating banks serve to privilege this line of business over competing forms of credit extension.

Higher rates of interchange for credit cards compared with debit cards have helped make the former cheaper for the cardholder to use, while the potential for debit cards to replace cash and cheques has probably been retarded. At the same time, to the extent that the level of credit card interchange causes merchant service charges for such transactions to exceed debit card service charges and the merchants' costs of cash, any resulting addition to consumer prices would imply that poorer consumers are to this extent being obliged to subsidise the rich.

All these aspects are explored in this chapter. In short, it does not follow from the necessity of interchange that the actual setting of interchange is free from the danger of abuse. Such abuse can improperly enhance the power producers have over consumers, make poorer consumers pay for the privileges of richer ones, and put the suppliers of one means of payment or credit in a privileged position, thus distorting competition and harming both producer and consumer welfare in general.

As payments by card – along with other methods involving interbank transactions through the national and international payments system – become ever more common in consumer purchases and in the settlement of retail debts, so the subject of interchange will rise in importance as a public issue. The advantages for society of replacing cash to an ever-increasing extent with non-cash methods of payment are, we believe, considerable. The increased use of payment cards and the development of payment card schemes have an important, progressive role to play. Interchange is a complex mechanism. Once the necessity for such a mechanism is accepted, the focus must shift to the best means of ensuring that it is not abused. In our view, while our present framework of competition law

provides an ultimate back-stop to protect the public, it is too blunt an instrument involving too many case-specific uncertainties to be a fully adequate means of addressing the interchange problem.

At the same time, in proposing any regulatory intervention in this area, great care has to be taken to ensure that pro-consumer competitive dynamics in the market for payment services are not stifled, and that innovation is not obstructed.

6.1.6 A transparent and objective interchange methodology

Transparency and objectivity, and resulting confidence on the part of both suppliers and consumers, are crucial to the setting of appropriate levels of interchange in the different payment streams in which it is shown to be necessary.

We do not consider that a multiplicity of interchange levels bilaterally negotiated between the various participants in each relevant payment stream would offer a satisfactory way forward. Indeed, bilateral interbank arrangements in this sphere are more likely to result in enhancement and abuse of market power than would a uniform level of interchange applicable to all issuing and acquiring participants in the particular payment stream.

It became evident from submissions made by banks which participated in the Enquiry, taken together with subsequent exploratory consultations with them, that all would favour or accept a change from the present methods of setting domestic levels of interchange, to a process under compulsory regulation –

- based on a transparent methodology
- with objective criteria being established for each relevant payment stream through a participatory process and justified in public
- with the resulting appropriate levels of interchange, where applicable, being independently assessed on the basis of audited data
- with the integrity of the process being verified under regulatory oversight
- with the levels of interchange so determined being thereafter enforced.

We recommend that the necessary regulatory scheme be drawn up and implemented so as to enable this change to be effected and enforced as soon as practicable. Details of the proposal are set out in the section of this chapter dealing with appropriate regulation of interchange.

We note here that the need for such a change, and the wisdom of it, was not supported by card schemes – and we shall address their particular arguments and reservations in some detail in this chapter. Among retailers consulted, while there was unanimous support for

safeguards against excessive interchange, there were different views as to the best means of achieving that outcome.

6.1.7 Interchange and other payment streams

In this chapter we also consider interchange arrangements in the electronic funds transfer (EFT) and early debit order (EDO) payment streams. Our recommendations in this regard are that interchange fees in these payment streams be brought within the transparent and objective regulatory scheme proposed where the necessity and level of interchange can be determined.

6.1.8 Card scheme rules

In this chapter other issues raised in connection with the card schemes, in particular the "honour all cards" rule and the "honour all products" rule, are also addressed. We have concluded that the former is legitimate while the latter is not.

We consider whether the schemes should be obliged to permit merchants to surcharge customers who use cards to pay for purchases. In the context of our proposal for a regulatory solution to the interchange problem, we advise against interference with the schemes' rules against surcharging.[22]

We also deal with scheme rules which have restricted merchants in providing cashback at the point of sale (POS), and make recommendations aimed at lifting them.

We briefly consider and make recommendations concerning current restrictions which limit the acquiring of card transactions to banks, and indeed to those banks which are also substantial issuers of cards. The regulatory issues involved are addressed in the chapter of this report dealing with Acess to the Payment System.

6.2 Payment cards in South Africa

6.2.1 Types of cards and card transactions

Payment cards are ordinarily classified as credit and charge cards on the one hand, and debit cards on the other. American Express explains the distinctions between these different types of cards:

> Charge cards require the balance to be paid in full every month. Credit cards allow the cardholder to delay payment of all or a portion of the balance under a revolving credit line which can be tailored to the financial situation of the cardholder. Both are distinguishable from

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[22] See Section 6.10 below.

> debit cards, which debit the cardholder's [bank][23] account for the amount of a charge immediately upon conclusion of the charge transaction.[24]

Usually charge cards are included when the expression "credit cards" is used, a practice we adopt in this report, unless otherwise indicated.

A simple classification by type of card tends, however, to obscure the fact that technological developments may allow the same card to be used as a credit card or a debit card depending on the cardholder's choice on each occasion at the point of sale. The more crucial classification is thus according to the *type of card transaction* which is involved when the card is used – a debit card transaction[25] or a credit card transaction[26]. In South Africa a unique card named a "cheque card",[27] which functions like a debit card but only requires a signature for identification instead of a personal identification number (PIN), has also been developed.

As Ms Louw of the Enquiry's Technical Team outlined during the hearings:

> The criteria to be able to have a credit card or debit card are significantly different. Credit cards are seen as a product in their own right, where debit cards are more used in conjunction with the facility of a bank account or the banking service. So if you open a bank account you will be issued with a debit card, [whereas] you have to apply for a credit card.[28]

Obviously the issue of a credit card depends upon the applicant qualifying in the eyes of the issuer as credit-worthy. In South Africa, the credit card is thus effectively available only to a better-off minority. Among payment cards, it is the debit card which, while arriving later on the scene, has the potential of replacing cash with plastic as a mass means of effecting or achieving retail payments.

6.2.2 Global development of payment cards and electronic payments

American Express began in 1850 as an express delivery business in New York.

> Although in its early years American Express was not itself a financial services company, its largest and most consistent clients were banks. Delivering the banks' typically small parcels – stock certificates, notes, currency and other financial instruments – was considerably more profitable than transporting larger freight. Soon the company would scale down its parcel and

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23 American Express referred here only to a cardholder's "current" account, but a debit card may also be linked to other bank accounts.

24 American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking, p 1.

25 The definition for a debit card transaction in the relevant Payment Clearing House (PCH) agreement is given as: "… a means of payment instruction initiated through the presentation of a debit card, or the provision of the debit card number thereof, including the BIN registered in the card register." (PCH agreement for Debit card payment instructions, p 4).

26 The definition for a credit card transaction in the relevant PCH agreement is given as: "… a payment instruction initiated through the presentation of a credit card or its credit card number, including the BIN registered in the card register." (PCH agreement for Credit card payment instructions, p 4.)

27 Also known here as embossed debit cards, hybrid cards or signature-based debit cards.

28 Transcript 17 April 2007, p 46.

> freight delivery business in favor of creating and selling its own financial products.[29]

It launched a money order business in 1882, and the first travellers' cheques in 1891. Extending to Europe in 1895, it began conducting commercial banking services in 1904, and official currency exchange services in the US in 1905. Having expanded its travel and financial services business after the First World War, and again after the Second World War, American Express issued its first charge card in 1958.

> … Within five years, more than 1 million cards were in use at approximately 85,000 establishments within and outside the United States. Soon, the company began introducing local currency cards in markets outside the United States, adding programs that made it possible for cardmembers to extend payment on large travel expenditures, and launching additional products…
>
> Despite the introduction in 1987 of a new revolving credit product in the United States, the company's share of the U.S. card market fell during the late 1980s and early 1990s. Trouble was also brewing on the merchant front. In Boston in 1991, a group of restaurateurs, upset about what they felt were American Express' unfairly high rates, staged a revolt that came to be known as the Boston Fee Party. Outside the United States, card suppression – when merchants try to dissuade customers from using the American Express Card – began to rise.
>
> Years later, the company's chief executive would say, in retrospect, "If not for the strength of our brand name, American Express would have collapsed by the late 1980s." …
>
> Rebuilding relationships with merchants became a top priority, as did significantly increasing American Express Card acceptance across a wide range of industries and geographical markets. The company also began forming a number of strategic partnerships with selected airlines, banks, retailers and other key businesses around the world. …
>
> Within the decade, American Express was again operating from a position of strength.[30]

American Express describes itself today as "a world leader in providing charge and credit cards to consumers, small businesses and corporations."[31]

Diners Club, with cards issued today in more than 200 countries, began in 1950 in New York to meet the needs of wealthy diners. Within a year its charge cards were held by 20,000 people and were soon being accepted by restaurants, hotels, car rental agencies and florists. Membership and card acceptance soon spread around the globe. The paper card was replaced with a plastic card in 1961. A corporate card was introduced in 1979, and "the industry's first rewards program" in 1984 (frequent flyer miles etc). In 2004 it entered an alliance with MasterCard to enhance card acceptance.[32]

Although Diners Club claims to have issued the world's first charge card,[33] other accounts differ. The following is stated by Visa International and Global Insight, Inc. in *The Virtuous*

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29 American Express, *Our Story*, http://home3.americanexpress.com/corp/os/history.asp

30 *Id.*

31 *Id.*

32 Diners Club International, *About Diners Club*, http://www.dinersclubus.com/dce_content/aboutDinersClub

33 *Id.*

Circle: Electronic Payments and Economic Growth.[34]

> The introduction of charge cards [in the United States] in the early 1900s, beginning with Western Union in 1914, represented a breakthrough in payments. But while these cards enhanced customer loyalty and stimulated repeat buying behavior, they were generally limited to the local market or in-store use.
>
> In 1958, Bank of America took a major step forward, introducing what eventually became the modern credit card. Based on extensive test marketing in Fresno, California it became clear there was a large market for a general-purpose bank card featuring a revolving credit facility and wide acceptance. With the launch of Bank of America's card, the consumer was not tied to one merchant or product but was now free to make credit purchases at a wide range of outlets. As the adoption of the bank card increased among consumers, merchants, and banks, the potential size of the market for transactions expanded geometrically. It was a profound turning point in the history of money.
>
> The development of the modern electronic payment network took an important step forward in the mid-1970s with the creation of a global joint venture that would eventually be known as Visa. Through shared investments, the Visa association created a global system to authorise transactions, clear and settle electronic payments, codify operating regulations to protect consumers and merchants alike, and set interoperability standards to ensure that, unlike cash and cheques, a Visa card could be used anywhere in the world.

MasterCard developed from the Interbank Card Association formed in 1966 by a number of banks in the United States. The right to use the name "Master Charge" was bought from the California Bank Association. It was renamed MasterCard in 1979.[35] Under this name the association subsequently developed as a global four-party credit card scheme to rival Visa in its reach and power. In 1985 it acquired an interest in EuroCard (predecessor to Europay International) and in 1988 acquired the Cirrus® ATM Network. In 1991 it launched Maestro®, which it describes as "the world's first online point-of-sale debit network".[36] MasterCard has recently converted from an association of member financial institutions to a corporation owned by shareholders trading on the New York Stock Exchange. Visa has since undergone a similar conversion.

The account given by Visa and Global Insight continues:

> Two developments in the 1990s further broadened the utility of electronic payments:
>
> - debit cards, a popular "pay now" product, allowed consumers to access funds in a demand deposit account to conduct a transaction at the point of sale; and,
> - e-commerce emerged as a mainstream business channel, both relying on and stimulating electronic payments.
>
> The rapid adoption of these relatively recent developments demonstrates the speed at which the payments landscape is changing. Looking forward, there is broad experimentation in ways to migrate electronic payment functions into consumer devices such as mobile phones, PDAs

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[34] *Supra.*

[35] MasterCard Worldwide, *Frequently Asked Questions*, http://www.mastercard.com/us/company/en/docs/MasterCard%20FAQ.pdf

[36] MasterCard Worldwide, *Corporate Overview*, http://www.mastercard.com/us/company/en/docs/Corporate%20Overview%20060107.pdf

> and other popular electronic products.[37]

Similar developments are well under way in South Africa. E-commerce transactions increased by 35 per cent in 2006, amounting to 14.5 million transactions estimated at a value of R9.5 billion.[38] The March 2004 launch of Wizzit[39] – an alliance banking partner with The South African Bank of Athens, under which it operates as a division providing "a low cost, transactional bank account that uses cell phones for making person-to-person payments, transfers and pre-paid purchases, and a Maestro debit card for making payments in the formal retail environment"[40] – is an example of how electronic transactions are facilitated among even poorer sectors of the population.

6.2.3 Card issuing in South Africa

Accounts of the origins of payment card issuing in South Africa are difficult to reconcile. According to the Diners Club South Africa website, "Diners Club International was established in South Africa in the sixties as the leading charge card operator in the country."[41] Mr Jordaan of FNB said however – evidently referring to credit cards – that the market for payment cards had begun with Barclays in 1968.[42] Absa, for its part, told us that credit cards were first introduced by Barclays in the 1980s.[43]

Writing in the *South African Journal of Economic History,* [44] Stuart Jones provides this more detailed account:

> The acquisition of Wesbank in 1975 not only provided Barclays National [Bank] with the country's biggest car finance company, it also brought with it the Wesbank card. Schlesinger's Wesbank had introduced the credit card to the South African public in the early 1970s. It was characterised by two features, revolving credit and high interest rates. The Wesbank card began the revolution in the way of making payments that has transformed retail transactions in the last quarter of the twentieth century. Today it seems hard to believe that in the early 1970s bank managers were advising customers against the use of such cards on the grounds that they would encourage them to get into high interest debt. Less than thirty years ago ordinary bank managers still reflected the conventional wisdom of an earlier era and, in 1970, certainly did not foresee the way in which credit cards would mushroom in the decade that followed. Modern banking had emerged to provide a means of making and receiving payments at the time of the Industrial Revolution and the introduction of the credit card in the 1970s was a continuation of this process with the aid of modern technology. In the 1970s, though, it would not have been possible without a multi-divisional structure. This enabled

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37 *The Virtuous Circle: Electronic Payments and Economic Growth*, p 7.

38 MasterCard, March 2007, Second Submission, p 16.

39 Wizzit, October 2006, Banking Enquiry submission, p 5.

40 http://www.wizzit.co.za. Wizzit offers a full banking functionality including internet banking, debit orders, transfers and access to all point of sale and ATM devices.

41 http://www.dinersclub.co.za/pages/personal/about.php. Diners Club South Africa is one of 158 Diners Club franchisees worldwide.

42 Transcript 19 April 2007, p 159.

43 Exhibit LL, slide 19.

44 "Banking in the 1970s", *South African Journal of Economic History*, Vol 14, September 1999, 195-231.

> Barclays to reorganise Wesbank with its focus on vehicle finance and to abolish the Wesbank card, whose business was merged into that of Barclay's Visa card.[45]

According to Absa,[46] Standard Bank began to issue MasterCard in the late 1980s. The issue and use of debit cards is a more recent development. Absa says it was the first to introduce these in the 1990s, with Standard Bank following in the late 1990s.[47]

Credit and charge cards

According to figures submitted to the Enquiry in respect of locally issued cards, roughly 6 million credit and charge cards bearing the Visa or MasterCard labels are in circulation in South Africa – 2.5 million of these being Visa credit cards[48] and 3.2 million being MasterCard credit and charge cards.[49] American Express credit and charge cards issued amount to fewer than 150,000,[50] and Diners Club cards approximately 100,000.[51]

Confidential: MasterCard

Confidential: Nedbank

Debit cards

Figures given by the big four issuing banks indicate that at least 22 million debit cards are in circulation in South Africa. Taking all issuers into account, the total number of debit cards will be marginally higher. According to Visa it has approximately 11.5 million debit cards in South Africa,[52] while MasterCard and Maestro debit cards together number some 12 million.[53]

Confidential: MasterCard

Taking the available figures together, the big four issuing banks account for well over ninety per cent of the payment card base in South Africa.[54] The following table shows the

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45 Pp 213-214.

46 Exhibit LL, slide 19.

47 *Id.*

48 VISA, October 2006, First Submission, pp 37-38. Visa does not issue charge cards in South Africa (Visa, 2008, March, Banking Enquiry – Request for information from Visa International Service Association, p 2).

49 MasterCard, October 2006, First Submission, p 16. During the hearing on 18 April 2007, Mr Grobler estimated that close to 4 million credit cards and about 9 million debit cards have been issued in South Africa under MasterCard and related brands (Transcript 18 April, pp 143-144). The latter figure seems too low in light of the earlier submission: see footnote 53 below.

Confidential: MasterCard

50 Nedbank, Second Submission, March 2007, Issuing, p 5, says that of American Express credit and charge cards issued, 144,663 related to "performing" accounts (December 2006).

Confidential: Nedbank

51 The figure for Diners Club was given by Mr Fergus of Standard Bank, Transcript 19 April 2007, p 87. Visa, October 2006, First Submission, p 38, estimated that there are approximately 150,000 American Express credit cards and 370,000 Diners Club credit cards in circulation. It seems safer to rely on the figures given by Nedbank and Standard Bank respectively, by virtue (respectively) of their involvement in or association with the issuing of these cards.

52 VISA, October 2006, First Submission, pp 37-38.; see also Transcript 18 June 2007, pp 217 (Mr Clark) and Exhibit AAA (Visa, June 2007, Second Submission, document B, p 7).

53 MasterCard, October 2006, First Submission, p 16. The number of Maestro debit cards was given as 11.3 million and the number of MasterCard debit cards as 700,000 in the period ending 30 June 2006.

Confidential: MasterCard

54 Visa reported 2.5 million credit cards and 11.5 million debit cards issued in South Africa (VISA, October 2006, First

approximate percentage share of the debit card and credit card market held by each of the big four banks, and by other banks.

Table 1 Percentage share of debit and credit card market

	ABSA	Standard Bank	Nedbank	FNB	Other[55]
Credit Cards	26	33	14	21	6
Debit Cards	38	29	10	21	2

Confidential: FRB Absa SBSA Nedbank

Source: Banks submissions, March and April 2007, Second submission, Issuing

Table 2 sets out the figures made available to the Enquiry for the various payment cards issued by the big four banks in South Africa.[56]

Submission, pp 37-38). MasterCard reported 3.9 million credit cards (of which 3.2 million are credit and charge cards and 0.7 million MasterCard debit cards [cheque cards]) and 12 million Maestro debit cards issued in South Africa (MasterCard, October 2006, First Submission, p 16). With a total of 28,416,091 cards reported by the big four issuing banks, (6,112,827 + 22,303,264)/(2,500,000 + 11,500,000 + 12,000,000 + 3,900,000) = 0.95. Thus approximately 95 per cent of the card association cards present in South Africa have been issued by these institutions.

Confidential: MasterCard

55 Combining membership information provided to the Enquiry by Visa and MasterCard, other issuers of four-party scheme cards in South Africa would be: African Bank, Albaraka Bank, Capitec Bank, Investec Bank, Ithala, Mercantile Bank, Rennies Bank and Teba Bank.

56 In the case of American Express cards, the figure given for Nedbank (the exclusive licensee of American Express in South Africa), the issuer is actually American Express itself with the issuing function performed by Nedbank on its behalf.

Table 2 Payment cards issued by the big four banks in SA

	ABSA	Standard Bank	Nedbank	FNB
Credit Cards				
MasterCard	939,464	2,099,847	711,812	N/A[57]
Diners Club	N/A	N/A	N/A	N/A
American Express	N/A	N/A	196,771	N/A
Total Credit Cards[58]	1,721,776	2,126,240	908,583	1,356,228
Total Credit Cards for Big Four		6,112,827		
Debit Cards (MasterCard/Maestro and Visa)				
PIN	8,714,532	6,069,722	1,728,242	4,619,501
Signature based	6,349	400,944	525,129	238,845
Total Debit Cards	8,720,881	6,470,666	2,253,371	4,858,346
% Visa	54.70	0.43	N/A	N/A
% MasterCard	45.30	99.57	N/A	N/A
Total Debit Cards for Big Four		22,303,264		
Other cards				
Buy Aid	N/A	N/A	187,121	N/A
Private	N/A	34,740	480,115	N/A
Gift Cards	N/A	285,738	N/A	N/A
Total	N/A	320,478	667,236	N/A
Total Other Cards for Big Four			987,714	
Total cards issued by these banks:			29,403,805	

Confidential: FRB Absa SBSA Nedbank MasterCard

Source: Banks submissions, March and April 2007, Second submission, Issuing

Visa estimates that the South African banks issue approximately 6 to 7 million proprietary ATM cards.[59] It further estimates that there are 6 to 7 million store cards in circulation.[60]

MasterCard states:

> Payment cards constitute the principal means of payment that support e-commerce and continue to enable the rapid expansion of the on-line economy. This has led to the establishment of new distribution channels and to greater convenience and lower prices for consumers, and increased economic productivity, competition, innovation and growth.[61]

Whether in fact competition generally has increased, or has increased to the extent that it could and should as a result of card schemes – and whether prices to consumers are indeed lower or as low as they could and should be – are matters which we consider below.

Confidential: FRB MasterCard

57 FNB does not issue MasterCard cards except for Maestro Travelcards (11 995 cards included in the PIN based debit card figure).

58 Diners Club figures do not appear here, as their cards are not issued by any of the banks. Diners Club did not provide its own data.

59 It is not clear how that estimate fits with the banks' figures reported above. ATM cards are usually now combined with debit cards, which are scheme-branded.

60 Visa, October 2006, First Submission, p 38.

61 MasterCard, October 2006, First Submission, pp 18-19.

Nevertheless, the greatly increased convenience and other aspects of utility for card users, the increased productivity generally inherent in this utility, and the *potential* for enhanced competition and lower prices inherent in the spread of payment card networks, seem beyond serious dispute.

In the opinion of Mr Carl Munson, Associate General Counsel of MasterCard who came from New York to participate in the hearing on 18 April 2007,

> the technological development of [South Africa] and the development of the payment systems here … is in some respects even ahead of many developed countries in the world. …[T]his year the banks and the schemes in South Africa will introduce Chip & Pin, the most advanced form of electronic payment. … [T]hat has only recently come to Europe. There are many countries in Europe that are no farther ahead than South Africa …, and I can tell you as an American to my disappointment, that there are no plans in the United States to introduce Chip & Pin, so from a technological standpoint the South African payment system and the card systems in general in South Africa is favourable.[62]

But the relative sophistication of the South African financial and payments system is not automatically, and not readily, translated into benefits for the broad majority of the South African people. The huge inequalities in property, income, education, infrastructure and facilities which characterise our society reveal themselves in – among other things — the continued predominance of cash in retail transactions.

6.2.4 Continued predominance of cash

Figures provided by ABSA during the hearings indicate that cash is the means of payment used in 49 per cent of transactions in which that bank is involved.[63] FNB found that cash made up about 60 per cent by transaction volume when payments by cheque, cash, credit cards and debit cards are compared.[64] In the case of major food retailers, cash is still used by customers in 87 per cent of transactions.[65] In other words, payment cards would account for only some 13 per cent of such transactions in this country, whereas in the UK 63 per cent of retail sales are done using payment cards.[66]

About two-thirds of the world's population is unbanked. In Visa's submission, payment card products "draw the unbanked into the banking system", thus suggesting that their payment instrument promotes financial inclusion.[67] While there may be truth in this point at a general level, we have not been provided with evidence to show this effect in South Africa. The picture here indicates that, even as poorer people have begun to have bank accounts and to

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62 Transcript 18 April 2007, pp 11-12.

63 Transcript 17 April 2007, p 67.

64 Transcript 19 April 2007, pp 123-124, referring to Exhibit PP, slide 5.

65 Exhibit LL, slide 5.

66 Transcript 17 April 2007, p 67. In South Africa, Visa considers cash to be its "main competitor" (Second Submission, June 2007, document N).

67 Visa, June 2007, Second Submission, document A, p 5.

be issued with debit cards as a consequence, their actual utilisation of those cards has initially been very low.

It does appear that debit card transaction volumes are growing much faster than credit card volumes,[68] but this growth is off an extremely low base.[69] As Mr Fergus of Standard Bank acknowledged, the number of debit cards has grown exponentially but the problem has been to get them used.[70]

We have been unable to reconcile the Euromonitor figures for debit and credit card numbers and usage (provided by Nedbank[71]) with the figures provided by Bankserv.[72] The differences cannot be accounted for simply by the fact that Bankserv's figures relate mainly to off-us transactions processed through it. Nevertheless, it seems clear that average debit card usage is in general much lower than average credit card usage. Figures for 2006 suggest that the average usage of a debit card was no higher than 4 to 5 transactions during the entire year, whereas the average annual number of transactions per credit card may be as high as 40. Whatever the case in this regard, debit card usage presents a far from satisfactory picture nationwide.

The low usage of debit cards appears in part to be a consequence of a lag in merchants' acceptance of cards in both rural and impoverished urban areas. During the hearing on 18 April 2007, Mr Bodibe (of the Panel) observed:

> I live in Kempton Park. If I cross the road to Tembisa, it is a cash economy, no usage of cards, so why is that situation like that, and why are we not seeing a proportionate increase of terminals in those type of situations?"[73]

Mr Grobler of MasterCard answered as follows:

> You know, I think it is a question that should be asked to the acquiring banks, but I can give you my view on it. I think if you look at the growth of the point of sales infrastructure over the

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68 Transcript 19 April 2007, pp 17-18 (Nedbank); FNB Exhibit PP, slide 5, gives the compound annual growth rate in volume of credit card transactions in 2002-2006 as 20%, while that of debit card transactions has been 129%. This is FRB data and cannot account for the entire industry. Bankserv data (submitted September 2007) indicates that the compound annual growth in debit card transaction volumes of which it is aware has been 124% and in credit card transaction volumes 21%.

69 In 2002, Bankserv processed only 4.4 million debit card transactions, compared to 56 million credit card transactions. In 2006 Bankserv recorded 112 million debit card transactions and 120 million credit card transactions (Bankserv, November 2007, Data submitted to the Enquiry).

70 Transcript 19 April 2007, p 84.

71 Nedbank presented figures showing that in 2006 there were 24 million debit cards and 88.5 million debit card transactions in South Africa. In the same year, there were 7.2 million credit cards and 302.2 million credit card transactions, an average of approximately 42 per card, per year. (Exhibit NN, slide 3. These are figures extracted from Euromonitor, March 2007, Financial cards – South Africa.)

72 See footnote above. Figures provided by FRB add to the puzzle. The 2006 usage of debit cards *issued by FNB* is reflected as 42,303,000 transactions for 4,700,000 cards, i.e. an average of 9 transactions per year In the case of credit cards, FRB gives the number of credit cards issued by them as 1,930,000 whilst the number of credit card transactions were given as 62,461,000 resulting in just over 32 transactions per card in 2006, well above the average for debit cards. Exhibit PP, slide 3 (erroneously numbered 1) and FNB, March 2008, Response to request for additional information, p 5.

Confidential: FRB

73 Transcript 18 April 2007, p 108.

> last two years, in the last two years the point of sales infrastructure grew by about 30 per cent in South Africa. There are about 655,000 point of sale devices in the market at this stage – not merchants, devices – and I would like to make the assumption that the markets you are referring to, are starting to be addressed. So, that is the one point. The other point is that communication is obviously very important for the merchant to establish the transaction and this is where I believe that technology can play a role. … Capitec Bank actually launched chip card technology where it is not … necessary for every transaction to go online to get authorisation for the transaction. So it is a transaction that is not dependent on telecommunications infrastructure. I would like to make the assumption that that technology will facilitate the development of point of sale infrastructure into the areas that you are referring to.
>
> So, just to summarise, I think there is a wonderful growth of the point of sale infrastructure. I think those markets are in the process of being addressed, but I think technology will actually support that going forward as well. …[74]

In a subsequent hearing, addressing the question of limited merchant acceptance of payment cards, Mr Gericke of Nedbank said:

> To see greater acceptance there have to be a few factors in play. First of all, merchants need to have point of sale presence. Secondly, and this is really the crux for me, … cardholders need to demonstrate that they want to purchase rather than draw cash on their debit cards. And then thirdly, we need to be able as acquirers to provide technology that is appropriate for that market.
>
> ... Generally we see that debit card holders have used their cards in the main to draw cash – they just go the ATM and draw the cash. What we have seen in recent times is that there is a strong multiplier when those card holders who used it purely for cash start purchasing [with the card], so there is a strong growth in the market and we see, as that connection is made, there will be more demand at the merchant to present the card for payment for purchases.
>
> … The point I want to raise around the appropriate technology is that a point of sale device as we have seen in many of the stores we go to is not necessarily the most appropriate for the spaza shop in Tembisa, and what we as Nedbank have done is to create telephony solutions over cellphone where the merchant can acquire that transaction over the cellphone, or phone into a call centre and acquire that transaction on that basis.
>
> And so it is a function of really the three things: the need of those merchants to say, “I want to start accepting card”; that is in part driven by customers who present their card for payment; and then thirdly, enabling technology beyond just the point of sale device.[75]

Caution related to unfamiliarity and relatively low financial literacy of many merchants and cardholders, may contribute to the low level of acceptance and usage of cards.

The tendency of debit-card holders to use them only to draw cash, and then to use cash for their purchases rather than insist on using the card to effect transactions, is likely to be connected with the per transaction charge which debit card users currently have to pay their issuing bank – a matter to which we return below.[76] In turn, as Mr Gericke’s testimony bears

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74 *Id.*, pp 109-110.

75 Transcript 19 April 2007, pp 38-40.

76 No per transaction fees are levied on credit card transactions, whereas debit card transactions attract a per transaction fee ranging between R2 and R5 (for an average transaction value of R225 as specified in Table 8) on the basic savings and current accounts offered by the big four banks.

out, this must retard the process of merchants in poorer areas signing up to accept cards.

Benefits of non-cash and paperless means of payment

Visa and Global Insight[77] say that the trend away from cash and cheques internationally is driven by the well-established benefits of electronic payments to all parties. Putting matters in a favourable light for the card schemes, they provide the following list of typical benefits to buyers and sellers:

Benefits to Buyers

- The convenience of global acceptance, a wide range of payment options, and enhanced financial management tools.
- Enhanced security and reduced liability for stolen or misused cards.
- Consumer protection through an established system of dispute resolution.
- Convenient and immediate access to funds on deposit via debit cards.
- Accessibility to immediate credit. Intuitively, the comparative cost of arranging for a consumer loan relative to the ability to obtain credit at the point of sale is substantial in considering both the direct processing costs as well as the implicit opportunity costs to borrower and lender.[78]

Benefits to Sellers

- Speed and security of the transaction processing chain, from verification and authorisation to clearing and settlement.
- Freedom from more costly labor, materials, and accounting services that are required in paper-based processing.
- Better management of cash flow, inventory, and financial planning due to swift bank payment.
- Incremental purchasing power on the part of the consumer.
- Cost and risk savings by eliminating the need to run an in-house credit facility.[79]

There is also increasing reliance by governments on payment cards for the safer and more efficient distribution of certain social welfare benefits. Net1 has been in the forefront of this development in South Africa, developing its own electronic payment system linked to a payment card with an embedded chip, capable of being used by those without a formal bank account.[80]

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77 *Op cit.*

78 We don't accept the accuracy of the expression "obtain credit at the point of sale", but if the point is to emphasise the flexibility of this form of credit it is a valid one. Flexible access to credit is not unique to credit cards, however. A debit card can also be used to draw against a credit (e.g. overdraft) facility arranged in connection with the cardholder's bank account. See Transcript 17 April 2007, pp 108-109 (Mr Volker).

79 *Id.*, p 8. This latter element would be irrelevant, of course, in the case of most small and medium-sized merchants who would not in any event run such in-house schemes. We deal with this aspect further in the section of this chapter dealing with appropriate regulation of interchange.

80 Net1 describes itself as a "provider of smart card technologies and systems that create a secure and affordable transacting channel between formal businesses and the 'un-banked' and 'under-banked' populations of developing countries." http://www.aplitec.co.za/About_Us.htm. "The Net 1 PENSION AND WELFARE product was designed to enhance the participation of social grant beneficiaries in the economy of their countries. The system seeks to eliminate previous deficiencies and improve the lifestyles of all its users. The system creates a secure and affordable transacting

Visa and Global Insight also explain the way in which increased volumes of card transactions tend to reduce average transaction costs in a way that cash transactions cannot match.

> The cash-based system is a physical system driven by *variable* costs, so that transaction costs decline only slightly as volume increases. The payment card system, however, is more of an information system, whose cost structure is driven primarily by the *fixed* costs of setting up its interconnected components. The greater the volume of transactions carried over an electronic network, the *lower* the average cost per transaction.[81]
>
> The relatively low use of the payment card system in Belgium results in a cost per transaction of US$0.60, higher than the cash cost of US$0.52 – because low volume does not allow for maximum exploitation of the fixed costs.[82]

The advantages where non-cash forms of payment take over from the use of cash are further described and elaborated from the Visa and Global Insight point of view as follows:

> The stock of currency held outside of the banking system constitutes a potential source of unproductive economic resources because these cash stores are not available for credit expansion.[83]
>
> Expanded use of electronic payments in the system reduces friction and increases the velocity of transactions.[84]
>
> Electronic payments expand the available options for the secure receipt of wages and income as well as for spending.[85]
>
> Electronic payments empower the consumer in several fundamental ways that cash and cheques cannot. One of the clearest ways is the security that dispute resolution provides, offering consumers a form of insurance against purchases of faulty goods or services that are not delivered or lower in quality than expected. Insurance against lost, stolen or otherwise unauthorised use allows consumers to quickly shield themselves from liability, at zero cost in some markets, unlike lost cash or cheques.[86]
>
> Electronic payments also provide the ability to control payment for goods and services over time by allowing buyers to pay now, pay later, or prepay. Credit cards provide liquidity through pre-approved credit availability, something that transaction-specific loans cannot do.[87] This works favorably for consumers, merchants, and banks because the process facilitates current period sales while minimising the cost of obtaining credit. Debit cards offer convenient and

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channel between formal businesses or Government and the 'un-banked' and 'under-banked' populations who have no or limited access to traditional banking facilities." "The Net 1 U.E.P.S. (Universal Electronic Payment System) has secured a foothold in a number of African countries by supplying turnkey banking solutions that are ideally suited for developed and developing economies. The U.E.P.S. system enables traditional financial institutions to surpass the offerings of competitors through the technological innovations available in the U.E.P.S. solution." http://www.aplitec.co.za/Our%20Solution/Products/Banking.htm. See also Transcript 30 November 2006, pp 91-183 (Dr Belamont).

81 *Op cit*, p 10. This and the immediately following paragraphs quoted are selected extracts, and are not necessarily contiguous in the original.

82 *Id.*, p 11.

83 *Id.*, p 13.

84 *Id.*

85 *Id.*, p 11.

86 *Id.*, p 15.

87 We have noted above that debit cards can also be used to access a pre-approved credit facility.

> immediate access to funds on deposit. Globally branded electronic payments have the ubiquitous and interoperable features that lend themselves to immediate acceptability by consumers and businesses.[88]
>
> No matter what the physical vehicle used to transmit the information – whether credit card, debit card, PC, PDA, mobile phone, or smart card – the underlying electronic payments system is critical to facilitate transactions in the global, digital economy.[89]
>
> Increasingly, cash and even cheques represent a legacy form of payment that act as a drag on economic efficiency, present significant levels of security risk, and have no capacity to support the type of value-added payment functions that are now expected among consumers, small- and medium-sized enterprises, corporations, and the public sector.[90]

With regard to the dispute resolution benefit that electronic payments apparently provide consumers, we believe the benefit is somewhat idealised. In practice, many cardholders experience considerable time-consuming difficulties in getting issuing banks to reverse debits on their cards despite the promises of the card schemes. The Ombudsman for Banking Services indicated that his office does not receive a great deal of credit card complaints.

> Our impression is that all the major banks have a clear process in place to deal with disputed debits… [The process] is however not communicated to customers or merchants very well. Our impression is that most customers and merchant have no idea of how the charge back process works and the time frames within which disputes must be lodged. We have further found that the bank's credit card divisions do not keep the customer informed of the progress on a dispute.[91]

Garcia-Swartz *et al*, in "The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics",[92] confirm the benefits of non-cash means of payment as a record keeping and consolidation mechanism:

> All payment methods except for cash provide consumers with a record keeping mechanism useful for budgeting, planning, and income tax preparation. Rather than having to keep track of each paper receipt, [cheques] and payment cards provide itemized monthly statements; many also have online statements accessible anytime.[93]
>
> … [P]ayment cards offer the option of consolidating payments – consumers charge everything on one card and pay only one bill at the end of the month. Many consumers value the enforced fiscal responsibility that cash, [cheques], and debit cards provide (Thaler, 1981[94];

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88 VISA and Global insight*, op cit*, p 15

89 *Id.*, p 18.

90 *Id.*

91 Ombudsman for Banking Services, March 2008, Response to Competition Commission Enquiry question.

92 *Review of Network Economics*, vol 5, issue 2 – June 2006, pp 189-191. Although the authors are dealing specifically with the United States, the essentially standard features of card payment systems means that their observations may be applied more widely.

93 Cash payment, on the other hand, offers purchasers a degree of privacy inasmuch as their payments are not recorded. Understandably, the authors have difficulty quantifying this benefit in monetary terms.

94 Thaler, Richard H. and H. M. Shefrin (1981) "An Economic Theory of Self-Control," *Journal of Political Economy*, 89: 392-406. (Citation in the work quoted.)

> Stavins, 2001[95]).

Moreover, where these non-cash forms are not linked to credit,

> … they can help consumers to limit their debt. [Cheques] and payment cards also provide improved theft and loss prevention as compared to cash, as well as easier dispute resolution in the event of problems.[96]

Using a payment card to obtain cash back at the point of sale saves consumers the need to make a separate trip to an ATM, and may reduce merchants' cash handling and banking costs.

Other claims are made for the special utility of credit cards. The credit card combines the benefits of a non-cash and paperless means of payment with a flexible source of unsecured credit. MasterCard says:

> Credit cards and charge cards are now such a part of everyday life that their benefits are often taken for granted. A cardholder can walk into a shop anywhere in the world and make purchases with no local currency. The shopkeeper can sell confidently to customers whom they have never met before secure that he will receive payment.[97]

However, there seems no reason why this advantage should not apply equally to debit cards within a global scheme operating in an on-line environment.

According to Visa,

> For the business owner, accepting credit cards could increase sales by enabling customers to make impulse buys even when they don't have cash on hand or sufficient funds in their [cheque] accounts. Experts advise that accepting credit cards can also improve a business's cash flow, allowing businesses to receive the money within a few days rather than waiting for a personal [cheque] to clear or an invoice to come due."[98]

The "payment guarantee" removes the risks involved in accepting personal cheques.[99]

Arguments in favour of the welfare benefits of credit cards include the following:

- Consumers benefit by having greater control over the timing of their outlays, thus being able to take better advantage of opportunities that arise for favourable deals.
- This in turn increases competition between merchants.
- As a result of the credit card schemes taking on the risk of lending to the merchants' customers in order to finance their purchases, the smaller merchants, who would not

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95 Stavins, Joanna (2001) "Effect of Consumer Characteristics on the Use of Payment Instruments," *New England Economic Review*, Issue Number 3: 19-31. (Citation in the work quoted.)

96 Garcia-Swartz *et al*, *op cit.*, p 191.

97 MasterCard, October 2006, First Submission, p 17.

98 Visa, June 2007, Second Submission, document H, p 2.

99 *Id.* The nature of the "payment guarantee" and the extent to which merchants are relieved of risk under the rules of the card schemes are discussed below.

be able to engage in credit extension themselves, are able to compete on a more equal footing with larger merchants.

- The increased spending resulting from credit cards enables merchants to benefit through higher turnover and increased economies of scale and scope.

In fact, these latter benefits are not nowadays exclusive to credit cards. They are intrinsic to any flexible credit facility which can be accessed with a payment card. Where a debit card is linked to a bank account with a credit facility, the issuing bank takes the risk that the cardholder may fail to repay. The risk in this respect is ultimately the same with credit card debt.[100]

Relative cost of cash

According to Visa:[101]

> In fact when everything is taken into account, there is convincing evidence that it costs retailers less to accept cards than it does for them to handle cash – because cash handling costs are significant. They include, for example, the costs of sorting, administering, securely transporting and banking cash. In addition, when merchants accept cash they inevitably suffer from 'shrinkage'.
>
> In addition, the fact that so many retailers offer 'cash back' to card-paying customers suggests that they prefer not to deal with large amounts of it. Cards are far more efficient. They provide a fast, flexible service to customers. They tend to lead to higher sales. And when accepting cards, merchants benefit from a valuable payment guarantee. Millions of merchants worldwide accept Visa, suggesting that the benefits of the system far outweigh the costs.

These obviously self-serving paragraphs blend together a number of valid points with others that do not withstand critical examination.

We do not accept that there is convincing evidence that accepting cards is cheaper for merchants than accepting and handling cash. We believe it has the *potential* to be significantly cheaper, and this is one of the reasons why the methodology and the levels of interchange – which feed downstream into merchants' costs and prices – need to be scrutinised.

No adequate data is available to us from which we could draw firm conclusions regarding the relative cost to merchants in South Africa of accepting payment by card as compared with payment in cash. However, Shoprite Checkers provided some figures suggesting that its

100 In the case of credit cards however – as we shall show further in this chapter – the schemes and their participating banks have contrived via interchange to shift a significant part of the cost of extending credit to their privileged customers onto the shoulders of merchants and, through them, onto consumer prices.

101 Visa, June 2007, Second Submission, document S, p 12.

costs of cash are *lower* than its costs incurred in card acceptance.[102] We have not probed these figures further and we lack comprehensive comparative data for South Africa which might make them meaningful.

Mr Munson of MasterCard argued that studies of the costs to merchants of accepting cash are likely to understate them:

> There are a number of costs of accepting cash that typically are not mentioned when people consider cash costs. People will generally consider for example, the cash handling costs, they will measure the fees … that the bank charges the merchant for handling the cash at the end of the day. There are also cash handling costs that are often not accounted for; in other words, you have to have employees who are spending time counting the cash, balancing the cash register and doing things like that. Another [cost] that is often not taken into account is what is sometimes euphemistically called slippage [or "shrinkage"], which means that the clerks are taking money out of the cash register, so that the merchant is not getting the full amount of cash that was expended by consumers. So the … actual cost of the cash to the merchant will vary and … there are hard studies to do to measure this.
>
> We did a study in Australia a number of years ago and I would say one of the difficulties of doing these studies, is the merchants are very reticent to provide these numbers, not surprisingly because if they tell the credit card companies what their cash costs are, it could affect the negotiations, so they tend to hide these facts, but we did a study with merchants in Australia a number of years ago. The only way we could get any information at all, was to agree not to publish the data itself and so, you shall have to take my word for it, but what it showed was that … [the] fully measured out of pocket cost to merchants for handling cash varied quite considerably, depending upon the nature of the merchant. For very large retailers, supermarkets in particular, cash handling costs were relatively low and they were lower than the cost of accepting a credit card, but for small merchants, single proprietary stores, cash handling costs were several times the cost of accepting a credit card.
>
> So, once again, these are questions that cannot be answered in the abstract. If you really want to know what is the cost of accepting cash, you would have to go out and collect the information. You have to collect the data and then you would have to look at what is the cost to this type of merchant or to that type of merchant, and it would probably … vary country to country and merchant category to merchant category. …[103]

Despite these observations, international comparative data which was submitted to the Enquiry on MasterCard's behalf at the hearing on 18 April 2007 does suggest that Shoprite Checkers' position as last disclosed to us would not be at all unusual.

Slide 10 of Exhibit MM1, presented by Dr Koboldt for MasterCard, showed that in the United States, for a typical grocery transaction, the cost *to a retailer* of accepting cash is in fact

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[102] In a letter to the Commission from Shoprite (through its attorneys) dated 20 July 2006, it estimated a total annual turnover of R32 billion in 2005 for its retail operations (p 1). Of this, 68.8% (R22.016 billion) was attributable to cash and 29.19% (R9.34 billion) to debit and credit cards (p 2). On p 12, the total amount of merchant service fees charged to Shoprite by Absa was said to amount to about R34 million per annum, or "about half of Shoprite's annual total merchant's fee expense". (R68 million would be about 0.73% of the total debit and credit card turnover.) However Shoprite also made the contradictory statement on p 2 that its costs arising from the payment of merchant's fees amounted to approximately R100 million a year (which would equal 1.07% of the debit and credit card turnover). On p 16 Shoprite stated that its cash handling fees amounted to about R213 million *per annum* (0.97% of the cash turnover) – including the processing of cash, the transit charges, insurance and in-store theft. That would make cash more expensive than card acceptance, if the more conservative figure given for merchant service fees is correct. In a subsequent spreadsheet submitted, however, Shoprite lowered its total figure for the costs of cash to roughly R111 million *per annum*, making cash (at 0.5%) cheaper than card acceptance.

[103] Transcript 18 April 2007, pp 103-105.

lower than for every other means of payment. However, when the full cost *to society* is also factored in, cash turns out to be roughly as costly as credit cards, and costlier than both signature-based and PIN-based debit cards. Dr Koboldt explained:

> By social costs I mean the entire cost incurred by the economy within the economy as a result of using cash for that particular transaction rather than another bank.[104]

Garcia-Swartz *et al*,[105] say with reference to the United States:

> [M]erchants face relatively high net private costs for electronic payment methods as compared to paper payments….
>
> Consumers, on the other hand, face far higher net private costs for cash and [cheques] as compared to cards. In fact, consumers receive net benefits from using credit to pay for larger transactions. Consumer private costs are almost entirely time-based for all instruments, including such items as the time cost of obtaining cash at an ATM and the time cost of processing a payment at the point of sale, both of which favor electronic payment methods. Consumer private benefits are driven by cash back for [cheques] at the grocery store, which enables consumers to avoid going to an ATM for smaller cash purchases. For credit cards, rewards are by far the largest item, although the option value of credit is non-trivial for larger purchases.[106]
>
> Merchant studies have found that paper methods are the cheapest for merchants. This is confirmed in our study of the distribution of private costs and benefits. But what is cheap for merchants is relatively expensive for other parties to a transaction. Certain parties, especially consumers, receive considerable benefits from payment cards, which tip their net private costs in favor of that method of payment.[107]

Making an analysis of grocery store transactions in the United States, these authors conclude:

> [C]ash – the cheapest instrument for merchants – is not the cheapest instrument for the economy as a whole, at either the smaller or the larger transaction size. Counting all parties, PIN debit transactions are cheapest, followed closely by signature debit. For the smaller transaction, cash is third and credit is fourth. But for the larger transaction, paper instruments, especially cash and non-verified [cheques], emerge as more costly forms of payment. Thus adding other parties to the transaction has changed the relative cost situation considerably.[108]

They find that the "implicit cost of cash increases dramatically with transaction size."[109] Included here is also the increased risk of loss through theft. Where small purchases are concerned, the transactional costs of cash may well be lower than the costs of cards for merchants.[110]

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104 *Id.*, p 97.

105 *Op cit.*

106 *Id.*, pp 194-195.

107 *Id.*, p 196.

108 *Id.*, pp 187-188.

109 *Id.*, p 185.

110 On the consumer side, however, per transaction charges associated with withdrawing cash for purchases are consistently higher compared to the charges associated with a POS debit card transaction. On basic savings accounts offered by the big four banks, the per transaction charges (for an average transaction value of R279.42) range between R2.80 and R2.00 for a debit card POS purchase, whereas for an on-us ATM transaction, the charges range between

The social costs of cash relative to payment cards and other electronic means of payment would obviously include the costs to consumers associated with robbery and theft, and the inconveniences involved in minimising such risks.[111] The banks' costs incurred in cash handling relative to electronic payment processing must be counted as a social cost. And the central bank incurs production costs for cash; society thus subsidises the individual user.

Dr Koboldt made the valid observation that

> private payment systems such as the MasterCard payment system, consisting of the scheme, issuers and acquirers, must be self-financing. They must recover their costs exclusively from fees charged to users of the payment system. By contrast, cash is a subsidised payment system. The users of cash are not bearing the full cost incurred in providing the payment system – the cost of printing and distributing notes, the cost of collecting notes that are to be taken out of services and actually [destroyed] – they are not borne by the merchant deciding to accept cash for the transaction, nor are they born by the cash user. They are borne by society as a whole, because cash, being legal tender, is a publicly subsidised payment system. And it is just important bearing in mind when you then look at the welfare impact.[112]

Moreover, merely comparing the (net) costs of card usage with the (net) costs of cash – whether the private costs or the social costs – is surely too narrow a framework for judgment. The utility to the user of each means of payment is quite different, not only for the individual user but also in the aggregate. Value-in-use cannot ultimately be reduced to monetary equivalents. If the aggregate social benefit (utility) of card usage is so great in comparison with that of cash as to warrant a greater social expenditure in providing them, then so be it.

The point remains, however, that the comparative benefits of payment cards – however great they may be when compared with cash – would not entitle the card schemes or their participating institutions to appropriate to themselves a supra-competitive profit by virtue of providing payment card services. If such services could be provided more cheaply and yet the benchmark for the remuneration of the providers is set against the private cost of cash, then it implies a power in the market to price up to the cost, or near the cost, of that unsatisfactory and increasingly archaic substitute. If the benchmark is the social cost of cash, then the implication is even more serious – that the schemes and/or their participants have the power to appropriate to themselves by their private decisions an element of social subsidy which, in the case of cash, is provided by the public power under ultimate democratic control.

Accordingly, what must be sought in the case of payment card services and other innovative means of payment is the full utilisation of their progressive potential at the lowest, i.e., most

R5.00 and R4.60.

111 Cf Mr Munson's example concerning the dangers of making ATM cash withdrawals to pay for purchases in some areas: Transcript 18 April 2007, pp 102-103.

112 Later he added that "for cash, the difference between the cost to the merchant and the cost to society is very, very large, which basically shows that cash is a heavily subsidised payment system." *Id.*, p 67.

competitive, prices to consumers and cost to society. For reasons which we shall explain shortly, there are serious grounds for concern that the aggregate prices of payment card services may be kept artificially high by the actions of the schemes and the combination of their participating institutions in interchange arrangements.

6.2.5 Global strength of Visa and MasterCard

In understanding the current competitive landscape for payment cards in South Africa, it is important to take account of the extent to which the four-party schemes, Visa and MasterCard, have established their position internationally.

According to MasterCard, it provides services in more than 210 countries and territories.[113] It has a network of more than 24 million merchant acceptance locations around the world.[114] More than 1 billion cards have been issued worldwide under the MasterCard brand and its related brands[115] – Maestro®, Cirrus® and MasterCard® PayPass™.[116] Financial institutions issuing cards under these brands numbered almost 25,000 worldwide by 2005.[117] In that year, cardholders across the world used MasterCard-branded cards (excluding Maestro and Cirrus) for more than 19.1 billion transactions, generating a gross domestic volume of $1.7 trillion [118] and net revenue for MasterCard of $2.9 billion.[119]

According to Visa, it has 1.5 billion cards globally, issued by some 22,000 banks (and other licensed institutions). The total annual expenditure by cardholders, using these cards in about 50 billion transactions with 24 million merchants, is US$4.5 trillion.[120]

Both Visa and MasterCard are able to switch and settle transactions internationally. Domestic transactions may also be switched offshore via processing centres located in the USA, Europe and elsewhere. Currently, for example, domestic transactions involving cards issued by Investec Bank are switched through Visa's international network.[121] Switching a transaction in this way takes a fraction of a second, and both the MasterCard and Visa networks have vastly greater technical capacity than is currently used.

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113 *Company Fact Sheet* on www.mastercard.com.

114 *Id.*

115 *Id.* People may, of course, hold more than one card.

116 *Company Fact Sheet, supra.*

117 MasterCard, October 2006, First Submission, p 16.

118 *Id.*

119 *Id.*, p 15.

120 Visa, June 2007, Second Submission, document B (first part) p 7.

121 Also, Mercantile Bank testified that it has been switching its credit card transactions through Visa. (Transcript 28 May 2007, p 162.)

6.2.6 Network advantages of four-party schemes

> Global cooperative associations combine the competition and innovation of the private sector with economies of scale, shared technology and infrastructure, and interoperability.[122]

It is claimed that the four-party or open loop system allows and encourages competition among issuers for cardholders and among acquirers for merchants,[123] and that "the benefit that arises from competition amongst issuers and from competition among acquirers that is seen within a four-party scheme is not found"[124] in the three-party or closed loop system. This section explores the evidence presented to the Enquiry in this regard.

With a roughly 50/50 split of the South African market between Visa and MasterCard scheme cards, [125] the tendency on the part of the major banks is towards issuing both.[126] In this situation, once some major banks issue both scheme cards, others that did not follow could well find the amount of their interchange receipts falling and the amount of interchange they pay away rising, relative to those that did. This process must tend to consolidate the dominance of the four-party schemes in the payment card market.[127] Efficiencies and network effects evidently drive the market towards convergence (and towards four-party schemes).

According to Mr Volker of Absa, although the big four banks might each be able to operate its own three-party scheme in the longer term, the duplication of infrastructure would make the system generally less efficient, and smaller banks would simply not be able to afford to enter the acquiring market.[128]

Mr Fergus of Standard Bank said in this regard:

> If you have a three party scheme the cardholders [in that scheme] all have to be with one [issuing] organisation. So, if Standard Bank had a three-party mass market product, it could

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122 *The Virtuous Circle: Electronic Payments and Economic Growth*, *supra*, p 5.

123 Cf Visa, June 2007, Second Submission, document B (third part) p 17.

124 Absa, Transcript 17 April 2007, p 68.

125 Transcript 18 April 2007, p 144 (MasterCard).

126 See Table 1 above.

127 At the same time, an advantage to banks in issuing (and acquiring) for both schemes is that banks can take advantage of certain competitive dynamics between the schemes in respect of scheme charges, introduction of new products, etc. (Absa, Transcript 17 April 2007, pp 164-165 (Mr Sweeney).) Despite the strength and scale of the major card schemes, banks do have some ability to play one scheme off against another, having regard to the fact that there are different choices of cards available, including "white cards". (Nedbank, Transcript 19 April 2007, pp 64-65.)

128 Transcript 17 April, pp 160-161. The duplication of infrastructure should not be exaggerated. Where acquiring infrastructure is concerned, there can be and is significant sharing between schemes. Thus the same merchant terminals can usually be used for Visa and MasterCard, as well as Diners Club, American Express and other (white label) card transactions. Nevertheless, each three-party scheme at least has to have a separate acquiring contract with each merchant. This points to the relative efficiency of schemes which link all the participants without their having to conclude multiple direct contractual arrangements. Moreover, the ability of a three-party scheme like American Express to operate its merchant acquiring via an existing communications network with merchants has depended on that network being established in the first place to meet the needs of four-party scheme transactions.

> only issue it to its customers. It could not issue it to anyone else and the card would only be accepted at retailers who had signed up for that scheme. So, you would not have one scheme, you would have in South Africa ... twelve schemes, all potentially with different systemic risk, different financial risk, different standards, different operating rules, different dispute resolution criteria, you know, and you have then got to have the management and the supervision of all those schemes.
>
> The open scheme says that the four banks [*sic*] can issue cards to their cardholders and those cards can be used at merchants acquired by all of those four banks, and that is the difference. … The costs [of numerous competing three-party schemes] would be absolutely enormous to the … merchants, and the cardholders. … [T]he greatest advantage that MasterCard or Visa have, is thirty years of financial settlement experience and thirty years of experience in the rules and regulations that we all comply with. [Especially in] dealing with disputes, … dispute resolution between the cardholder and the merchants, so they are not favouring one or the other. Those rules have evolved over thirty years and they are a fantastically balanced set of documents. To start that from scratch has an enormous cost. … The costs in payment cards is in the disputes.[129]

Mr von Zeuner of Absa explained that a change to a multiplicity of three-party schemes would be a step backwards:

> The card of any individual bank would never enjoy the same level of merchant acceptance as a Visa and MasterCard and can I illustrate our point by our own experience over white label cards when we in the late 90's had a bank teller card equivalent to a white label card that just never took off other than being a mechanism that we used in our ATM's.[130]

MasterCard's representatives, beginning with Mr Munson, were questioned by members of the Panel about the need to retain the four-party model:

> MRS NYASULU: … [Y]ou asked the question, is interchange necessary? Can I turn that on its head and say rather – and let's just assume for one minute that I am not going to fight with you on whether interchange is necessary or not, but rather say – is a four-party payment system necessary?
>
> MR MUNSON: … Four-party payment systems, as compared with the other models? … I would call it a two-party system, or a private legal system, where the merchant actually offers the credit card. That is the original model. In four-party systems as compared to three-party systems like the American Express system, and there is even another variation which you might have seen a slide in my remarks, a 3½-party model, where you have issuers, but only a single acquirer, I call that a 3½-party model. So, … to answer the question I think you have to say, in comparison to what, and then you can conclude a few things.
>
> First of all, given the history of the business. The business started with the two-party systems and then there was the introduction of the three-party systems, and then the introduction of the 3½- and the four-party systems. … So, if you look at the evolution of the business, the business evolved from the two-party model, where if you wanted to use your credit card at a store, you had to get a credit card from that store. So, if you shopped at a lot of stores, well then you had to have a lot of credit cards. … Now, that evolved to a three-party system. The advantage of a three-party system is that the entity that runs the system can sign up multiple merchants, different merchants to accept its cards and then can go to the cardholder and say you only need one card, and you can shop at many different locations, and … I think it is pretty obvious that it provides a benefit to the cardholder. At the same time it provides a

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129 Transcript 19 April 2007, pp 107-108.

130 Transcript 17 April 2007, p 72. Standard Bank, April 2007, Second Submission, Issuing, Part I, p 10, defines a "white label" card as "a piece of plastic that is issued by a bank or non-bank and is interoperable in certain respects, but is not association branded."

benefit to the merchant.

First of all, the merchant does not have to go to the expense and run the risk of running its own business, especially smaller merchants, who probably could not afford their own credit card business, and they now have a greater number of customers to draw from …. No one knows me if I go into a shop in South Africa. They do not know if I have good credit or bad credit, but if I have a MasterCard, they are pretty comfortable that if they sell me something, they are going to get paid. … I should say American Express, because we are talking about [the] three-party [model]. If I would have pulled out the American Express [card], they would be pretty comfortable that they will be getting paid. That is three-party. But there is a further improvement. We can have a four-party system.

In a four-party system, instead of having just one company offering cards, and just one company signing up merchants, we can allow different companies, typically banks, to issue these cards and we can allow different companies to compete for the business of the merchants. Now, from both the cardholder's and the merchant's point of view, I would contend that is an advantage. … There is now a new form of competition in the market, so that cardholders and merchants will have additional choices. If you want a MasterCard card as a consumer in South Africa, you are not limited to dealing with one entity. You can go out, and from what I heard yesterday, have as many as eleven choices to choose from, and if you are a merchant and you want to accept MasterCard cards, from what I heard yesterday, you have a choice not just of one entity to go to, one acquirer, you have a choice of four. …

There is another benefit which I think in the long run may even be more significant, and that is because these issuers and acquirers within the system are still competing with each other, they are constantly innovating, and because MasterCard has to worry about the desirability of its service, it is also competing and this tends to drive innovation. If you look at the major innovations in the payments market over the last 20 or 30 years, for example the introduction of electronic payments – because in the old days credit card transactions were not electronic, they were paper-based. You know, you zip-zapped the card, and you filled out a receipt, and that was physically transported somewhere and then someone keyed in their numbers. And one of the greatest innovations which took place in the 1970's was the introduction of the electronic terminal. That introduction was driven by the four-party systems. A more recent example of sort of the same thing is the introduction of chip cards, where you replace the mag-stripe with a much more secure and much more versatile computer chip in the card, and that innovation is driven by a four-party system.

MRS NYASULU: Okay, I am going to stop you there for a while if you do not mind, because you have answered the first part of my question. What I now want to probe with you is, you are obviously assuming that the only way that we can introduce competition is to follow the four-party model, whereas I am saying, there is nothing that stops us introducing competition within a three-party model, and having many American Expresses, in other words, compete that way. … Hence my question about why the four-party scheme is being touted as the only one, because the three-party model also gives merchants access to a system that they want, it gives consumers or cardholders access to a system that they want, so it does everything that the four-party model does. It just does not charge interchange.

MR MUNSON: Two points I would make. First of all, I perhaps I did not express it well, but in fact the three-party model does not do everything that the four party model does. There is no intra-brand or intra-system competition. If you want an American Express card, you have one choice. You go to American Express ...

MRS NYASULU: Is that a bad thing?

MR MUNSON: It is for you folks to decide whether more competition is better than less competition, but it is a fact, that there is an additional form of competition within a four-party system. It is a fact that if you look at merchant fees around the world, you compare merchant fees, MSC's between three party systems and four party systems, generally the merchant fees of four-party systems are lower.

CHAIRPERSON: But there is no interchange.

MR MUNSON: So, let me address that. There is no interchange fee. Why is that? Well, because once again, interchange fee is this term that we use to apply to the – to use Mr. Bodibe's example before of reallocating the costs within the system, and I say, yes that is the purpose of interchange. But do not misunderstand. The mere fact that a three-party system does not formally need an interchange, because it does not have to move money between different banks, does not mean it is not moving money between the acquiring and the issuing sides. In fact, there is some good indication to believe that in most cases they are actually moving more money from the merchant's side to the cardholder's side, in other words there is even more subsidisation of cardholder fees going on in three party systems.

So yes, four party systems need interchange, but both systems need to balance the demand as Dr Koboldt explained, and therefore you do not avoid the need to balance the system just because you have a three-party model.

MR GROBLER: Can I just possibly … explain in the context of South Africa … [the point about] the development of the acceptance infrastructure. Through the four-party model it is developed through the four – we actually have got five – acquiring banks in South Africa. I want to include Capitec as an acquiring bank as well. So, the collective result is much wider than the three-party context.

But I think if you look at the amount of products that has been issued in the four-party model in comparison to the amount of products that has been issued in the three-party model, currently in South Africa there are about 24 million debit cards that can be used at point of sales in the four party model, that have been issued. Part of that is the Mzansi card, and really for us to address the market that we really need to address I would make the assumption that in the context of the three-party model it may be much more expensive … to penetrate the market as deep as we can do potentially through the four-party system. I do not want to argue it is an either or. I think it's a both factor.

MRS NYASULU: I would support it on the basis that I said I would support theories. You and I can only put theories on the table, we have not tested it. But if I am willing to explore theories I am quite happy for you to explore the same and it is quite possible that it would be expensive.

MR MUNSON: And, we are not against three-party models.

MRS NYASULU: And I am not against four-party. I am looking for a different way to do things and whether ...

MR MUNSON: My own personal view is that consumers and merchants are most benefited when they have as many choices as possible. Personally I do not think it is a bad thing that American Express exists. I mean, certainly they prompt us to pay even more attention to our business, because we know they are a very effective competitor and they run a very fine company. So, to me though, it should not be a choice between three- and four-party, it should be both, and three-parties do bring certain advantages to the market and four-party systems bring other advantages, and I think consumers and merchants are benefited if they have both choices.

DR KOBOLDT: Can I just add one observation that is more a theoretical observation. The benefit of intra-scheme competition I think extends further than just being able to say, well I [can] get my MasterCard from Nedbank, ABSA, or whoever. The benefits extend to fostering competition amongst banks for a whole range of services, to the extent that there is a tendency for customers to want to have relationships or a single relationship with the bank for a range of services if you had only three-party systems competing with each other. Centrally, if I wanted a credit card, I could only go to one of those few banks who are sufficiently large to be able to run a three-party system. We heard yesterday from ABSA that it is not even guaranteed that they could … launch a three-party system on their own, so that would severely limit the number of three-party systems that could be sustained in the market. So, if I

> am a smaller bank and I cannot run a three-party system of my own, I am also limited in terms of access to customers who want single bank relationships. So, if somebody wants a credit card, and a current account and maybe some other products, and I cannot offer a credit card …, I cannot compete in that space, so there are wider competition benefits from a four-party system than just intra-scheme competition in terms of choice of provider of issuing services.[131]

On similar lines, Visa and Global Insight say:

> As a highly decentralised entity, Visa permits a great degree of autonomy to member institutions in product development, product management, pricing, and promotion. The unique characteristics of this governance structure[132] enable the central organisation to ensure cooperative efforts in the management of common assets, while fostering a competitive market model at the retail institutional level. While the common benefits of system sharing are conferred on all members, greater product innovation, quality and diversity are achieved at lower prices locally.[133]
>
> There are considerable benefits in maximising joint assets and ensuring interoperability in the payment system. Huge investments in physical and knowledge capital are required to establish and maintain the infrastructure that drives the flow of international transactions – including instantaneous authorisation, ongoing risk management processes, and daily clearing and settlement. The nature of the system's cost structure, with high fixed costs relative to low marginal costs, requires a substantial volume of transactions to warrant the infrastructure investment. But it is through the interoperability of the system that common benefits are produced with larger volumes. This results in efficient sharing of common resources, fully utilising the fixed assets of the business, and exploiting economies of scale and scope.[134]

Nedbank confirmed that the four-party model has promoted interoperability between banks which, in the South African context, has been "a great success story".[135] Visa noted that interoperability between banks drives electronic payments, which are more efficient than cash, bring people into the banking system, increase spending, and reduce the grey economy and increase tax revenue.[136]

FNB expressed the advantages of the four-party model in this way:

> MS DE BEER: … Essentially, the four-party model has many contributors. It is a global interoperable system as we know it in South Africa today. So there are many contributors that contribute to the cost of that model. There are many contributors to maintaining that infrastructure, maintaining the integrity of that infrastructure. So … the four party model has succeeded in gathering critical mass. A three-party model has not…. [Through the four-party model], one is able to gain efficiencies, economies of scale, etc. In the three-party model as we know it today, the three-party model in fact [feeds] off the infrastructure that a four-party model eventually provided to the market. And that is the point that we are trying to illustrate, that the four-party model has already achieved critical mass which makes it necessarily more

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131 Transcript 18 April 2007, pp 121 - 131

132 In fact the structure of MasterCard is essentially similar.

133 *Op cit.*, p 16.

134 *Id.*, 16.

135 Nedbank, Transcript 19 April 2007, p 3.

136 Visa, June 2007, Second Submission, document B (first part) p 4.

efficient in that sense.[137]

In the roll-out of debit cards by Absa it was found to be important to get a brand more universal than the bank's own brand – hence the involvement of the card associations.[138]

> [O]n top of the brand, they also offered a world class body of rules, operating regulations, security standards that we could access at a marginal cost, compared to if we had to that ourselves. Plus, it would also open up the ability to have other bank's terminals acquiring our systems, and I [Mr Volker] think that whole system enabled greater economies of scale benefits to our consumers, and ultimately also to the merchants.[139]

However, most South Africans have no immediate need of a card that can be used overseas. This raises the question regarding the scope for developing white label or locally-branded cards as cheaper alternatives to the brands of the major card schemes – especially for consumers who do not enter into global internet transactions or use cards beyond the border of South Africa or beyond SADC.

Indeed, South Africa does have several successful, albeit small, white label cards in circulation. Expansion of such cards on a national basis has intuitive appeal, especially given the successful national white label schemes developed in the past in countries such as Norway. However it is important to point out that the successful national white label schemes were generally developed together with the banking industry and before global standards of interoperability became widespread. Even in the Scandinavian countries, as we discuss below, the movement now is in the direction of link-ups with globally branded four-party schemes.

In South Africa, interoperability in the payment card arena was developed in conjunction with these four-party schemes. Establishing or developing an entirely new proprietary or interoperable network on a national scale is inherently complex and expensive.

> MR GERICKE: So Chair, as I understand the question it's around extending effectively white label cards to look and feel and operate like a Visa and MasterCard but not through the Visa or Master [schemes].
>
> CHAIRPERSON: Yes that is exactly the question.
>
> MR GERICKE: There would be real difficulty in that because for interoperability you will have to create a payments platform of sorts, with its own rules. What works in these two-sided models or the private label card businesses is that that there are very specific retailers and only their stores that can be shopped at by clients. As soon as one wants to take a private label, white label card, across multiple domains you need a payments platform of sorts to

137 Transcript 19 April 2007, pp 191-192.

138 Transcript 17 April 2007, p 100. Visa advanced much the same argument: A four-party scheme not only enables the co-operation between the participating institutions and their customers in a fundamental way. It also facilitates this co-operation by assisting participants with dispute resolution, fraud protection and compliance monitoring, and provides a clearing and settlement system between them should they need it. (Visa, June 2007, Second Submission, document B (first part) p 16.)

139 Transcript 17 April 2007, p 100. Buy-aid societies' cards do not carry a global or international cards scheme logo; they might carry a bank logo but they are only national cards and they can only be used in South Africa. Examples are Pretorium Trust, Cape Consumers, Koopkrag and so forth. See *id.* pp 12-13.

> allow for the interaction and allow for the exchange of the messages and make sure the technology can talk to one another.
>
> CHAIRPERSON: Well … I am setting up this particular scenario with a payment system of some sort [in mind]. … [Y]ou can in cooperation with the others set up a payment system of some sort.
>
> MR SHUTER: Yes, Chair, that is possible. If one looks at many European countries and how they started their debit card schemes, they were local within country and [they were] proprietary systems that the banks created, or the regulator created, that facilitated that card payment within that region. So that is possible, but it still requires a payments platform to be created and to be synthesized with all the rules of acceptance, but it is possible.[140]

Mrs Nyasulu observed that both closed systems – American Express and Diners Club – are aimed at high net worth individuals.[141] Mr Fergus offered the explanation that this is on account of "the intrinsic cost of the closed scheme," which required higher than normal transaction values for merchants on the one hand, and higher than normal benefits to cardholders on the other hand, in order to generate the necessary revenue. "There are relatively few people in any market who are prepared to pay the premium for all those services."[142] Although he was not prepared to say that three-party schemes are suitable only for high net worth individuals, he did not know of any three-party scheme that is suitable for the lower end of the market.[143]

In the light of the information presented to the Enquiry, it appears that the actual and potential benefits arising from the four-party networks are considerable and that an attempt to prohibit and replace them domestically with only three-party schemes would be misconceived. To the extent that remedies are required to address abuses, or the dangers of abuse, brought about by the growth and power of these schemes, those remedies must be so constructed as not to isolate South Africa from the mainstreams of global development, or throw the baby out with the bathwater.

6.3 Merchant acquiring and merchant service charges

6.3.1 Merchant acquiring in the three-party and four-party schemes

As we have seen, an essential characteristic of four-party card schemes such as Visa and MasterCard is that the schemes themselves do not issue cards or acquire merchants'

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140 Transcript 19 April 2007, pp 25-26.

141 Transcript 19 April 2007, pp 95-96. American Express acknowledged in its Submission, October 2006, p 2, that its credit card network "is focused on the premium segment – aimed at high-spending, financially reliable cardholders – thereby offering a significant range of innovative and value-added benefits to merchants and cardholders above those generally available from other credit card networks." Likewise on p 3: "Amex's business model permits it to operate as a significant niche player, focusing principally on providing premium services to high net-worth card members and Amex merchants."

142 *Id.*, p 96.

143 *Id.*, pp 96-97.

transactions.[144] These functions are separately carried out by independent issuers and acquirers who do so as participants in the schemes concerned. Both MasterCard and Visa have recently restructured their global operations, so that participating issuers and acquirers are no longer technically "members" but simply licensees in terms of the schemes.[145]

In South Africa, at the time of making its first submission to the Enquiry, MasterCard had nine principal member banks and one affiliate member bank.[146] Visa, at the time of making its submissions, had ten principal members[147] and two associate members[148] in South Africa. However, at the time of the initial submissions, while all these participating banks were allowed to issue Visa and/or MasterCard scheme cards, only the four big banks were allowed to *acquire* both credit card and debit card transactions. Capitec[149] and Mercantile[150] joined these ranks only recently (see further below).

Visa says:

> The traditional model for Acquiring in the South African market is a very simple model in which the Acquiring Bank contracts with the Merchant to process all card transactions that are accepted at the merchant.[151]

The original point of sale (POS) devices used a dial-up modem across a normal telephone line and the communications costs associated with the use of the POS device were for the merchant to settle directly with Telkom. A number of variants and improvements have developed, including improved communications, host-to-host systems, third party processors and outsource network providers.[152]

Currently, GPRS (General Packet Radio Service) telecommunications technology is allowing faster connectivity at lower costs in previously underserved and inaccessible areas. Larger retailers have established direct host-to-host links between their own mainframe and the mainframe of their acquiring banks. Measures are in place to maintain the security of these connections. Settlement of merchants' entitlements to payment is able to take place several

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144 Nor does the scheme itself interact directly with cardholders. See e.g. Visa, June 2007, Second Submission, document B (first part), p 11.

145 Visa Europe, however, continues to function within the new structure as a members' association under licence. (Press release by Visa, 11 October 2006, accompanying letter to the Competition Commission from attorneys Deneys Reitz on behalf of Visa International Service Association, 14 June 2007.) MasterCard now refers to what were formerly "members" as "simply customers". (See e.g. MasterCard, October 2006, First Submission, p 4.) They continue to operate under licence to MasterCard. (*Id.*, p 6.)

146 MasterCard, October 2006, First Submission, p 14.

147 In the Visa scheme, a Principal Member may issue cards and acquire merchants, subject to Visa licensing. (Visa, First Submission, October 2006, p 20.)

148 An Associate must be sponsored by a Principal Member. (*Id.*, p 21.)

149 Capitec, March 2008, Further questions for Capitec.

150 The MasterCard license for Mercantile was approved in November 2007, and the Visa application is expected to be approved shortly (Mercantile, March 2008, Competition Enquiry Questions and Answers).

151 Visa, June 2007, Second Submission, document G.

152 *Id.*

times a day.[153]

The process typically involved when a participating bank acquires a merchant for a card scheme, and the scheme's concern with the risks involved, were described by MasterCard's representatives as follows:[154]

> MR GROBLER: I think typically when an acquiring bank will approach a merchant, part of the process will be to look at the viability of the business case of the merchant. And the second point that will be addressed is … the Merchant Category Code, that is the business segment in which the merchant operates typically. That will play a very important role in terms of the risk inherent in the business. The acquiring bank will also then do an assessment in terms of the business practice and the integrity of the merchant and at that stage the acquiring bank will typically engage in discussions with the merchant on the merchant service fee. After they have reached agreement on that, there will be typically a merchant acquiring agreement which the merchant will engage in and the acquiring bank then has got the responsibility to do training with the merchant in terms of risk and security. … [T]hat is more or less, on a very high level the process. It is also expected from the acquiring bank to visit the merchant or to do site visits on an annual basis. That is a normal conventional merchant. I have not referred to the typical mail order or the telephone order environment. …
>
> I have referred to a typical smaller merchant, you know, where the acquiring bank will typically install a point of sale device with the merchant, so that is normally not an integrated system. In the scenario of larger retailers obviously the point of sale equipment is integrated with their infrastructure and that may be a … more complex process. But I think on a high level what is important is assessment, is the training of the merchant and then the merchant agreement.
>
> MR MUNSON: … [E]ssentially MasterCard has two concerns that it relies upon the acquirer to address. One is, to make sure that we do not bring into the system a fraudulent merchant or a merchant that is operating a business in a way that will increase the risk to the business, and secondly to make sure that the merchant is abiding by the rules, terms and conditions of the system, accepting cards, etc. … [T]he acquirer provides two essential services and the first is, the acquirer actually assumes the risk, financial risk to the system if the merchant does something wrong, and secondly the acquirer assures us that the merchant is following whatever rules are applicable to the merchant's business as it participates in the system.
>
> MR GROBLER: … [W]e also expect the acquiring banks to monitor the incidence of charge backs. Now, a charge back is a technical term that we use for transactions that have been disputed by cardholders with merchants and if it exceeds a certain ratio, then we expect the acquiring bank to take some action with that merchant, you know, normally it is corrective action, it is training and some kind of intervention with them.
>
> MR BODIBE: Now that the merchant is now compliant and the agreement has been signed, what financial outlays should the merchant invest to participate in the system? So basically how much do they pay for the terminals and also for ensuring integration of their communication systems with the bank's system? …[155]
>
> MR GROBLER: ... You know, it is obvious that there is a business agreement between the acquiring bank and the merchant but what will typically happen in South Africa, and again I am referring to the smaller merchant, I am not referring to the bigger retailers, is that the smaller merchant will typically rent the point of sale device from the acquiring bank. The acquiring bank will provide the merchant with stationery and the necessary supporting material …. [T]here is a move away from fixed line telecommunication to GPRS

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153 *Id.*

154 Transcript 18 April 2007, pp 73-81.

155 Mr Munson intervened to point out that the question could be answered by MasterCard only at a general level, and that the details of such arrangements with merchants would best be obtained from the acquirers. *Id.*, p 76.

communication, so [normally] that will be set up for the merchant and I would say that is more or less the capital outlay for the smaller merchant. For the bigger merchants it is obviously a bit more complex in terms of integration with their systems…..

MR MUNSON: … [I]f you look at the way the acquiring business is structured around the world you find different models, [but] ultimately what it boils down to is to connect a merchant to the MasterCard system. It does require investment in equipment, in communications, in training and in ongoing monitoring, and the model can vary from country to country and from merchant to merchant. Essentially the negotiating process is to decide, is the acquirer going to put up the capital and then charge a monthly fee or a service fee or make it part of the merchant service charge, or is the merchant going to provide that equipment on its own and thereby reduce the amount of money it pays the acquirer and assume the cost itself, and there are many, many variations that can be made to accomplish those purposes.[156]

Mr Bodibe asked MasterCard about the factors usually built into the service charge paid by the merchant to the acquirer.

MR GROBLER: As I have indicated and I am typically referring to the single acquiring model, … what will typically be reflected in the merchant's service fee, will be the risk profile of the merchant; it will be the turnover of the merchant; it will be the product set of the merchant, the kind of products, internal risk involved in that, whether the merchant is well established or not; and the cost of service to merchant. … [I]n the single acquiring scenario where we made the assumption that the acquirer provides the terminal and the stationery, there is obviously a cost involved in that as well, a maintenance cost. So, I would say those are more or less the variables that will play a role in the merchant's service fee. …[O]bviously there is some business strategy behind it as well. Some of the acquirers may try to focus on smaller merchants, some may focus on bigger merchants or retailers…

… [T]ypically if it is a product that has got inherent risk to it, let me think about mail order, telephone order, and there may be a higher level of risk in terms of the delivery of the product on that, [then] that may play a role in the setting of the merchant's service fee.

MR MUNSON: Risk can be a huge factor. I recall earlier in my career at MasterCard, in the 1990's, you may recall there were a wave of airline failures. Pan American ran out of business, TWA went out of business, Continental went through chapter 11 and if you think about it, if you were an acquirer of an airline where huge amounts of tickets are bought in advance and then the card holders come back to the bank and say, I bought this ticket and the airline is out of business, give me my money back, and then under the charge back process that Eddie mentioned, the issuer then charges that back to the acquirer and says, give me my money back, and now the acquirer is sitting there with a liability and its customer, the merchant, is out of business. … [I]t is just an example that the risk that the acquirer takes can be very large. On the other hand, if the acquirer is dealing with a mainline retailer or large department store that has a long track record, you know, the risk may be relatively small. So risk plays a huge part in the setup and management of the payment system for the issuer, for the acquirer, … and for the scheme because we actually guarantee the payment of the issuer to the acquirer and if the acquirer cannot [meet] the charge backs, we guarantee that. So we are very concerned about who are our issuers and who are our acquirers, how well are they running their businesses. Are they taking excessive risks? So risk becomes one of the most important factors in just about every aspect of the business.

(The main scheme rules relating to the allocation and management of risk are outlined below.)

Visa explains that third party processors have arisen to take on some or all of the processing

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[156] In answer to Mr Bodibe, Mr Munson confirmed that merchants would ordinarily have a choice whether to invest in their own equipment or rent it from the acquiring bank. (*Id.,* p 78.)

responsibilities on behalf of their clients – whether these clients be retailers or acquiring banks. "A number of these Third Party Processors connect directly to Visa and MasterCard on behalf of their customers." Visa allows outsourcing by its members [licensees] of certain card payment services, albeit under careful scheme rules.[157] The acquiring bank must nominate the processor and remains responsible to the scheme for adherence to standards and good business practice.[158]

As has been explained above, three-party schemes like American Express and Diners Club do their own card issuing and merchant acquiring. However, to extend its operations, a three-party scheme may give acquiring and issuing licenses to institutions to carry out these functions on its behalf. In the case of American Express, this is described as its Global Network Services (GNS) business model.[159] In South Africa this model prevails, with Nedbank functioning as the sole licensee for American Express.[160]

> Essentially Nedbank is licensed by American Express to issue and acquire Amex cards in the South African market. We are the only entity that is licensed, so we commonly call that a closed loop system. We are the single issuer – you won't find an American Express card which does not say Nedbank on the back – and we are the single acquirer. So for a merchant to accept American Express cards, they have to sign a merchant agreement with Nedbank.[161]

Acceptance of American Express cards by a merchant is a simple matter where Nedbank is also the acquirer for the merchant's acceptance of MasterCard and Visa cards: the same Nedbank infrastructure is readily available. Where an American Express card is used at a merchant whose acquiring service for accepting MasterCard and/or Visa cards is from another bank, that other bank plays a "courier role" by routing the American Express transaction to Nedbank.[162] That other bank is allowing its infrastructure to be used for the acceptance of American Express cards.

Such an arrangement depends on a bilateral agreement between Nedbank and the other bank, before a merchant relying on that other bank's infrastructure can accept American Express cards. However, the actual acquiring relationship where the merchant accepts American Express cards is not with that other bank, but with American Express through its sole licensee, Nedbank. Thus it remains a closed system in this situation as well.[163]

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157 Visa, June 2007, Second Submission, document E.

158 *Id.,* document G.

159 American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking, p 3.

160 Nedbank describes itself as the appointed 'Independent Operator' of the American Express Card Service (Nedbank, March 2007, Second Submission, Issuing, p 13). On behalf of the scheme, Nedbank negotiates, sets and receives all fees applicable to end users on these cards. (*Id.*) In turn, the payments to American Express are negotiated bilaterally between Nedbank and the scheme.

161 Transcript 19 April 2007, p 13 (Mr Shuter).

162 *Id.*, p 14.

163 *Id.,* pp 14-16. This is confirmed by American Express in its Submission, October 2006, p 2: "Amex's merchant agreements are bilateral agreements between the merchant and Amex as acquirer."

Diners Club is likewise a closed system. At the time when submissions were made to the Enquiry, Diners Club South Africa (Pty) Limited was a wholly owned subsidiary of Standard Bank (SBSA), operating under a franchise from Diners Club International.[164] Diners Club South Africa is the issuer and acquirer of Diners Club cards in South Africa, negotiates merchant service charges with merchants and decides on the level and incidence of fees on Diners Club cards.[165] Diners Club transactions are acquired using, for a service fee, the merchant acquiring infrastructure of banks acquiring under the four-party schemes.[166]

6.3.2 Scheme rules and practices in the allocation and management of risk

The four-party card schemes allocate liability for the costs of fraud and other risks in the system by means of various rules and practices. Visa states:

> How the liability is distributed between the cardholder and merchant, by the issuer and the acquirer is a matter of local law, custom and practice, and the commercial bargaining position of the merchant and cardholder, and set out in the cardholder agreement and the merchant contract.[167]

However, in general, “the liability [loss] lies where it falls”.[168]

> Once [the card transaction has been] approved, the cardholder receives the goods and the merchant receives a ‘payment guarantee’ from the acquiring bank.[169]

In providing such a guarantee, the acquiring bank is supported by a “promise of the issuing bank to honour payments made by the acquiring bank”.[170]

Visa and MasterCard both underwrite these guarantees, and take initial responsibility to cover any losses that a member institution may incur because of another member institution’s default.[171]

In most instances the issuing banks are liable for fraudulent transactions in the system.[172] The promise of the issuing bank to pay the acquiring bank includes fraudulent transactions

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164 SBSA, April 2007, Second Submission, , Acquiring, p 4; Issuing, Part I, p 3. SBSA bought a controlling interest in Diners Club SA in 1966 and acquired the rest of the shares in 1987. (*Id.*, Issuing, p 11.) As franchisee, Diners Club SA pays Diners Club International a royalty fee of 0.2% of turnover. (*Id.*, Issuing, p 12.) Confidential: SBSA

165 *Id.*, Issuing p 12 and Acquiring p 29. For Diners Club fees to cardholders in South Africa, see *Id.*, Annexure 4A. Diners Club itself did not make a submission to the Enquiry.

166 See SBSA, April 2007, Second Submission, Acquiring, p 28; also Nedbank, March 2007, Second Submission, Acquiring, p 19; FNB, March 2007, Second Submission, Acquiring, pp 14-15. Cf Absa, March 2007, Second Submission, Acquiring, p 14.

167 Visa, June 2007, Second Submission, Annexure H, p 1

168 *Id.*

169 *Id,* Annexure S, p 6.

170 *Id.*

171 Transcript 18 April 2007, pp 73-81 (MasterCard) and Visa, June 2007, Second Submission, Annexure E, p 2.

172 FNB, March 2007, Second Submission, Acquiring, p 8 and Nedbank, March 2007, Second Submission, Acquiring, p 10.

and transactions for which the cardholder ultimately defaults. The payment guarantee, in most instances, enters into the cost calculations of the interchange fee that is paid over from the acquiring bank to the issuing bank.

However, the merchant – and likewise the merchant's acquiring bank – will be vulnerable to "chargebacks". A chargeback, as defined by Visa, is "the ability of the Issuing bank to 'charge back' a transaction to the Acquirer unpaid." [173] The acquirer will usually then have recourse against the merchant. Issuing banks are only entitled to make chargebacks to acquirers, and acquirers to merchants, for valid reasons which are described in the operating rules and regulations of the schemes.[174]

Mr Herzfeld of the South African Retailers Payments Issues Forum (SARPIF), while supporting the right of cardholders to dispute transactions during the chargeback period, pointed out that this leaves the "payment guarantee" to the merchant far less than "unconditional". In his experience, where a chargeback is made, the merchant is ultimately left to resolve the dispute with the cardholder.[175]

Absa explains that:[176]

> For point of sale transactions made by either credit cards or debit cards, the customer is liable for lost and stolen cards up to the point of reporting a card lost or stolen. …[177]
>
> After the customer reported the card lost or stolen, the liability passes on to the issuing bank. This card is then loaded onto the "hot card" file which updates to each of the point of sale terminals. This takes two days to be effective and the card remains on the hot card file for 60 days. The verification of the hot card file then happens automatically by the terminal. The merchant will then have a message that the card is lost or stolen and what the appropriate protocol to follow at this stage is. If the merchant follows the appropriate procedure then the liability remains with the issuing bank. If the merchant does not follow the procedure then the merchant bears the risk of potential loss.
>
> For point of sale purchases made by credit cards, suspected fraudulent transactions are first charged back to the merchant who then has to prove that the transaction is authentic by submitting the point of sale slip signed by the customer.[178] The merchant may then submit the transaction for settlement whereupon the liability will move to the issuer. If fraud has occurred then the issuer is liable for this; if it has not occurred (e.g. where the cardholder forgot about the transaction) then the transaction would be paid by the cardholder. Where it

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173 Visa, June 2007, Second Submission, Annexure H, p 1. Chargebacks are an integral part of the system, provided for in the scheme's operating regulations. There is a range of possible reasons for chargebacks, but typical instances are where the cardholder asserts that he or she did not authorise or participate in the transaction, or where a processing error has occurred. Also, as Visa puts it, "The cardholder by using their Visa card is offered protection where a merchant fails to deliver goods and services in accordance with the cardholder's specification or contract. If the cardholder used cash, the cardholder would have to sue the merchant directly; instead, they raise a concern with the Issuer who deals with the Acquirer, who looks to resolve this situation with the merchant." Where there is a dispute between the issuer and acquirer, the scheme will arbitrate. (See Visa, *id.*, document H, read with Attachment 6.)

174 See e.g. Visa, *id.*, Attachment 6.

175 Transcript 13 November 2006, pp 29-30.

176 Absa, March 2007, Second Submission, Issuing, p 11.

177 Absa's account deals further with exceptional cases, which we omit in quoting this summary of the general rules.

178 Since debit card transactions are on-line PIN based transactions, this circumstance does not arise for debit cards.

can be shown that the merchant was negligent, (for example, if the signature is vastly different to that on the card), then the acquiring bank would be liable and would pass the charge through to the merchant.

In the mail order, telephone order and internet environments (where the card is not physically presented to the merchant) if the customer signs an affidavit stating that he or she did not make the transaction, it will be charged back to the acquiring bank which in turn will charge it back to the merchant. However, if special security requirements of MasterCard and Visa in respect of such transactions have been met,[179] the issuing bank would be held liable (and so would have to recover the payment from the cardholder). In counterfeit fraud (such as card "skimming") and application fraud (identity theft), unless negligence on the cardholder's behalf can be proven, the issuing bank is also responsible in respect of all types of cards.[180]

With the introduction of the EMV card,[181] a "liability shift" has occurred. This means that the acquiring side becomes liable for fraudulent EMV card transactions if they take place through terminals that are not EMV compliant.[182] At the same time, the improved technology should significantly reduce the risks of fraud.

6.3.3 Flow of payments in three-party and four-party schemes

The diagram below indicates the flow of payments involved in three-party systems. In this instance, as we have seen, a single organisation issues the cards and acquires the transactions resulting from use of its cards. The card scheme (i.e., the scheme owner) itself is the only true intermediary between cardholder and merchant. The only fees payable by

179 "3DSecure" and "Verified by Visa".

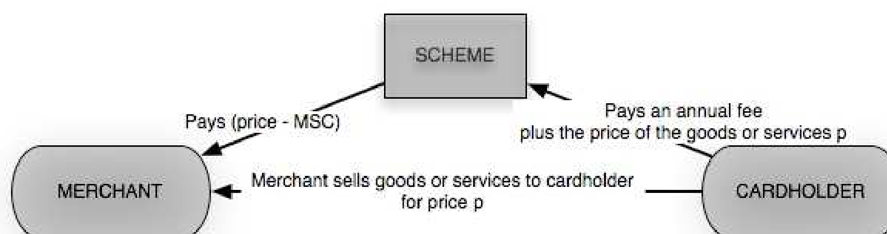
180 Absa, *id,* p 12.

181 EMV stands for "Europay MasterCard and Visa", which jointly introduced the innovation. EMV chip cards, now being actively promoted in South Africa, entail improved security for card transactions because they are harder to counterfeit, can support offline PIN verification, can support biometric verification, and make use of sophisticated mutual authentication between the terminal, the card and the authoriser. (Visa, June 2007, Second Submission, document I.) For the first time, the issuer can set various risk parameters that can be personalised on the card. New market segments can be penetrated, as more information can be stored on chip cards. Visa has introduced a "chip incentive rate" in respect of the interchange on EMV card transactions. In fact there is a combination of incentive and disincentive applied to acquirers (and thus ultimately to merchants). It is not necessary to set out all the details of it here. Essentially, where a magnetic-stripe card is presented by the cardholder, the interchange rate normally applicable to such cards will be reduced if the device used by the merchant is a chip data device. The lower rate will also apply if a chip card is presented and such a device is used – and a still lower rate if the device has PIN capability. Conversely, a rate of interchange higher than normal is charged if a chip card is presented but a magnetic-stripe terminal is used. This obviously encourages the roll-out of such devices. As chip cards become the norm, the incentive rate will fall away. (*Id.*) When asked for more information concerning the application of the incentive rate in South Africa, Visa stated that "There is no incentive interchange rate (e.g. CHIP) applied to South African domestic transactions" (Visa, March 2008, Banking Enquiry – Request for Information). MasterCard implemented a "chip migration incentive scheme" in the SEAMA region on 4 April 2003. They are currently considering implementing a similar scheme in South Africa (MasterCard, March 2008, Further documentation and information requested by the Banking Enquiry). Confidential: MasterCard

182 SARPIF stated: " 'Liability shift' date for EMV enabled transactions in South Africa was 1 January 2005 – to date no South African bank has issued any cards. However, merchants are expected to be EMV compliant and certified from that date. The shift in liability is from the issuing bank to the acquiring bank who will seek to pass the risk on to terminal-owning merchants." (Exhibit R, slide 11. See also Transcript 13 November 2006, pp 34-35.) Despite the existence and evident rationality of the particular scheme rules, disproportionate power relations between banks and their customers must tend to leave both merchants and cardholders vulnerable in actual disputes with their acquirers and issuers respectively as to where any loss should ultimately fall.

parties to a payment transaction under this model are the merchant service charge (MSC) paid by the merchant and an annual fee and/or a per transaction fee charged, along with the price of the purchase, to the cardholder's account. The scheme withholds or deducts the merchant service charge when remitting the price of the cardholder's purchase to the merchant. Because the issuing and acquiring functions are performed by the same institution – i.e., the scheme owner, although it may perform these functions with the assistance of licensees – there is no explicit interchange fee as in the four-party schemes. As explained above, there is nevertheless an *implicit* or notional flow of interchange (or "intrachange") within the scheme owner, in the sense that revenue raised on the acquiring side would be applied by the scheme owner to support the issuing side of its business. Such a notional flow, being purely internal, does not appear in the diagram below.

Figure 3 Flow of payments in a three-party system



In the open or four-party schemes, where issuing and acquiring is done by separate institutions (in South Africa, banks), interchange flows from the acquirer to the issuer in off-us transactions. When a cardholder uses a card of one of these schemes to make a purchase at a merchant, the bank that provided the card (the issuing bank), debits the cardholder's account with the price of the goods or services purchased. The issuer then pays the merchant's bank (the acquiring bank) the retail price, less the interchange fee applicable to the specific card used. Finally, the acquiring bank pays the merchant the retail price less the merchant service charge negotiated with that merchant.[183]

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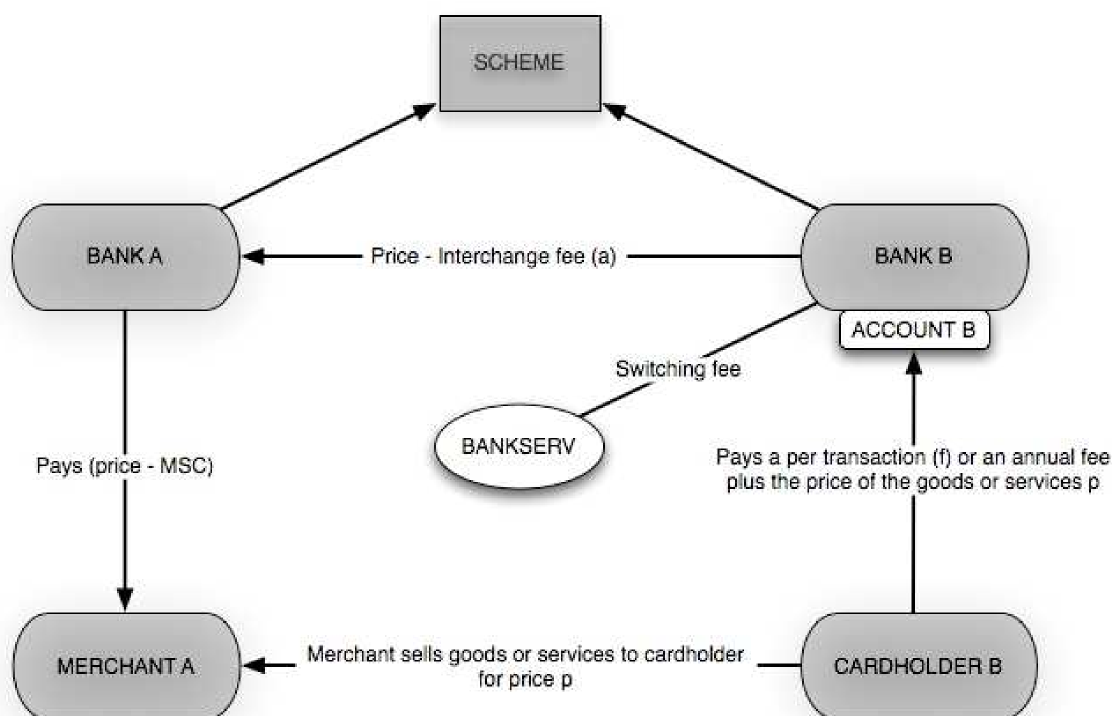
183 Visa, June 2007, Second Submission, document C, provides a detailed description of what occurs in a typical payment card transaction within its scheme. (Essentially similar processes occur within the MasterCard scheme: see http://www.mastercard.com/za/merchant/en/how_works/index.html.) "The transaction flow is the same for debit cards, credit cards or charge cards." The cardholder presents the card to the merchant as payment. The merchant is obliged to check that the card is valid. If the transaction is below a pre-established "floor limit", the merchant must check to see if the issuer has listed the account number in the current scheme bulletin (the "Card Recovery Bulletin" in Visa's case). If the transaction amount is over the floor limit, authorisation is required. The card is swiped through a point of sale terminal, or in the case of a chip card its chip is read. The data in the magnetic stripe or the chip instructs the terminal. The authorisation request is directed to the issuer, via the designated switch. In South Africa this is usually Bankserv, but could be one of the global switching centres of the card scheme. The issuer either responds directly, or authorises the switch to respond on its behalf. If the transaction is approved, the transaction receipt is completed. The cardholder is billed (the cardholder's account is debited) by the issuer, whom the cardholder pays. The merchant is paid by the acquirer, either immediately or following settlement between the issuer and the acquirer. In international transactions, clearing and settlement would take place via the card scheme's own systems involving accounts with overseas banks.

The fee charged by the issuing bank directly to the cardholder varies according to the applicable card used in the transaction.

Figure 4 Flow of payments in a four-party system



Apart from fees paid by participating banks or other institutions to the scheme owner, the significant fees in a four-party model are the interchange fee (a), the fees payable by the cardholder (f) and the merchant service charge (MSC).[184] (There is also a switching fee payable by the issuing bank to the designated switch, which facilitates authorisation of the transaction. In most cases in South Africa, Bankserv will act as the switch and will charge a small fee of around 10 cents per transaction – where large volumes are involved.) The interchange fee is typically set on a multilateral basis for all the members participating in the card scheme,[185] whilst the merchant service charge gets set by each individual acquiring bank in a bilateral negotiation between the acquiring bank and each of its merchants. Even though the level of the merchant service charge differs significantly between merchants and acquiring banks, the flow of payments discussed above applies to both credit card and debit card transactions. The only major difference between debit card and credit card transactions is that the per transaction fee (f) currently only applies when a debit card is used. In the case of a credit card the cardholder pays an annual fee but no per transaction fee.

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184 The merchant service charge is sometimes referred to as a "commission" or as a "merchant discount". For reasons discussed later in this chapter we consider "discounting" to be an incorrect way of analysing payment card transactions.

185 We deal further below with how interchange is set.

6.3.4 Merchants accepting cards

According to information submitted to the Enquiry, more than 130,000 merchants[186] in South Africa are contracted to the big four banks to accept payment cards.

Table 3 Number of merchants acquired by the big four banks in South Africa

ABSA	30,800
Nedbank	32,200
Standard Bank	33,500
FNB	34,066
Total	**130,566**

Confidential:
FRB
Absa
SBSA
Nedbank

Source: Banks submissions, March and April 2007, Second submission, Acquiring

Citing figures from Euromonitor International for the 4th quarter of 2006, MasterCard indicated that there had been a 25 per cent growth in the number of point of sale (POS) terminals in South Africa over the preceding two-year period.[187] FNB's annual growth in POS devices has been 36 per cent compound over the last four years.[188]

Merchant service charges

From the data provided to the Enquiry, the merchant service charge for credit card transactions applied by the big four banks to transactions involving the Visa or MasterCard schemes ranges between 1.8 per cent and 7 per cent of the transaction value. The range for debit card transactions is between 0.6 per cent and 6.5 per cent.[189] The merchant service charge or so-called "discount rate" for American Express transactions range between 1.8 per cent and 9.0 per cent.[190] For Diners Club, the rates range between 2.05 per cent and 5.9 per cent.[191] The average MSC for American Express cards is, however, consistently higher than on MasterCard and Visa cards.[192] We have not been provided with comparable data for

Confidential: Nedbank

Confidential: SBSA

186 This category refers, more precisely, to separate merchant locations. Large retailers, for example, will have a number of such locations. It is not clear to what extent multiple acquiring relationships may have led to some double counting in this figure. MasterCard reported that over 124,000 merchant locations in South Africa accept its cards. (MasterCard, October 2007, First Submission, p 14.) Visa refers to 127,000 merchants accepting its cards – by which merchant locations are presumably intended. (Visa, June 2007, Second Submission, document B (first part) p 7.) American Express has about 73,000 merchants in South Africa that have contracted to accept its cards. (American Express, October 2006, p 7. We do not have comparable figures for Diners Club.

Confidential: American Express

187 MasterCard Worldwide, "South Africa: The Card Payments Landscape", Exhibit MM slide 12. (ATM's had increased 15% over the same period.)

188 Transcript 19 April 2007, p 113 (FNB).

189 Transcript 17 April 2007, p 28.

190 Nedbank, March, 2008, Supplementary submission to the Banking Enquiry, p 7. The MSC is at an average of 2.96 per cent for American Express (Nedbank, March 2007, Second Submission, Questions on Issuing, p 13).

Confidential: Nedbank

191 SBSA, April 2007, Second Submission, Acquiring, p 29.

192 Cf Nedbank, August 2007, Questions from hearings and Technical Team, p 4.

Diner's Club, but we suspect the same will apply.

The variation in the merchant service charge on VISA and MasterCard transactions, within and between the big four banks, is depicted in the table below.

Table 4 Merchant service charges (MSC)

	ABSA		Standard Bank		Nedbank		FNB[193]	
	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
Credit Card	5.00%	1.75%	7.00%	1.88%	9.99%	1.75%	9.75%	1.75%
Debit Card	5.00%	0.6%	6.50%	0.65%	9.99%	0.55%	9.75%	0.55%
Hybrid Card	N/A	N/A	7.00%	1.50%	N/A	N/A	N/A	N/A

Confidential:
FRB
Absa
SBSA
Nedbank

Source: Banks submissions, 2007 and 2008

Revision of the merchant service charge commonly occurs on an annual basis.[194] Typically, banks categorise merchants according to turnover size and apply differentiated rates of merchant service charges accordingly. Several banks point out that they review the volumes and applicable fees of a newly signed up merchant after 3-6 months, and adjust the merchant service charge accordingly.

Table 5 Merchant classification

	Classification based on turnover
ABSA	Corporate clients >R50 million turnover per annual Commercial clients - all other clients
Nedbank	AA - Corporate clients A > R250 000 per month B > R100 000 per month C < R100 000 per month
Standard Bank	N/A – It classifies according to merchant category code
FNB	Large > R400 million annually Medium: R40 million - R400 million annually Small < R40 million annually

Confidential:
FRB
Absa
Nedbank

Source: Banks submissions, March and April 2007, Second submission, Acquiring

However, various other factors also affect the particular level of the charge. Nedbank gave the following account of the factors which it takes into consideration when negotiating a merchant service charge:

193 FNB charges very small merchants a minimum charge of R300 instead of a percentage of their turnover. The table does not take this into account (FNB, April 2008, Clarification of 18 March 2008, p 2). Also see FNB, March 2007, Second Submission, Acquiring, p 13.

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FRB

194 See e.g. ABSA, March 2007, Second Submission, Acquiring, p 11.

> MR GERICKE: … [W]hat we would be using in determining the fee level and those pricing ranges would typically be … the volume of transactions per number, the value of those transactions, the average transaction value, very importantly the merchant category. Merchant category has a direct bearing on costs like fraud for instance. We are also aware of what our competitors are doing in this market, it is a very aggressive market and as Nedbank we win and lose business daily, so we do take close heed of what our competitors are doing. We then also evaluate the depth of the overall banking relationship with Nedbank – where we have clients who are multiple users of other products and services, we bring that to bear on the price. We look at the complexity of integrating that merchant into our system: some of them have multiple lanes in their stores, they need multiple devices or in fact they have their own infrastructure which we need to then electronically plumb into our backing systems. And then, also very importantly, we look at the value added services having done a needs analysis. What I mean by that [is], we offer things like cash-back to our retailers [i.e. the ability of retailers to provide customers with cash back at the point of sale]; we offer airtime top-ups; and depending on the needs analysis and going through these factors at a high level we then determine a range and we would then negotiate the final fee with the merchant within that range, generally.
>
> MR BODIBE: So the application of this principle means that you will charge differently depending on the size of the merchant and so forth…?
>
> MR GERICKE: That is correct.[195]

Nedbank would not, as a general rule, price the rental for a terminal into the merchant's service charge; it would be distinct and separate.[196] This is evidently the norm.[197]

FNB say that the biggest ten of its merchants account for 88 per cent of the merchant service charge revenue that the bank receives. These merchants pay FNB's lowest merchant service charge, which averages 1.89 per cent for this category.[198]

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Interchange sets a floor for merchant service charges

It has been pointed out that, despite the uniformity of interchange, merchant service charges vary considerably under pressure of competition between acquirers and could theoretically be below the level of interchange.[199]

Taken in isolation, however, it would not be possible for an acquirer's merchant service charge to be less than the cost to it of paying interchange to issuers, because then the acquirer would be out of pocket, as Mr Volker of Absa acknowledged.[200] Mr Munson of MasterCard put the same point this way: "banks have shareholders, banks are regulated, banks must cover their costs, banks must engage in profitable activities, banks cannot take

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195 Transcript 19 April 2007, pp 33-34.

196 *Id.*, pp 62-63. Rentals are shown "as a separate line item" and are not included in the figures for merchants' service charges. *Id.*

197 See further below.

198 FRB, March 2007, Second Submission, Acquiring, p 13.

199 See e.g. Transcript 17 April, pp 156-157 (Mr Sweeny and Mr Stillman).

200 Transcript 17 April, p 151.

financial risks".[201] Interchange "is one of [the acquirer's] costs, and it will have to recover that cost from its customer which is the merchant. … [I]f the acquirer wishes to run its business profitably, it will have to recover all of its costs."[202] As Mr Shuter of Nedbank stated: "It is indisputable that interchange is a significant input cost in the merchant service [charge] in the four-party model".[203]

According to the acquiring figures provided to the Enquiry by Absa, Standard Bank, Nedbank and FNB, 62 per cent of the total merchant service charge goes towards the interchange fee paid away. Confidential: FRB

Visa says, referring to the situation internationally,

> Acquirers use a wide range of methodologies to ensure their total MDR [merchant discount rate i.e. merchant service charge] revenues sufficiently cover Interchange Fees and other costs to build [a] positive business case….
>
> In certain circumstances, Acquirers have used so-called 'Interchange Plus' contracts which involves pricing to the merchant based on Visa Interchange rates plus additional 'processing' fees as appropriate. …
>
> Some Acquirers may bundle their Visa payment card acceptance business with other banking services for their merchant customers, and offer pricing options reflecting the suite of services offered.[204]

As Mr Volker also argued, "the merchant is not just a customer of the bank in terms of the acquiring relationship but in terms of a broader banking relationship which includes cash handling, foreign exchange dealings, capital market lending, etc., so it could be that in terms of the broader relationship there is some kind of special deal that is made that could affect the acquiring business" so as to make the merchant's service charge lower than the rate of interchange on card transactions.[205]

The potential for this might also be greater in the case of banks whose issuing base is large enough relative to their acquiring base to ensure that minimal net interchange is actually paid away, or that are net receivers of interchange.[206] However, the evidence showed that it would be highly exceptional, if indeed it ever occurs, for a merchant service charge in South Africa to be lower than the rate of interchange applicable to the type of transaction concerned.[207]

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201 Transcript 18 April 2007, p 14

202 *Id.*, pp 84-85.

203 Transcript 19 April 2007, p 46.

204 Visa, June 2007, Second Submission, document B (third part) p 4.

205 Absa (Mr Volker), Transcript 17 April, p 151. See also Visa, June 2007, Second Submission, document J.

206 The merchant service charge stays the same regardless of whether the transaction is on-us or off-us: Transcript 17 April 2007, p 33.

207 Note that, in Table 4 above, the lowest rates of merchant service charge reported are in all instances higher than the

Realistically, therefore, the interchange fee generally sets a floor for the merchant service charge.[208] Being a fixed fee charged to acquirers, the *interchange component* in the merchant service charge is sheltered from competition on the acquiring side.[209] It is no answer to this to say that the acquiring market is fiercely competitive (see below) – because that competition, whether mild or fierce, is going on ultimately *above the interchange floor.*[210]

Fundamentally, if the interchange charge were not passed through or substantially passed through to the merchant, it could not be effective in its declared purpose of achieving a balance between merchant demand and cardholder demand. As Visa expressed it,[211] interchange is a coordination mechanism. "It seeks to achieve indirectly, by influencing behaviour, what is achieved directly in a three-party system by its proprietor."[212] This vital function of interchange in four-party systems is discussed further in this chapter in the section on the necessity of interchange (Section 6.6).

6.3.5 Interchange enters into consumer prices

By means of the merchant service charge, interchange further passes through into the prices which merchants charge to consumers.

Mr Bishop, appearing as part of FNB's team, tried to persuade us to the contrary,[213] but we found his argument difficult to follow. Varying market conditions and varying competitive circumstances of merchants will obviously affect the extent to which the costs incurred by this one or that can be recovered through the prices individually charged to consumers. But

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applicable rate of interchange. FNB indicated that it does not have any agreements where the merchant service charge for a transaction is lower than the applicable interchange fee. (FNB, March 2007, Second Submission, Section 4, p 13.) It was stated by Ms de Beer of FNB that this remains true when rebates of the merchant service charge to certain large merchants based on transaction volumes are taken into account. (Transcript, 19 April 2007, p 158.) Standard Bank "does not acquire any merchants for a MSC that is below the interchange fee." (SBSA, April 2007, Second Submission, Acquiring, p 26.) Nedbank stated that "[i]n exceptional circumstances we will quote MSC rates lower than the interchange rate" (Nedbank, March 2007, Second Submission, Acquiring, p 19), but provided no actual instance of this. Asked under what circumstances larger merchants will be eligible for an MSC lower than the interchange fee, Absa answered: "Not applicable." (Absa, March 2007, Second Submission, Acquiring, p 12.) However, Shoprite stated in their letter of 20 July 2006 (see above), p 12, that the merchant service charge on debit card transactions which they pay to Absa is lower than the interchange fee applicable to debit cards. In response to this, Absa stated that "Shoprite utilises a full range of banking services from Absa and, due to this wider relationship that exists between Shoprite and Absa, a group wide relationship rebate is passed on to Shoprite. This group wide relationship rebate is netted against the Merchant Service Charge (MSC) paid by Shoprite, which explains why Shoprite's MSC appears to be lower than the interchange fee." (Absa, March 2008, Banking Enquiry Response to additional questions, p 1.)

Confidential: FRB

Confidential: Absa

208 Transcript 17 April 2007, pp 49-50.

209 Transcript 17 April 2007, p 29.

210 Cf the finding of the European Commission in relation to MasterCard's multilateral interchange fee (MIF): "A MIF effectively determines a floor under the merchant service charge and merchants are unable to negotiate a price below it. This can considerably inflate the costs of payment card usage at merchant outlets to the detriment of merchants and their customers." MEMO/07/590, Brussels, 19th December 2007, p 2.

211 Visa, June 2007, Second Submission, document J

212 In the academic literature, likewise, the stated purpose of the interchange is to promote usage and acceptance of the payment stream by indirectly influencing the prices paid by downstream users. See e.g. Rochet, J. and Tirole, J., 2001, *The economic analysis of the interchange fee in payment card systems.*

213 Transcript 19 April 2007, pp 141-145.

costs unavoidably incurred by all on a sustained basis higher up in a supply chain must ultimately pass on down.

The four-party schemes and their participating institutions rely in general – notwithstanding price competition between acquirers – on interchange passing through to merchants as a component of merchant service charges. This serves as a mechanism capable of regulating merchant demand for cards, and it would seem entirely arbitrary to deny in general a similar pass-through further down (from merchants to customers.)

Indeed, it was accepted during the hearings, when the costs to the merchant of accepting various cards were compared with the costs to the merchant of accepting and handling cash, that both costs would find their way in general into consumer prices.[214] This was the premise of the debate on whether cash customers might be subsidising card users, or debit card users subsidising those using credit cards.[215]

Inasmuch as the "intrachange" of the three-party schemes is reflected in their merchant service charges, consumer prices are likewise ultimately affected. To the extent that a relationship emerges between the level of the merchant services charges applied by the four-party schemes and the somewhat higher merchant service charges applied as a premium by the three-party schemes, if there is an effective floor set to merchant service charges by four-party interchange then that serves as a support also for the higher three-party charges.

6.3.6 Competition among acquirers in the four-party schemes

A number of those giving evidence to the Enquiry were at pains to emphasise that competition between the acquiring banks for contracts with merchants is very intense. Nedbank's affirmation of this has been quoted above.

Mr Jordaan of FNB argued:

> First of all it is a very competitive market out there. It is not that there is one party that has exclusivity over a merchant. If we go to any of our customers and they feel that what we are charging is too high, they are very quick to go to our competitors…[216]

Ms de Beer spoke of acquirers every day "trying to eat other acquirers' breakfast."[217]

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214 As Mr Cope of Pick n Pay explained with reference to the merchant service charge: "It is part of our normal cost structure, so to the extent that we have payroll operations, occupancy and administrative costs, it is part of that cost. The fact that we do at the end of each year, make a profit… [implies that] it is recovered in prices." Transcript, 13 November 2006, p 8.

215 As to this issue, see further below.

216 Transcript 19 April 2007, p 124.

217 *Id.,* p 130.

Absa likewise maintained that the acquiring market is "hugely competitive with massive competition between the banks to get the best deals", with merchants who are highly aware of the bargains they can variously extract from the banks, and with deals renegotiated annually.[218]

When dealing with the ability of merchants to switch acquirer, Ms de Beer of FNB said:

> In cases where the equipment is not owned by the retailer, obviously the retailer would need to take a commercial decision as to whether he wants to fund it off his own balance sheet, or whether he wishes to rent those services and the equipment through the services of another acquirer. So, switching could be very simple. For smaller merchants, it is simply a matter of signing up with another acquirer and for that acquirer to install another [point of sale] device at that customer's outlet.[219]

Also, contracts with merchants tend to be of a short-term nature, normally twelve months, but typically with a 30-day notice period. In a few cases there would be a longer notice period.[220]

It is evidently possible for merchants to switch their acquirer without having to switch their main banking relationship at the same time. In the case of FNB, about 20 per cent of the merchant acquiring customers have their main banking relationship with another bank.[221]

Confidential: FRB

We have referred above to the level of interchange as a floor for the price competition between acquiring banks for merchant contracts. It was stated in evidence by Absa that, when interchange was lowered in 2003, this was reflected in a fall in merchants' service charges, even though merchants were not necessarily aware of what interchange is or of the level of it.[222]

Ms de Beer of FNB said that, when interchange came down in 2003, "the full benefit was passed on to the majority of the customers [i.e. merchants] that contributed to the volume."[223] According to Mr Jordaan, the extent of competition on the acquiring side compelled this.[224] FNB submitted substantive information in this regard in June 2007.[225] It stated that the reduction of the interchange fee by 28 basis points (from 1.99 per cent to 1.71 per cent) in November 2003 resulted ultimately in a reduction of 30 basis points in the

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218 Transcript 17 April, p 156 (Mr Sweeny).

219 Transcript 19 April, p 127. Standard Bank reported that 14 of its large merchants own their own POS devices, while there are others which rent POS devices from third parties. (SBSA, April 2007, Second Submission, Acquiring, p 19.) Nevertheless, Standard Bank owns about 36,000 out of the roughly 38,000 devices from which it acquires. (*Id.*, p 20.)

Confidential: SBSA

220 *Id.*, pp 128-129. See also Nedbank, March 2007, Second Submission, Acquiring, p 17. Other banks provided similar answers to the acquiring questionnaire.

221 *Id.*, p 126.

222 See Transcript, 17 April 2007, pp 157-159.

223 Transcript 19 April 2007, p 178.

224 *Id.*, p 188.

225 FNB, June 2007, Impact of interchange reduction on average merchant fees.

merchant service charge. The average merchant service charge decreased from 2.68 per cent in November 2003 to 2.38 per cent in April 2004, further reducing to 2.05 per cent in March 2007 due to continued pressure on prices. Nedbank also provided similar evidence in August 2007.[226]

Confidential: FRB

Before attributing the reduction in the merchant service charges simply to *competition*, one must bear in mind that the banks themselves had just *agreed* to bring interchange down so that merchant service charges could be deliberately lowered and (especially debit) card usage generally increased. The 2003 reductions are therefore not proof *per se* that when acquirers' costs come down in South Africa the benefit is passed through downstream.

6.3.7 Eligibility for participation as acquirers in the four-party schemes

On paper, any institution that complies with the MasterCard and Visa rules and requirements will qualify to be a member according to their acceptance criteria and can subsequently obtain access to this open payment scheme as an issuer and/or acquirer.

MasterCard's eligibility criteria, as set out in its first submission,[227] indicate that any financial institution that is authorized to engage in financial transactions under the laws and/or government regulations of the country or any subdivision thereof in which it is organised or principally engaged in business would be allowed membership.[228] Any such financial institution also

Confidential: MasterCard

> must be regulated and supervised by one or more governmental authorities and/or agencies authorized and empowered to establish and/or enforce rules regarding financial transactions and the financial condition, activities, and practices of entities engaging in such financial transactions. With respect to any financial institution that does not take deposits, it shall be a further requirement that financial transactions constitute substantially all of the business conducted by such institution.[229]

In the event that these eligibility criteria would violate the laws or regulations of any country, then the MasterCard Board may modify them accordingly, consistent with the purposes of MasterCard.[230] The stated purposes include –

Confidential: MasterCard

> 1. To facilitate the interchange of card privileges on an international basis.
>
> 2. To facilitate the entry into the card business by members and prospective members without regard to size and at minimum risk and cost.
>
> 3. To promote the development of sound practices in the operation of the card programs

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226 Nedbank, August 2007, Supplementary Submission – Questions from hearings and Technical Team.

227 MasterCard, October 2006, First Submission, Annex E, p F-2.

228 "Financial transactions" refer to the making of commercial or consumer loans, the extension of credit, the effecting of transactions with payment service cards, the issuance of travellers cheques or taking of consumer or commercial deposits.

229 *Id.*

230 *Id.*

> of its members by establishing high standards.[231]

In the Visa scheme, an organisation must meet Visa International's eligibility criteria, as set out in its Bylaws.[232] Section 2.01 of the Bylaws requires essentially that a participant be "[o]rganized under the commercial banking laws or their equivalent of any country or subdivision thereof, and authorized to accept demand deposits".[233] However, an organisation "whose eligibility is required to prevent the corporation, any of its members … from being in violation of applicable law" will also be eligible.[234]

According to Visa,

> [o]ne of the main reasons for limiting membership to financial institutions [in fact, we would add, authorised deposit-takers] is that members have considerable financial exposure to each other and benefit from the fact that every member is a financial institution under the laws of its own country, and subject to continuing scrutiny of the local banking regulator. Visa guarantees interbank payments between members, Visa takes initial responsibility to cover any losses, which may be incurred by banks to ensure and guarantee the reliability and security of the system to merchants and cardholders.[235]

The national and international regulatory framework applicable to banks (including applicable measures against money-laundering) mitigates risk within the four-party system. Thus "banks are logical and relatively safe business partners for Visa."[236]

The licensing structure for participating institutions differs as between Visa and MasterCard. Visa issues separate licenses for issuing and acquiring, but includes both credit and debit cards in the same licence; MasterCard has separate licences for credit card and debit card participation, but combines issuing and acquiring in respect of that card type into one licence in each case.[237]

In South Africa, although all registered banks clearly qualify as eligible for membership under the rules of both the Visa and MasterCard schemes, smaller banks have been unable to enter, or have faced considerable difficulty entering, the acquiring market. As stated above, there have (until recently) been only four acquirers of credit and debit card transactions (the

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231 *Id.*, p F-1.

232 See Visa, June 2007, Second Submission, document E. We have not been advised of any change in these requirements following Visa's subsequent international re-organisation.

233 Paragraph (*a*). Other paragraphs extend eligibility to organisations controlled by such an organisation, and to associations of such organisations and those controlled by them.

234 Paragraph (*d*). Paragraph (*e*) further extends eligibility to an organisation "(i) whose membership the Board of Directors deems necessary to penetrate a given country in which no Principal [member] has jurisdiction, (ii) that the Principals with jurisdiction in a given country unanimously agree should be made eligible in such country". Visa does have "a very few member[s] who are not technically commercial banking institutions and/or do not accept demand deposits…" (Visa, June 2007, Second Submission, Annexure E, p 2.)

235 *Id.*

236 *Id.* The care with which applicants for membership are evaluated for risk is evident from, for example, Attachment 2 to this document.

237 See Mercantile Bank, March 2007, Second Submission, Issuing and Acquiring, pp 10-11.

big four banks). Two smaller banks, Capitec[238] and Mercantile,[239] have joined only recently.

Thus it is primarily the big four banks that have been able to benefit from the growth in the acquiring market which Mr Jordaan of FNB describes as "incredibly rapid",[240] and which (along with the growth in issuing) has been a concomitant of South Africa's economic growth.

Despite the indications of competitiveness in the acquiring market for the four-party schemes, the competition remains oligopolistic – and it is thus open to doubt to what extent the unit cost savings which come with higher transaction volumes are being or will be passed down to merchants in the form of generally lower merchant service charges, and ultimately to consumers in the form of lower retail prices.[241]

To a significant extent, the barrier to entry by smaller firms is of a structural character, and will not readily be resolved by remedial measures. Mr Munson of MasterCard pointed this out:

> [T]he nature of the acquiring business is such that it is a business that is based upon scale efficiency. It is much more of a scale business than an issuing business, and therefore what you will find in every country with strong electronic payments is that the number of issuers in four-party systems exceeds by several times the number of acquirers. This is true in the United Kingdom, this is true in the United States, this is true anywhere….[242]
>
> In the UK there are only four large acquirers; in Mexico, for example, there are only two; and there are countries in Europe with debit systems in particular where there is only one acquirer.[243]

While giving due weight to this analysis,[244] we do consider that additional and unnecessary barriers exist which further add to the difficulties of entry by new players.

One of these barriers is caused by deficiencies in the current regulatory framework applicable to the payments system in South Africa. This aspect is addressed fully in the chapter of this report dealing with Access to the Payment System, and so will only be referred to briefly in the present chapter. Other barriers, however, are caused by what we consider to be unjustifiable restrictions in the rules applied by the Visa and MasterCard

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238 Capitec joined MasterCard in the acquiring ranks in March 2007, and Visa in February 2007.

239 Mercantile became an acquirer for MasterCard in November 2007, and, according to the latest information provided to the Enquiry, is still awaiting acceptance of its application to Visa.

240 Transcript 19 April 2007, p 112.

241 It was persuasively presented as one of the benefits of payment cards over cash, that because most costs are fixed costs and relatively few are variable costs in the case of card systems, greater transaction volumes must translate into lower average costs per transaction. Significantly lower average transaction costs should result in significantly lower merchant services charges.

242 Transcript 18 April 2007, pp 10-11.

243 *Id.*, p 11.

244 See also Mercantile Bank, March 2007, Second Submission, Issuing and Acquiring, p 14: "The cost of infrastructure requires economies of scale hence significant volume is required."

schemes themselves. These aspects are clearly distinct.

The current restriction of acquiring to banks

At the hearing on 19 April 2007, when asked about the qualifications and requirements to become an acquirer for each of the (four-party) schemes and card transaction types, Mr Jordaan said it was FNB's understanding that the acquirers must be registered as banks.[245] It had been thought, until the questioning of MasterCard on the previous day, that this restriction derived from card scheme rules. It had now been clarified that, in terms of MasterCard scheme rules, the requirement was that an acquirer had to be a financial institution subject to regulatory supervision.[246] In South Africa, regulatory supervision has not been developed (as it has in other countries) so as to enable non-bank institutions to enter this market. Hence acquiring is currently restricted to banks.

During the hearing on 18 April 2007, MasterCard had confirmed that it does not restrict issuing or acquiring to banks. The chairperson addressed the following questions to Mr Munson and received the following answers:

> CHAIRPERSON: Whilst we are talking about these acquiring models, you, in your presentation, made reference to the fact that you do not prevent any banks from acquiring. Can you just expand on that. You do not have any conditions for banks who qualify to acquire?
>
> MR MUNSON: Well, first of all, take away the term banks. We do not limit our business to banks.
>
> CHAIRPERSON: That was going to be my next question. But carry on.
>
> MR MUNSON: Let me step back and answer your question a little more broadly. If anybody, any institution, be it a financial institution, a bank, an insurance company, any kind of institution, if they want to participate as an issuer or as an acquirer in the MasterCard system, they have to qualify for membership, for participation. Okay. And generally speaking the requirements for participation are the following:
>
> They must be engaged in the business, the payments business, and number two, they must be a regulated and supervised institution. By that we mean there must be some government regulator like a banking regulator, that is monitoring their business and enforcing sound fiscal practices. Now, why is that? Well, the answer is because … MasterCard guarantees the settlement of its issuers and acquirers to each other. So, in other words, if one of our participants, one of our customers, goes out of business, and there is a huge amount of money owed to other participants in the system, we are on the hook for that. That is our responsibility. So, we want to make sure that whoever participates in our business, is not causing excessive additional risk to our system and to us. So the general requirement is that there would be regulation and supervision. It is a general requirement. Exceptions can be made. We have a group within MasterCard that actually will go out if there is a request to join the system and measure the specific risk of a particular entrant, and sometimes permission is granted to participate in the system, even though you are not supervised. Though very often in that case, the participant will be required to essentially post a guarantee or get a letter of

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[245] Transcript 19 April 2007, p 158.

[246] *Id.*, pp 171-172. This is the case with the MasterCard rules, at least.

guarantee from someone else.

So, the focus here is to make sure that whoever participates in the system, is not unduly increasing the risk or if they are increasing the risk, that that risk is covered somehow so that the system is not left holding the bag, you know, having a lot of transactions that cannot be paid off because the party that brought the transactions into the system has gone out of business. …

So, we are not limited to banks, we are looking at limiting typically to regulated and supervised financial institutions. I give you an example of how that can change over time. You may have heard that when the Reserve Bank of Australia regulated interchange fees, at the same time they made some changes in who could participate in the four-party systems. The truth of the matter is they did not change that from the standpoint affecting our rules. What they did was, based upon conversations that they had with us, and I presume with others, is they created a new system of regulation and supervision, so that entities which previously had not been regulated and supervised, if they wish to get into the business, would be regulated and supervised, and that then would allow them to participate in our system, because that would meet our requirements. So, that was the way that Australia could, at least in theory, improve their participation in the four-party systems. …

The final point is, if you want to participate in the system you have to get a licence. The licence allows you to use the trademarks, the licence allows you to submit transactions into the system and you are [governed] by the rules, etc. Our licences are not specific to issuing or acquiring. We grant you a licence.

It is then up to the licensee to decide, does it wish to engage in both the issuing and acquiring businesses, does it only wish to engage in the issuing business, or does it only wish to engage in the acquiring business, and that third choice may be restricted, depending on the location you are talking about.

In some places, I think including South Africa, we have generally frowned upon someone who is only an acquirer and is not also issuing. In other places that is permitted. But the licence itself does not prevent someone from going into the acquiring business, or into the issuing business. Both are permitted and certainly if someone is issuing and has a good issuing portfolio, they are never prohibited from going into the acquiring business, with a single exception. … The one exception is that if we perceived that a bank, a participant in a system which had not previously been involved in acquiring, who is going into the acquiring business in a risky way, for example, they are going to bring in merchants that were high risk merchants, you might frown at that. You might look very closely at that and in some circumstances we might not even permit it, because once again, it would increase risk to the system. The acquiring business is a special business. It requires experience. It requires the right kind of knowledge and expertise, and so we do reserve the right to make sure that the acquirers are running their businesses properly.

CHAIRPERSON: I just want to sum up what you have said, so that I am sure that I understand exactly what your submission is. You must be a regulated financial institution, that is what you have said?

MR MUNSON: You must be regulated and supervised.

CHAIRPERSON: Financial institution. Those were the words you used.

MR MUNSON: Financial institution generally is someone who is regulated and supervised. But do you have to be a financial institution? No. But you have to be regulated and supervised.

CHAIRPERSON: Well, I am quoting you, Sir. You can clarify it. But that is what you said. You said he must be a regulated financial institution and in addition, if they are in South Africa, you cannot only be an acquirer, but you must also be an issuer.

MR MUNSON: That is my understanding.

CHAIRPERSON: … So, if I sum all of this up, it means only banks can be involved with your business. If I look at all these requirements you have set out, whatever way you want to put it, it means only banks can be involved in your business?

MR MUNSON: Let me, may I ask you a question? What do you mean by the word bank?

CHAIRPERSON: A deposit taking institution in terms of the South African law.

MR MUNSON: And what I am telling you is, that the term financial institution is not synonymous with the word bank. We have financial institutions which are not banks, which participate in our system. I give you a ...

CHAIRPERSON: I am talking about South Africa ...

MR MUNSON: The rules are the same in that regard. Let me give you an example.

CHAIRPERSON: … I know you are going to tell me about what is happening all over the world. I am just interested in what is happening in South Africa. That is why in particular, I also made reference to the other additional statement you made to say in addition, if you are in South Africa, you will frown upon giving somebody a licence if he is not an issuer as well. So, I am more interested in what is happening in South Africa. Let us talk about South Africa because that is my jurisdiction. I do not want to go outside my jurisdiction. So, it means if I sum up all of this, it means only banks can be involved in your business?

MR MUNSON: Wrong.

CHAIRPERSON: Okay. Only financial institutions can be involved in your business?

MR MUNSON: If you properly understand the term financial institution ...

CHAIRPERSON: You are still going to tell me what you mean by financial institution.

MR MUNSON: A financial institution is an institution engaged in the business of payments that is regulated and supervised.

CHAIRPERSON: Regulated and supervised?

MR MUNSON: Yes.

CHAIRPERSON: Okay.

MR MUNSON: Can I give you an example?

CHAIRPERSON: No, no. I understand. I fully understand. I do not need an example.[247]

In Visa's case, only "appropriate supervised credit institutions may be acquirers."[248] It is accepted in the UK and the EU, says Visa,[249] that "only appropriate supervised credit institutions should have direct access to [a] funds transfer system which processes third

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247 Transcript 18 April 2007, pp 112-120.

248 Visa, June 2007, Second Submission, document A p 2.

249 *Id.*, referring to document E.

party systems."[250] The reference to "credit institutions" is not clearly delineated in the Visa submission. The implication is that acquiring is not essentially limited to banks. Yet the Visa eligibility rules as submitted to us and quoted above do specify authority to take deposits as a basic criterion. Nor does Visa state, as MasterCard does, that its rules applicable to South Africa would currently permit non-banks to acquire its card transactions if the entities concerned were subject to local regulation.

We accept that caution is warranted in the open schemes over their eligibility criteria for acquiring. "By signing a merchant," says Visa, "an Acquirer is agreeing to underwrite that merchant's bankcard transactions."[251] The risk here pertains essentially to chargebacks of disputed transactions. The longest period during which an issuing member may charge back a disputed transaction to the acquirer is four months.[252]

> An Acquirer is responsible to Visa for the proper performance of its merchants, processors and agents and is liable to Visa for any breaches of regulations and for any disputed transactions. Visa puts a premium both on the credit-worthiness of the Acquirer and on its knowledge of and expertise in the card business.[253]

Visa is not in favour of allowing merchants to function as their own acquirers.

> Merchants benefit from the sophisticated and costly steps that Visa acquirers put in place to manage risk. Merchants do not have the accountability or the expertise to manage the risks of the system to the benefit of all stakeholders.[254]

Visa has different tiers of membership, as noted above. Direct settlement risk rests on Principal Members, who guarantee those they sponsor in lesser categories of membership.[255] There are global Visa standards applicable to the member's responsibilities in such cases, and penalties where the rules are not followed.[256]

The potential risk introduced into the payment system by the spread of third party processors is of serious concern to the schemes.[257] This potential risk increases as outsourced network providers develop, providing POS devices or other terminals and signing up merchants for acquiring banks. The danger is of PIN data being captured, enabling the counterfeiting of cards, and causing the public to lose faith in the system.[258]

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250 *Id.*, document E.

251 *Id.*, document F.

252 *Id.* Visa may require the acquiring member to secure its exposure accordingly. The acquirer manages the dispute process on behalf of merchants.

253 *Id.*, document D.

254 *Id.*, document E. See also F. Among the measures required by Visa are the implementation of systems to monitor and detect changes in merchant activity patterns on a daily basis. See Attachment 4.

255 *Id.*, document E. Visa does allow its members to outsource sections of the member's card services programmes.

256 *Id.*

257 *Id.*

258 *Id.*

It appears, however, that this problem can be managed within the schemes through technological improvements and the enforcement of strict standards. The counterfeiting of magnetic-stripe cards currently occurs in any event through the use of illegal devices; and the identities and account details of customers are also held outside the system where they can be stolen. Recently a mass of data of this kind held by the revenue service in the UK was evidently compromised. In the United States, *Business Week* reported on 7 November 2007:

> In the past two months at least 17 computers containing personal data on a million or more individuals were lost or stolen, according to the Privacy Rights Clearinghouse. These episodes received little attention because they have become so common that they are no longer news.

As Visa points out, penetration of the TJX[259] computer network in the United States that handles credit card, debit card, cheque and merchandise return transactions for customers reportedly compromised more than 31 million accounts in that country, and more than a million others worldwide.[260] However, the customer records were those of the retailers, whose systems would seem to be vulnerable to penetration and theft by hackers quite independently of any direct access to the card payment system itself.

If an acquirer or issuer is not compliant with Visa's international operating regulations, then it may be fined or have its membership revoked. The acquirer is obliged to mandate the standards set out in these regulations when contracting with merchants. Commercial arrangements between acquirers and merchants on the one hand and issuers and cardholders on the other are left to the acquirers and issuers, subject to local law.

Acquirers are obliged systematically and on a daily basis to monitor, report and investigate changes in merchant deposit patterns, according to a number of specific parameters.[261] They must likewise monitor, report and investigate significant and unusual changes in merchant authorisation request patterns. They have to employ staff resources and implement security controls in order to fulfil these responsibilities, and have their compliance certified by auditors.[262] Before contracting with merchants they must determine that the merchant is financially responsible, and that there is "no significant derogatory background information about any of its principals".[263] Additional requirements are laid down where risky types of business are involved, such as online gambling for example. Internet transactions generally, where the card is not present, entail a higher risk of disputed transactions.

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[259] TJX Companies, Inc. is described as "the leading off-price retailer of apparel and home fashions in the U.S. and worldwide," with many hundreds of stores. *Id.*, document E, Attachment 1. The problem was discovered in December 2006.

[260] *Id.*

[261] *Id.*, Attachment 5.

[262] *Id.*

[263] *Id.*

An essentially similar position prevails in the MasterCard scheme.

In our view it would be unrealistic to expect the schemes, and it would be unwise to seek to compel them, to relax their standards beyond requiring acquirers and issuers to be regulated and supervised financial institutions, in the sense outlined by MasterCard. However, there is definitely a need to extend the regulatory framework of the payments system in SA so that banks are not the sole institutions regulated and supervised for this purpose. (This matter is taken up again in the chapter on access and regulation). So long as the framework restricts access to banks only, there would be no sound basis to proceed against either of the four-party schemes under the Competition Act for restricting their acquiring in this country to banks.

Regarding non-bank acquiring, FNB indicated that it saw no reason for them not to compete in the card payment area provided that they are properly regulated with a view to risk management.[264] The acquirer does not have to hold the customer's main bank account, or indeed any account of the customer involving a deposit.[265]

Visa's general international requirement that acquirers be authorised to take deposits is, in our view, too restrictive in the South African context (and indeed is likely increasingly to be challenged around the world).

However, if a proper regulatory and supervisory framework for non-bank acquirers were established here, schemes could – in terms of their own rules requiring compliance with local laws – be brought into line where necessary. To ensure this, the regulatory and supervisory framework would have to oblige the relevant card schemes to accept as eligible, without discrimination, those banks and non-banks meeting the domestic requirements.[266]

Acquiring restricted to issuers

Where the four-party schemes are clearly at fault, in our opinion, is in their rules or practice of restricting acquiring to institutions which issue their cards, and indeed which issue them on a significant scale.

Testifying on 19 April 2007, Mr Jordaan of FNB at first suggested a possible justification for

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264 Transcript 19 April 2007, p 169. "[T]he appropriate entry criteria should really only relate to whether the institution is fit and proper and can manage the risks appropriately": Mr Jordaan, *id.,* p 173.

265 *Id.,* pp 169-170. On the issuing side, to be able to issue a credit card, the issuer also does not have to be able to hold a customer's deposit. It is not inherent in the issuing of credit cards that one must have a deposit-taking licence or a sponsorship or other dependency upon a deposit-taking institution. (*Id.*, pp 170-171.)

266 A provision comparable to section 6A(3) of the National Payment System Act, 78 of 1998 as amended, but tailored for the purpose, is what we have in mind. Non-bank acquiring is dealt with fully in the chapter of this report on Access to the Payment System.

the prevailing position by saying that it would depend on the level of maturity of the market as to whether one could effectively have acquirers who are not issuers. In presenting this argument he set up the hypothetical case of a scheme being unable to develop if it only has issuers – it also needed acquiring. But then why restrict acquiring, especially when the acquiring market is considered difficult to enter? The converse – the development of the acquiring side of the market without a corresponding development of issuing – is manifestly unlikely.

Mr Jordaan acknowledged that it would merit investigation whether, in South Africa, we could have issuers completely independent from acquirers. FNB "would not be opposed to competing against somebody who is not an issuer."[267]

Ms de Beer of FNB said that it was a requirement of both schemes "that one should have an issuance programme, qualifying [one] to obtain an acquiring licence from the schemes."[268] She added:[269]

> There are association rules that almost penalise the acquirers if they do not have an issuance programme that meets a certain threshold. The schemes have since reviewed some of those regulations and some of them are currently under review, but there is a rule in the scheme that provides for a form of a penalty if your issuance programme is inconsistent with your acquiring volumes.[270]

Asked if this was true of both major four-party schemes, she said (evidently referring to the requirement of an issuance programme):

> It is true. In the one instance it is not a rule that has ever been enforced. In the other instance the rule has been enforced but has since been temporarily suspended since we believe it is under review.

Mr Munson of MasterCard assured us that "every issuer in South Africa that is admitted into the MasterCard system is permitted to acquire as well."[271] However, this soothing statement should not be taken to imply that a participant is allowed to acquire without issuing. We shall return to this aspect below.

Visa stated in the introductory document (A) of its second submission that, since March 2007, "it has not been necessary to be an issuer before being an acquirer" in the Visa scheme in South Africa.[272] On close inspection of the full submission, this statement turns

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267 *Id.*, p 160.

268 *Id.*, p 159.

269 *Id.*, pp 160-162.

270 According to MBL, "MasterCard will assess members with net acquiring activities with an incremental surcharge of 25 per cent or 50 per cent of the fees on local and international acquiring activities" (Mercantile, Second Submission, March 2007, Issuing and Acquiring., p 11.) These surcharges are triggered respectively when a member's merchant volume exceeds 75 per cent and 90 per cent of its total volume (made up of merchant volume plus cardholder volume).

271 Transcript 18 April 2007, p 10.

272 Visa, June 2007, Second Submission, document A p 1, referring to document D.

out not to be true.

Document D provides the detail. Visa has in the past applied in the CEMEA[273] region a rule restricting eligibility for acquiring licences to members holding a share of 15 per cent or more of the number of cards issued in the market concerned, or account for 15 per cent of the RSV[274] generated in that market.[275] Also required was a business plan proving a commitment to extending the acceptance base and plan (*inter alia*) for future growth in issuance.[276] Such a rule was not necessarily applied in other regions, and Visa Europe has no such rule.

Visa also states that "the CEMEA rule has not been applied to South Africa: Standard Bank have been acquiring for many years although they have until recently been mainly a [MasterCard International] issuer and did not meet the Visa CEMEA issuance criteria."[277] At a Management Committee Meeting of the CEMEA on 21 March 2007 it was decided that Visa CEMEA will not apply a minimum issuance requirement before granting an acquiring licence. However, there will still be a requirement that "a member must show an issuance portfolio and history of issuance".[278] Apart from providing an indication that double standards have been in operation, this means that a misleading impression was conveyed in the introductory document.[279]

The Visa and MasterCard requirements have had a perverse combined effect in raising the barriers against participation by smaller players, including smaller banks. This is illustrated by the experience of Mercantile Bank (MBL) in South Africa. At the time of making its submissions, MBL had only a Visa issuing licence.[280] It had no MasterCard licence. It wished to become an acquirer, but realistically could not enter this business in South Africa on a viable scale unless it could acquire merchants' transactions involving both MasterCard and Visa cards.[281] It was initially confronted by Visa's rule requiring a 15 per cent minimum share of issuing in the market concerned, in order for a Principal Member to be licensed to acquire. While Visa showed a willingness to relax this rule somewhat (as noted above), MBL was obliged to withdraw its application to Visa for an acquiring licence because it could not secure a licence from MasterCard at the same time.[282] MasterCard refused "to allow the

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273 Central Europe, the Middle East and Africa.

274 Retail sales volume.

275 Visa, June 2007, Second Submission, document D; Visa CEMEA Regional Operating Regulations, 4.2.A.

276 *Id.*

277 *Id.*, document D.

278 *Id.*

279 *Id.*, document A p 1.

280 Mercantile, March 2007, Second Submission, Issuing and Acquiring, p 1.

281 See Transcript 28 May 2007, p 170.

282 Mercantile, March 2007, Second Submission, Issuing and Acquiring., p 10.

Bank to acquire transactions as a Principal Member without issuing."[283] In view of the relatively small scale of its issuing business,[284] MBL obviously did not wish to incur the costs of more than one licence to issue cards. In any event, its issuing volumes under any one scheme would necessarily be reduced if divided between two of them. MBL reported that MasterCard would only "support" an application for a licence if persuaded that MBL was committed to a strong issuance program.[285]

Mr Bloem of MBL confirmed that it was very difficult for a relatively small bank in South Africa to make business decisions in the light of the power of Visa and MasterCard to grant or refuse access based not on technical considerations but on business volumes.[286]

In our view this approach of the schemes and the rules on which it is based are clearly restrictive of competition on the acquiring side. It challenges one of the claimed virtues of the four-party system that it promotes competition in both issuing and acquiring. In our view such restrictions on acquiring have no legitimate basis. Acquiring should not be limited to issuers or be prohibitively priced.

If the schemes do not voluntarily – both formally and in practice – abandon these restrictions forthwith, 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.

6.3.8 Restrictions on cashback at the point of sale

Standard Bank stated:[287]

> The proactive proliferation of pure cashback transactions at retailer stores benefits all participants (banks, retailers, associations and Customers) within the broader market in the following way:
>
> - it enables access to cash and general banking especially in deeper rural areas where mechanisms such as ATMs do not make economic sense;
> - retailers, especially deeper rural merchants, are incentivised to provide the capability through their POS devices thereby attracting customers into their stores, recycling their cash holdings and inherently reducing security risks and bank costs; and
> - customers have frequent access to mechanisms that provide cash and over time can start migrating their transaction behaviour from cash to suitable electronic mechanisms such as debit card purchases.

Elaborating on cash back at the point of sale, Mr Gericke of Nedbank said:

> We have enabled all our devices for cash back at the point of sale. It is not necessarily that all merchants want to offer it. It is a service that we believe is very necessary, but it is very much

283 *Id.*, p 4.

284 *Id.,* p 6.

285 *Id.*, p 12. See also Transcript 28 May 2007, pp 172-174.

286 Transcript 28 May 2007, p 174.

287 SBSA, October 2006, First Submission, p 57.

> in its infancy and the adoption rate from a retailer perspective has been pretty low to date. But we are currently in the market piloting with a number of small merchants and it's a distinctive strategy that we have, to promote cash back at point of sale. Where Nedbank provides an acquiring service to a merchant, it offers cash back as a value added service.[288]

Mr Shuter added that Nedbank had a joint venture with Pick 'n Pay regarding cash back at the point of sale. More broadly enabling its merchant base in this regard was a relatively new strategy. There was resistance among some merchants because of the security issues around cash. The service, while intellectually appealing, is still in its infancy and involves more complexities than may appear to be the case.[289]

Mr Gericke stated that Nedbank has no restriction to the effect that cash back at the point of sale may only be provided in conjunction with a purchase.[290] However, in Nedbank's submission of March 2007, both MasterCard and Visa rules are cited which restrict cashback at POS in this way.[291]

According to Standard Bank, among the reasons why the adoption and proliferation of cashback at POS has been slow in South Africa are the generally slow adoption rate of debit card transactions by customers *and* –

> the current prohibition of the card associations' international operating rules to enabling pure cashback only transactions (although this view has changed since inception, given the uniqueness of South Africa in enabling access to cash and banking in deep rural areas in accordance with Financial Sector Charter requirements)…[292]

Now, either there is a "prohibition" or there isn't one. In a society in which people are entitled to know their rights and freedoms, and to act upon them, it is not enough that a "view" changes on the part of those with power. What is the true governing state of affairs?

MasterCard International's *Bylaw and Rules* (published April 2005) provide:

> Cash disbursements may be provided only by members [meaning, in South Africa, participating banks] at their facilities and through their authorized agents. For purposes of this rule, an authorized agent is a financial institution authorized to provide cash disbursement services on behalf of a member pursuant to a written agreement with a member.[293]

On the face of it this would prohibit entirely not only cashback at POS but also the provision of ATM services other than by banks or other financial institutions on their behalf. However,

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288 Transcript 19 April 2007, p 36.

289 *Id.*, pp 36-37.

290 *Id.,* p 39. The amount will be limited by the issuer to the amount authorised for ATM withdrawals, but the merchant may set a lower limit. Where a customer makes a purchase and asks for cash back, the two transactions will be charged for separately. "The purchase attracts a price, a transaction fee as it would for a normal point of sale purchase transaction and the cash portion would attract a fee as if it was a cash withdrawal. So there are two separate fees, yes." (Mr Gericke, *id.*, p 74.)

291 Nedbank, March 2007, Second Submission, ATM Transactions, p 15.

292 SBSA, October 2006, First Submission, pp 56-57.

293 Chapter 2, Rule 8.1 (MasterCard, October 2006, First Submission, Annex O).

as far as debit cards are concerned, the *Maestro Global Rules* (published July 2005) permit "Purchase with cash back", but stipulate:

> Acquirers and Merchants must ensure that cash is provided only when combined with a purchase Transaction.[294]

Visa International Operating Regulations (dated 15 May 2006) also provide that cashback services may be provided "only in conjunction with a purchase".[295] VISA's regulations have been amended for the CEMEA region, but evidently without altering this basic restriction.[296] (The regional amendments seem, if anything, more restrictive. For example, an issuer or acquirer wishing to provide a cashback service must obtain prior Visa CEMEA approval.)

Absa has told the Enquiry:

> Both MasterCard and Visa implement operating rules relating to cashback at point of sale. There are a number of qualifications and requirements that need to be met. These cover aspects such as security, risk and business best practice of cash back point of sale transactions. The details of these are specified in manuals from the different card schemes … In addition, Visa and MasterCard require that the point of sale infrastructure is certified to ensure it meets the necessary standards.
>
> … For risk reasons no issuer currently allows cashback at point of sale in South Africa on credit cards or embossed debit / cheque cards [i.e., cards which are not PIN-based].[297]

Our concern, of course, is not with rules reasonably designed to maintain the security and integrity of the payment streams. Absa further stated that Visa default rules prevent pure cash back transactions at point of sale. The MasterCard and Maestro rules quoted above involve a similar restriction. However, says Absa,

> … this prohibition is overridden by PASA rules which permit pure cashback transactions at point of sale and pure cashback transactions are offered in respect of debit cards.[298]

Confidential: Absa

The restriction of cashback at POS to transactions also involving a merchandise purchase has no evident justification in the public interest. *Prima facie*, it is unduly restrictive of competition and of the free use of an important innovation that could promote consumer and producer welfare.

There is confusion in the industry as to the applicability of the scheme rules. Standard Bank refers to them as applicable, but records its understanding "that Pick 'n Pay and Shoprite Checkers offer pure cashback notwithstanding the card association rules."[299]

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294 *Id.*, Chapter 6, Rule 9.1.2.2.

295 Vol. I, Chapter 5, regulation 5.4.S. (Visa, October 2006, First Submission, Annexure F (supplied on CD-ROM).)

296 Visa Regional Operating Regulations for Central Europe, the Middle East and Africa, 15 May 2006. (*Id.*)

297 Absa, March 2007, Second Submission, ATM transactions, p 7. The PASA interbank clearing rules for "Non-PIN Based Card Debit Payment Instructions" (Version 2006/1) permit cash disbursement only in bank branches: Rule 2.6.

298 *Id.*

299 SBSA, April 2007, Second Submission, Acquiring, p 32.

The PASA interbank clearing rules for PIN-based card debit instructions include both "Cashback" and "Purchase with Cashback" among *allowed* transaction types. It would seem to be something of a leap to say that, by virtue of this inclusion, restrictions imposed by card schemes on their participants are "over-ridden" (as Absa expresses it).

In our opinion the card schemes should be requested by the Commission formally and forthwith to withdraw their prohibitions on pure cashback at POS, at least to the extent that such transactions are *permitted* under domestic law. Failing satisfactory responses in that regard, we would recommend regulatory measures to correct the situation decisively. If such measures are not forthcoming, then the Commissioner should give consideration to initiating a complaint and investigating the relevant scheme rules for possible contravention of the Competition Act as prohibited restrictive practices.

6.4 The setting of payment card interchange

6.4.1 History and level of card interchange in SA

According to Absa,[300] a bilateral agreement between Barclays Bank and Standard Bank initially set the interchange rate between them for credit card transactions at 1.99 per cent of the transaction value. No bank was able to provide details regarding a date or the circumstances of the agreement. This rate appears to have been universally adopted by the South African banks involved in off-us credit card transactions before changes were made by mutual agreement of the banks in 2003.[301]

Again according to Absa,[302] a bilateral agreement between Absa and Standard Bank initially set debit card interchange between them at 0.75 per cent of the transaction value. We have been given no further details. Prior to the interchange rate changes in 2003, all South African banks involved in off-us debit card transactions were evidently applying that rate.[303]

We do not know the rationale behind the particular levels of interchange which originally applied.

Ms Louw of the Enquiry's Technical Team outlined the various approaches to the setting of interchange which have been utilised by the four-party schemes and their participating

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300 Exhibit LL, slide 19.

301 See e.g. Absa, October 2006, First Submission, Annex 3, p 66; Exhibit LL, slide 13.

302 Exhibit LL, slide 19.

303 *Id.*, slide 13. The reference is to PIN-based debit cards. See Absa, October 2006, First Submission, *loc. cit.* Reference to 0.73% in Exhibit KK, slide 13, based on Visa's First Submission, October 2006, p 46, seems mistaken.

institutions:[304]

> The setting of the interchange fees by members of a scheme or a country is one method which the card schemes use, and another is the setting of the interchange fee by the card scheme itself that will apply as a default to the participating members in a country, if bilateral negotiations fail. …
>
> In both these cases there are two important elements involved. The first one is the calculation of the costs and the second is the balancing of interests. … [A] third party like Edgar Dunn can be used to assist in the collection and the calculation of the costs associated with the provision of the service. These cost studies are then used by scheme owners as an input and the setting of the interchange fee. The cost calculations by Edgar Dunn would in essence then only be … a proxy for the imbalance in the system that would then be used as an input in the calculation of an interchange fee that would be set in a country.
>
> … Although debit and credit cards differ, the cost studies applied to these also differ but are both done by the same institution. The setting of the interchange fee as a balance can either be performed on its own right without the consideration of these cost studies [305] or in conjunction with the cost study that provides a proxy for the imbalance present in the system.

In neither case, however, do the elasticities of demand on the two sides of the market appear to be actively tested.[306]

6.4.2 The "Edgar Dunn" process and the decision of the banks in 2003

In South Africa in 2002, the member banks of MasterCard and Visa decided to use a cost study methodology in reviewing and revising the uniform levels of interchange fees applying between them.

Through their Association of Bank Card Issuers and Merchant Acquirers (ABCI), they engaged Edgar, Dunn & Company [307] (EDC) to assist them in determining the level of the interchange fees for credit cards, PIN-based (i.e. on-line) debit cards, and signature-based cheque cards or embossed debit cards (hybrid cards).[308] The process involved EDC gathering certain cost information from the participating banks (with each one's information kept confidential from the others), analysing this information by applying a methodology used in interchange cost studies for MasterCard, and coming to a conclusion as to appropriate cost-calculated interchange rates.[309] A proxy (a particular sub-set of issuer's costs) was used

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304 Transcript 17 April 2007, pp 23-24.

305 In this case the scheme setting the interchange fee simply relies on experience and its own or its participants' business judgment to arrive at the applicable interchange.

306 *Id.*, p 24.

307 Edgar, Dunn & Company describes itself on its website as "an independent global financial services and payments consultancy." Founded in 1978, it has offices in San Francisco, Atlanta, London, Sydney and Frankfurt, from which it provides services to clients in more than 30 countries on six continents.

308 See ABCI, October 2006, South Africa Domestic Interchange Study, Credit & Cheque Cards Final Report, and On-Line Only Debit Cards Final Report (2003).

309 The EDC reports outlined the same basic methodology for arriving at interchange fees on credit cards, cheque cards and debit cards. A proxy (a particular sub-set of issuer's costs) was used in each case to estimate the merchants' demand for payment cards on the basis that the merchant would have had to incur these costs itself if it were not for the scheme. The sub-set of costs serving as the proxy was adjusted according to the type of card under consideration.

in each case to estimate the merchants' demand for payment cards on the basis that the merchant would have had to incur these costs itself if it were not for the scheme.

After considering the EDC report, and with effect from 1 November 2003,[310] the South African banks agreed to reduce their interchange fees on credit and debit cards as it appears from the following table. A distinct interchange rate for hybrid cards was introduced for the first time.

Table 6 Card interchange levels in South Africa[311]

Card type	Pre- Nov 2003 rate	New rate Nov 2003
Credit	1.99%	1.71%
Debit	0.75%	0.55%
Hybrid (credit or debit)	1.99%	1.09%

Source: Banks' submissions, October 2006, First submissions.

Since then these rates have been uniformly applied in South Africa to both MasterCard and Visa card transactions,[312] and (at the time of writing) no other adjustment has yet been implemented.[313]

MasterCard and Visa themselves did not take part in the 2002/2003 interchange-setting process. Moreover, Visa has stated that, while it accepted the result as adopted by its member banks, the methodology used was not the one which it prefers.

> Visa did not participate in the cost study for a number of reasons: Edgar Dunn is a firm, used we believe by MCI [MasterCard International] members and MCI, to carry out cost studies. They have we understand [done] this in the UK market for example. Accordingly, we believed that the methodology that Edgar Dunn would use to calculate the Interchange Fee rate would be that of MCI and not Visa. We therefore did not want to let commercially sensitive, confidential data and material into the hands of a competitor's vendor. The banks, once they had decided what rates they wished Visa to apply in the Visa systems, simply informed Visa in writing, as is their right under Section 6.5 of VIOR, a precise (*sic*) of which is set out in Section 'Q'. Visa then makes any changes required by the members to the Visa system.[314]

Document Q in the same submission (Section 'Q' in the passage quoted) indicates that, in the absence of agreement to the contrary,[315] CEMEA[316] intra-regional fees are applied as the

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We discuss in the section on the potential for abuse of interchange the nature and suitability of such proxies in arriving at legitimate levels of interchange.

310 Transcript 19 April 2007, p 153.

311 Visa, June 2007, Second Submission, Attachment 7, provides a table indicating how the November 2003 rates apply to its various cards. The table makes it clear that the rate applied to premium credit cards is the same as for credit cards generally. Visa refers also to a rate of 1.00% on "airline cards", which we have not considered necessary to pursue.

312 Transcript 17 April 2007, p 93.

313 *Id.*, pp 24-25.

314 Visa, June 2007, Second Submission, document M.

315 Where unanimous agreement of Visa members in a market cannot be reached, a domestic (default) rate can be implemented on the basis of agreement of 50% + 1 of the members having together 75% of domestic VisaNet volume. This is issuer and acquirer volume, in US dollar equivalents, of transactions undertaken through VisaNet.

default for domestic transactions. However, these intra-regional fees are at the default international rate.[317] The current default rates appear to be generally lower for credit cards (1.60 per cent), and higher for debit cards (1.10 per cent 1.60 per cent) than have been set in South Africa (where, as indicated above, the rates are 1.71 per cent and 0.55 per cent respectively).[318] Also, in the absence of agreement between all the members in a country, the CEMEA Management Committee may ratify a proposed domestic default rate. Members in a country may enter into private agreements or bilateral agreements to establish domestic interchange fees.[319]

In MasterCard's case, its Rule 10.5 (Intracountry Interchange Fees) states that the interchange fee "... shall be the fee agreed to by members doing business within the country."[320] Prior to MasterCard's international restructuring, its regional authorities (in the case of South Africa, MasterCard's SAMEA[321] regional Board) had the power to set intracountry interchange fees when the members concerned could not agree, or where local law prohibited them from doing so. Following the restructuring, the MasterCard President and CEO, or his designee, has authority to set domestic rates for any country as well as inter-regional and intra-regional rates. Where this is done, the relevant participating institutions are bound by the rate.[322] However, as all participating banks agreed to the domestic interchange rates for South Africa in 2003 following the EDC study, MasterCard had no need to invoke these powers.

Confidential: MasterCard

Based on the most recent information supplied, the average credit card transaction value involving the big four banks in South Africa is in the region of R510; the average cheque card (hybrid card) transaction value is R380; and the average PIN-based (debit card) transaction value is R225.[323]

On an average credit card transaction of the value indicated, the issuing bank would receive R8.72 in interchange. The average interchange fee received by the issuing bank per cheque card transaction would be R4.15, and for debit cards R1.24.[324]

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316 Visa's Central Europe, Middle East and Africa region.

317 *Id.*, document L.

318 In the case of premium credit cards, the CEMEA and international default rate is 1.80%, whereas in South Africa no such distinction is currently made.

319 Visa, June 2007, Second Submission, document Q.

320 MasterCard, October 2006, First Submission, p 100.

321 South Asia, Middle East and Africa. *Id.* p 21.

322 *Id.,* pp 102-103. Later, however, MasterCard states that its default rates would not exclude bilateral agreements: *id.,* p 111. This evidently derives from "Golden Rules" developed by MasterCard in Europe, and which MasterCard "proposes to follow in South Africa" (*Id.*, Annex G, p 7.)

323 Exhibit KK, slide 4.

324 Transcript 17 April 2007, pp 25-26.

The banks' decision to reduce the debit card interchange rate further

The EDC report had concluded from the cost study that debit card interchange rates could appropriately be reduced from 0.73 per cent to 0.715 per cent. The banks, after considering this, decided to reduce the rate even further – to 0.55 per cent.

It has been explained to us that debit card interchange was deliberately set at a lower rate than the one indicated by EDC in order to encourage merchant acceptance of a card which was being routinely issued to bank account holders but for which they had as yet found little use.[325] Forecasts based on expected future volume growth of debit card usage over a two-year period were seen to warrant a lower rate.[326]

Mr Fergus of Standard Bank explained the purpose and likely effect of the decision as follows:

> My belief would be that the lower interchange encouraged more merchants to accept debit cards earlier. You normally have a chicken and egg [problem], and it is always a moot point whether it is the merchant acceptance which drives the use of the cards, or the cards that drives the merchants to acceptance. I think going into a lower interchange and hence a lower merchant service charge resulted in more merchants being prepared to accept the card, which resulted in more cardholders being prepared to use it.
>
> The biggest challenge in debit cards, we are just going through the hump now, is getting the first transaction away from the ATM. … [Nedbank's evidence] this morning showed an average of four transactions [per year per debit card in 2006.].[327] It is actually, the vast majority of the cardholders only using the cards for cash and an increasing use by a smaller percentage to make more transactions at the point of sale. … [T]he challenge is actually getting that switch in and I think the lower interchange encourages more merchants to accept debit cards sooner and hence it has accelerated the [use of the card]…[328]

In our opinion, from the point of view of public interest, a key challenge of the period ahead is to enable and encourage the use of the debit card as a convenient substitute for cash, without the cardholder having to pay a significant per transaction charge.

6.4.3 The Visa exemption

In 2001, Visa International Service Association Inc., commonly referred to as "Visa International",[329] applied through its South African branch, "Visa South Africa", for an exemption in terms of section 10(4) of the Competition Act.[330] A new company was to be

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325 See generally *id.*, pp 114-115.

326 Absa, October 2006, First Submission, Annex 3, pp 66-67.

327 See Exhibit NN, slide 3; Transcript 19 April 2007, pp 41-42.

328 Transcript 19 April 2007, pp 83-84.

329 See e.g. Visa, October 2006, First Submission, glossary, p 5.

330 *Id.*, Annexures A and B. Section 10 (4) provides: "A firm may apply to the Competition Commission to exempt from the application of this Chapter [Chapter 2: Prohibited Practices] an agreement or practice, or category of agreements or practices, that relates to the exercise of intellectual property rights, including a right acquired or protected in terms of

established in South Africa, to be owned and controlled by Visa's local member banks.[331] It was said that these members would agree on prices and set other trading conditions in a manner prohibited by section 4(1)(*b*) of the Competition Act, and that accordingly an exemption from the prohibition was required.[332]

Evidently on the basis that the intended practices would "relate to the exercise of intellectual property", the Commission granted the exemption sought – until 30 April 2013.

We make no comment either on the original validity of the exemption or on the wisdom of having granted it. It is not clear, moreover, whether the exemption granted is affected by the recent global restructuring of Visa, involving new entities which were not in existence at the time.[333]

Assuming that the exemption could apply, it seems to us irrelevant to this Enquiry and its outcome, for two reasons.

First, we have come to the conclusion that multilateral agreement on interchange is in principle reasonably necessary to the viability of four-party card payment schemes and so should not, in and of itself, be characterised as having the purpose of restricting competition in contravention of section 4(1)(*b*).[334]

Secondly, and in any event, we propose in this chapter that the problem of interchange and the danger of its abuse be addressed by way of a new statutory arrangement, which would ensure the setting of interchange by a transparent and objective process involving the participation of all stakeholders. The outcome would be binding on all issuers and acquirers to which the regulatory arrangement applies, including those participating in the Visa scheme.

6.4.4 The MasterCard advisory opinion

MasterCard stated in its first submission:

> Where MasterCard unilaterally and independently sets default interchange rates, the banks affected by such a determination are obliged to implement the decision taken by MasterCard.

Confidential: MasterCard

the Performers' Protection Act, 1967 (Act No. 11 of 1967), the Plant Breeder's Rights Act, 1976 (Act No. 15 of 1976), the Patents Act, 1978 (Act No. 57 of 1978), the Copyright Act, 1978 (Act No. 98 of 1978), the Trade Marks Act, 1993 (Act No. 194 of 1993) and the Designs Act, 1993 (Act No. 195 of 1993)."

331 *Id.*, pp 6-7.

332 *Id.*, Annexure A, p 2; also Annexure B.

333 According to the document *Visa Inc. Corporate Overview*, available to the public at www.corporate.Visa.com, Visa has completed its corporate restructuring. The company's world-wide operations are carried out by Visa Inc. itself through regional divisions, except in the case of Visa Europe, which is a separate entity operating under licence. This may mean that the business previously conducted in South Africa by Visa International Service Association Inc. is now conducted by Visa Inc. – which is described as "a new global corporation" (p 8).

334 Whether a scheme's interchange methodology may – quite independently of the question of multilateral setting – involve a contravention of section 4(1)(*b*), or alternatively section 4(1)(*a*), of the Competition Act is considered below.

The South African Competition Commission has endorsed, by way of an advisory opinion in 2005, MasterCard's Plan to set default interchange rates unilaterally.[335] Confidential: MasterCard

The background to MasterCard's request for an advisory opinion was its intention of commissioning EDC to conduct in South Africa a new interchange analysis similar to that which had been conducted in 2002/2003. This time, however, in place of a multilateral agreement between the participating banks, MasterCard itself would set the default rate. Issuers and acquirers of MasterCard transactions would be required to co-operate in the process, but could then reach bilateral agreements on different rates if they so chose.[336] Confidential: MasterCard

MasterCard argued in its request that the proposed method would comply with the Competition Act, *inter alia* because the participating banks would not be setting the interchange themselves and so there would be no horizontal co-ordination of conduct.[337] In its initial response the Commission noted that the Act may nevertheless be contravened where an umbrella body sets a price to be applied by members in a horizontal relationship.[338] Nor would it make a difference that the price set was only a default price from which the issuers and acquirers could depart bilaterally if they so chose.[339] Confidential: MasterCard

Following this, MasterCard met with representatives of the Commission and then set out further arguments on the issues in writing.[340] The independence of MasterCard from its participating institutions in the proposed process for setting interchange was emphasised.[341] Default interchange, it was pointed out, should not be characterised as restrictive of competition *per se*, as is contemplated by section 4(1)(*b*) of the Competition Act. It was not intended to eliminate competition but was necessary for the survival of a four-party scheme, and moreover facilitated the entry of new issuers and acquirers.[342] Confidential: MasterCard

In a letter dated 4 October 2005,[343] the Competition Commission stated that it now appeared that the proposed multilateral interchange fee would not contravene any *per se* prohibition in the Act. Whether it might have anti-competitive effects in a market had not been evaluated, and accordingly no opinion on that was expressed. Confidential: MasterCard

We note that advisory opinions are non-binding on the Competition Commission. We are at liberty to consider and express our own views on the same issues. For reasons expounded

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335 MasterCard, October 2006, First Submission, p 103; see also pp 110-112 and Annexes G-J to the submission.

336 See *id.*, Annex G (18 March 2005), pp 6-7.

337 *Id.*, p 7.

338 *Id.*, Annex H (20 May 2005), pp 3-4.

339 Id., p 4.

340 *Id.*, Annex I (30 August 2005).

341 *Id.*, p 5.

342 *Id.,* pp 6-9.

343 *Id.*, Annex J.

in this chapter, we agree that the default or multilateral setting of interchange fees for purposes of a four-party card scheme would not, in and of itself, amount to a contravention of the Competition Act. However, in our view, the methodology used may be such as to set interchange for illegitimate anti-competitive purposes – an aspect of the problem which was not raised in the advisory opinion, but which debate during the Enquiry has helped bring into relief. We deal fully with that aspect below.[344]

6.4.5 The current MasterCard / "Edgar Dunn" process

Following the advisory opinion, MasterCard has embarked upon the new interchange-setting process which it envisaged and has engaged EDC to carry out the requisite cost studies with the co-operation of participating banks. (FNB declined to take part in the process, partly on account of unhappiness with the methodology[345] – but in view of the bank's own subsequent submissions to the Enquiry regarding appropriate interchange methodology it seemed uncertain whether this standpoint would be maintained.[346])

Confidential: MasterCard

It appears likely that, as in the past, Visa will await the outcome of the process and allow its participating banks to agree on multilateral interchange fees corresponding to those applied in the MasterCard scheme.

We have been asked in various meetings with interested parties to give our blessing to the new process, and thereby give comfort to the participants that they would not thereby be regarded as contravening the Competition Act. We have declined to do so; our remit extends only to making recommendations to the Commissioner. In this chapter, and in making our recommendations on interchange, we draw attention to unsatisfactory features in the current methodology and propose a regulatory scheme which would eliminate those features while giving practical recognition to the necessity of interchange wherever such necessity truly exists.

6.5 Revenues and profitability in issuing and acquiring

6.5.1 Banks' revenue from card issuing and merchant acquiring

The table below assembles the information received from the big four banks in respect of

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344 See the section 6.7.

345 Transcript 19 April 2007, pp 153-154. FRB, in its First Submission, October 2006, p 71, indicated that it would be willing to commit itself to abide by the findings of a study such as that previously conducted by EDC provided that, *inter alia*, there was consensus reached on the costs to be included in the assessment, and the Competition Commission also committed itself to abide by the findings "so that even greater uncertainty is avoided".

346 See especially FRB, Second Submission, March 2007, Section 8, Position Paper 3: Interchange., p 10. At the time of that submission FRB stated only that it "would be open to a third party study" to re-evaluate whether the prevailing levels of interchange remain appropriate. (*Id.*, p 7.) Also see FNB, March 2008, Response to request for additional information, p 5, where they confirmed this stance.

their turnover, revenue, costs and profits in the issuing and acquiring markets in 2006.[347] For ease of reference, card issuing totals are imported from Table 1 and aggregated for each bank, while figures for the number of merchants acquired are imported from Table 3.

Table 7 Turnover, revenue, costs and profits from issuing and acquiring in 2006

		ABSA	SBSA	Nedbank	FNB[348]
Issuing	Turnover (R)	76,162,000,000	N/A	27,814,000,000	45,066.947,000
	Total Revenue (R)	2,553,000,000	2,413,655,680	813,000,000	N/A
	Total Costs (R)	1,513,000,000	N/A	439,000,000	N/A
	Profits before tax (R)	1,040,000,000	N/A	374,000,000	N/A
	Total Credit Cards	1,721,776	2,126,240	908,583	1,356,228
	Total Debit Cards	8,720,881	6,470,666	2,253,371	4,858,346
	Total cards issued	10,442,657	8,596,906	3,161,954	6,214,574
Acquiring	Turnover (R)	62,416,000,000	N/A [349]	51,105,067,914	52,000,000,000
	Total Revenue (R)	447,000,000	N/A	481,083,745	436,000,000
	Total Costs (R)	198,000,000	N/A	378,471,607	270,000,000
	Profits before tax (R)	249,000,000	N/A	102,612,138	158,000,000
	Number of merchants	30,800	33,500	32,200	34,066

Confidential: FRB Absa SBSA Nedbank MasterCard

Source: Banks' submissions, March and April 2007, Second submissions, Issuing and Acquiring

In the next table, the average interchange revenues receivable by an issuer on card transactions of average value are set out.

[347] N/A indicates information not supplied.

[348] The total issuing turnover for FNB has been calculated by the Technical Team from figures provided in FRB's, March 2007 Second submission, Issuing, p10 and FRB, April 2008, Clarification of 17 March 2008 response. It was not possible to perform similar calculations for issuing revenue, cost and profit.

Confidential: FRB

[349] Originally, SBSA submitted a value of R443,302,000,000. When the order of magnitude was questioned, a revised figure of R443,302,000 was submitted. Neither of these figures appears to make sense, so neither is shown.

Confidential: SBSA

Table 8 Average revenue from interchange per transaction

Average credit card transaction value	R 510
Average cheque card transaction value	R 380
Average debit card transaction value	R 225
Average interchange fee received by the issuing bank per credit card transaction (1.71% of ATV)	R 8.72
Average interchange fee received by the issuing bank per cheque card transaction (1.09% of ATV)	R 4.14
Average interchange fee received by the issuing bank per debit card transaction (0.55% of ATV)	R 1.24

Source: Banks' submissions, October 2006, First submissions.

Clearly the average credit card transaction brings to the issuer significantly more interchange revenue than does the average debit card transaction – R8.72 per transaction as opposed to R1.24.

The same interchange fees are currently applicable for both MasterCard and Visa transactions in South Africa. This is referred to as blending and constitutes a process of treating all card brands like a single card and charging identical fees. This also has the consequence that merchants face the same fee for accepting cards from different schemes. We deal later in this chapter, in the section on the potential for abuse of interchange, with the question whether competition between schemes over interchange fees leads to beneficial or harmful results.

The total interchange fees received and paid on card transactions for the big four banks are depicted in the following table. From this it appears that Standard Bank is the only net receiver of interchange. Nedbank, ABSA and FNB are net payers.[350]

Table 9 Gross and net revenue from interchange fees: the big four banks

	Absa		**Standard Bank**		**Nedbank**		**FNB**	
	2005	2006	2005	2006	2005	2006	2005	2006
A	437,040,000	663,300,000	613,850,110	726,935,246	304,758,000	323,025,000	376,046,000	477,613,000
B	440,000,000	667,000,000	375,208,494	441,388,426	602,290,654	721,297,508	461,947,101	574,882,402
C	-2,960,000	-3,700,000	238,641,616	285,546,820	-300,532,654	-398,272,508	-85,901,101	-97,269,402

A = Interchange fees received
B = Interchange fees paid away
C = A-B, or Net interchange fees received

Source: Banks' submissions, March and April 2007, Second submissions

Confidential:
FNB
Absa
SBSA
Nedbank
MasterCard

350 The fact that the aggregate of interchange fees paid away does not correspond with the aggregate of interchange fees received by these banks, is explained by the existence of transactions with other banks, including international banks, not reflected in Table 9.

Revenue from the merchant service charge

The total revenue earned from the merchant service charge (MSC) by the big four banks is presented in the table below.

Table 10 Revenue from the MSC: the big four banks together

	Total 2005	Total 2006	% Change
Total MSC received	**2,956,341,897**	**3,864,815,293**	30.73%
- from Debit & Cheque card transactions	577,357,497	942,556,751	63.25%
- from Credit card transaction	2,378,984,400	2,922,258,542	22.84%
Interchange fees paid away	**1,882,446,249**	**2,404,568,336**	27.74%
- re Debit & Cheque card transactions	230,437,922	386,771,677	67.84%
- re Credit card transactions	1,652,008,327	2,017,796,659	22.14%
Net MSC received by acquiring banks	**1,073,895,648**	**1,460,246,957**	35.98%
- from Debit & Cheque card transactions	346,919,575	555,785,074	60.21%
- from Credit card transactions	726,976,073	904,461,883	24.41%

Confidential: FRB Nedbank

Source: Banks' submissions, March and April 2007, Second submissions, Acquiring

While the total (i.e. gross) MSC received by the big four banks for all types of card transactions grew by 30.73 per cent between 2005 and 2006, the gross MSC received for debit and cheque card transactions grew considerably faster in the same period, by a rate of 63.25 per cent. This may be as a result of the increased volume in point of sale transactions on debit cards, which grew by 77 per cent between 2004 and 2005 and by 63 per cent between 2005 and 2006.[351] These figures are also indicative of the increased acceptance and use of payment cards at point of sale terminals.

Confidential: FRB

In respect of net MSC revenue – i.e., the MSC remaining in the hands of the acquiring bank after interchange has been paid away – at least two features appear from the table. First, the growth in net MSC revenue has been even faster than the growth in gross MSC revenue. Secondly, as in the case of gross MSC revenue, net MSC revenue for debit and cheque card transactions outgrew that for credit card transactions over the period. Net MSC revenue grew by almost 36 per cent, compared with approximately 31 per cent for gross MSC revenue, with net debit and cheque card revenue growing by 60 per cent and net credit card revenue growing by 24 per cent.[352]

Confidential: FRB

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351 Bankserv, November 2007, Data Submitted to the Enquiry.

352 Generally, when considering the revenue derived by banks from the MSC, it should be borne in mind that in on-us transactions (transactions in which the acquiring bank is also the issuer), the component of the MSC which would otherwise be paid away as interchange is retained and is thus available to contribute to the bank's costs of issuing. (In the context of three-party schemes, such a notional in-house transfer of revenue has been referred to as "intrachange".) In the last analysis, therefore, the interchange component of the MSC could just as well be treated as forming part of the issuing rather than the acquiring revenue of banks in on-us transactions as well. To the extent that profitability in acquiring would be reduced by such an allocation, profitability in issuing would of course be increased by a corresponding amount.

6.5.2 Growth rates in costs, revenues and profits

The table below indicates the growth rates of revenues, costs and profits in the acquiring business of major banks. With a revenue growth of 44 per cent and growth in costs of 29 per cent, profits before tax in the acquiring market grew year-on-year by 80 per cent. The slower growth in costs relative to the growth in revenue and profits, indicates the existence of economies of scale resulting from the increased volumes of transactions. This also signifies the need for review of the interchange fees on card transactions.

Confidential: FRB Absa Nedbank

Table 11 Profit growth rate in the acquiring market

Acquiring Business	Indication[353] of growth between 2005 and 2006	
	Turnover	53.38%
	Total Revenue	44.36%
	Total Costs	28.66%
	Profit before tax	80.45%

Confidential: FRB Absa Nedbank

Source: Banks' submissions, March and April 2007, Second submissions, Acquiring

The ratio of total profits to total costs in the acquiring business indicates a very profitable business with a ratio of 60.2 per cent.[354] The European Commission's *Interim Report on Payment Cards* (2006) stated that high profitability in these markets is often correlated with high fees charged to merchants and cardholders.

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The issuing market also seems buoyant, with an indication of a profit growth rate over 43 per cent between 2005 and 2006. Total costs increased by approximately 79 per cent followed by an increase in revenue of just over 62 per cent.[355] Even though costs increased substantially more than revenue and profits, profits before tax of 44 per cent and a ratio of total profits to total costs[356] of 49.4 per cent indicate that this is a very profitable business.

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353 Only ABSA and Nedbank provided us with data for 2005 and 2006, allowing for the calculation of percentage changes. This can be used as a proxy for the industry, seeing that South Africa has only four acquiring banks. The data is also representative of a large and a smaller bank among the "big four" in the market.

354 This calculation was done through the use of data submitted to the Enquiry in response to the Acquiring Questionnaires in March 2007 for three of the big four banks in South Africa (FNB, ABSA and Nedbank). This calculation can also be weighted according to turnover indicating a ratio of 63.4%.

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355 A breakdown in the components of costs was not provided to the Enquiry, but given the increased number of cards in circulation and the increase in the number of co-branded cards and loyalty programmes, these figures seem likely.

356 This calculation was done through the use of data submitted to the Enquiry in response to the Issuing Questionnaires in March 2007 for three of the big four banks in South Africa (FNB, ABSA and Nedbank). This calculation can also be weighted according to turnover indicating a ratio of 40.7%.

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Table 12 Profit growth rate in the issuing market

		Indication[357] of growth between 2005 and 2006
Issuing Business	Turnover	56.15%
	Total Revenue	62.14%
	Total Costs	79.08%
	Profits before tax	43.55%

Source: Banks' submissions, March and April 2007, Second submissions, Issuing

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Profit to cost ratios for the major banks (excluding Standard Bank which did not supply comparable data) were reported between 40 per cent and 125 per cent for their issuing and acquiring businesses. (It should be noted, when considering Table 13, that the cost and profit figures given by FNB for its card issuing in 2006 seem out of proportion to those reported by ABSA and Nedbank, having regard to the relative numbers of cards issued as stated in Table 2 above.)

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Table 13 Profit to cost ratios

		ABSA		Nedbank		FNB	
		2005	2006	2005	2006	2005	2006
Issuing	Total Costs	731,000,000	1,431,000,000	362,000,000	439,000,000	N/A	4,879,532,800
	Profits before tax	527,000,000	731,000,000	346,000,000	374,000,000	N/A	1,959,913,920
	Profit to costs %	72.09%	51.08%	95.58%	85.19%	N/A	40.17%
Acquiring	Total Costs	155,000,000	198,000,000	313,059,259	378,471,607	N/A	270,000,000
	Profits before tax	129,000,000	249,000,000	64,848,702	102,612,138	N/A	158,000,000
	Profit to costs %	83.23%	125.76%	20.71%	27.11%	N/A	58.52%

Source: Banks' submissions, March and April 2007, Second submissions, Issuing and Acquiring

6.5.3 Profits in card issuing without interchange

Evidence suggests that despite the healthy growth rates in the acquiring business, profits generated in the issuing businesses continue to be more lucrative than profits generated in acquiring.[358]

Data submitted in response to the issuing questionnaires, sent out to banks participating in the Enquiry in February 2007, also demonstrate that issuing revenue without interchange revenue also generates positive profits for the issuing banks. In the section of this chapter on the necessity of interchange in principle, we discuss the challenge to the legitimacy of

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[357] See footnote 353 above.

[358] Reported profits in the issuing and acquiring businesses of FNB, ABSA and Nedbank together imply that issuing profits are six times greater than acquiring profits.

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interchange inherent in these facts.

Table 14 Issuing profits without interchange

	ABSA		Nedbank		FNB	
	2005	**2006**	**2005**	**2006**	**2005**	**2006**
Profits before tax without interchange	453,000,000	569,000,000	42,242,000	50,975,000	N/A	1,868,437,185

Confidential: FRB Absa Nedbank

Source: Banks' submissions, March and April 2007, Second submissions, Issuing and Acquiring

(It should be noted that the evident disproportion in FNB's issuing profit figure for 2006, referred to above, is carried through into the derived figure that has been calculated for purposes of Table 14.)

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6.6 The necessity of interchange in principle

6.6.1 Competition policy and joint ventures

The general approach of competition policy internationally towards joint ventures is to recognise the productive efficiencies and consumer welfare that can result when resources are combined by firms which could not achieve similar results independently – but to recognise at the same time the dangers of anti-competitive harm which associations of actual or potential competitors entail.

American antitrust scholars Sullivan and Grimes say:[359]

> The joint venture concept is of interest to antitrust because whenever two or more firms cooperate in a business activity there may be competitive harm and because whenever there is integration of these firms' activities (one of the hallmarks of a venture) efficiencies may result. …
>
> It must be stressed at the outset that arrangements called joint ventures do not avoid, but are strictly subject to, conventional antitrust analysis. The joint venture label is no antitrust shield. All such activities, whether or not meeting any scholar's definitional norm, may involve or facilitate collusion, may reduce, discipline or inhibit actual or potential competition, or may foreclose rivals from inputs or outputs. Any activity that has such tendencies should be scrutinized in the conventional way.

Hovenkamp, rejecting the argument that joint ventures should be subjected to no higher scrutiny than single firms, says that the economic arguments for closer scrutiny of joint venture activity are overwhelming.[360] Among these arguments is the fact that

> …the participants in joint ventures are private actors seeking private gains. The gains from joint ventures come from two sources: efficiency gains, which result from reduced costs or

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359 *The Law of Antitrust: An Integrated Handbook*, 2nd edition, p 687.

360 *Federal Antitrust Policy: The Law of Competition and Its Practice,* 3rd edition, p 197.

> improved products; and market power gains, which result from the fact that the venture has sufficient power to cause market wide output reductions and price increases. One important reason for looking more closely at joint activity is that agreements creating significant market power can be formed very quickly. … All it takes is firms who collectively dominate a market and agree to do something jointly.[361]

Payment systems, as we have seen, are an example of a network industry. The establishment of common standards for interoperability contributes to efficiency and is one of the recognised benefits of joint ventures in network industries.[362] Such ventures may also facilitate innovation, enable the entry of additional new players, promote scale economies, and reduce transaction and management costs.[363] At the same time, the interaction of competitors in a joint venture provides the opportunity for them to –

> widen the venture in ways that may intensify their interaction, homogenize their conceptions about market conditions, and provide new channels and incentives for explicit collusion, oligopolistic interdependence, or soft, live-and-let live pseudo-rivalry.[364]

Writing in the November-December 1995 *Review* of the Federal Reserve Bank of St Louis, Carlton and Frankel said:

> Joint ventures, particularly those involving networks that contain many industry participants, present some of the most interesting and difficult antitrust issues. Modern payment and electronic funds transfer networks are technologies that have greatly benefited consumers and the economy by reducing transaction costs and allowing consumers to economize on their holdings of non-interest bearing forms of money. Payment networks, however, may also be able to engage in collective actions that allow their members to exercise market power… If members of a payment network exercise market power, the effects can be equivalent to a privately imposed sales tax on all network transactions.

In our view, for reasons given above, the progressive, pro-consumer, cost-reducing and output-enhancing *potential* of the network effects of four-party payment card schemes should be acknowledged. It does not follow, however, that we would accept that the manner in which these schemes are operating simply fulfils that potential and avoids anticompetitive harm. Among the critical issues is whether the setting of interchange within these schemes, as well as the methodology used and the levels of interchange applied, can meet the tests of legitimacy which competition law and policy prescribe.

6.6.2 Origins of interchange in card payment schemes

The origins of interchange are expounded in the 1984 judgment of the United States District Court, S.D. Florida, in *National Bancard Corporation (NaBanco) v Visa U.S.A., Inc.*[365]

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361 *Id.*

362 See Sullivan and Grimes, *op. cit.*, p 693.

363 *Id*, pp 690-696.

364 *Id.*, p 697.

365 596 F.Supp. 1231; affirmed 779 F.2d 592 (11th Circuit, 1986). According to Visa, interchange was first introduced in 1974 (Second Submission, June 2007, document S, p 8.), but the account given by the court in *NaBanco* shows that it arose earlier.

First the bank draft, and then the cheque, had previously developed as the means by which banks' customers could safely effect payments over long distances. About a century after the cheque gained common acceptance in the United States, the bank credit card was introduced.

> The bank credit card provides many of the same services as the personal [cheque], but, in addition, provides retailers of goods and services an extra measure of protection from the risk of default.[366]

Describing the typical credit card transaction when it was still paper-based,[367] the court said:

> Once a potential consumer has opened a bank credit card account with a particular issuing bank, he or she may use that bank credit card in lieu of cash to purchase goods and services from any merchant participating in that particular bank credit card system. The merchant, after a sale, then transmits the consumer/cardholder's draft evidencing this transaction (referred to in the parlance of the industry as "paper") to its merchant bank, this sum being immediately credited to the merchant's account minus a small charge agreed upon earlier by contract (called the "merchant discount"). If the merchant bank happens to be the same bank which issued the card, the consumer/cardholder's account in the bank will be processed "in-house" in what has been described as an "on-us" transaction. When the issuer bank differs from the merchant bank, the process becomes more complicated. First, the merchant bank sends the transactional paper to the issuer bank. The issuer bank then will either send the merchant bank the requisite sums due and owing from its cardholder, or will directly credit the merchant bank's account at the issuer bank, if the merchant bank has such an account. In either case, the issuer bank is ultimately responsible for the sums due and owing from its cardholders, and thus, absent a breach of agreed procedure by the merchant or merchant bank, the issuing bank bears the risk of default by the cardholder.
>
> The process by which transactional paper is moved from the merchant bank to the issuer bank involves certain costs. In the system at issue here, the issuer bank withholds a small amount (called the "interchange fee") from the monies due and owing the merchant bank to cover the costs of this processing. Even more simply stated, the merchant bank (if not the issuer of the card used in a sale) must process the paper generated by the sale to realize both the small profit hopefully provided in the merchant's discount charge to the retailer and reimbursement for the sale amount credited to the account of the retail merchant. The paper then goes to the issuer bank which reimburses the merchant bank but only after the deduction of the interchange fee.[368]

The plaintiff, NaBanco, was not a deposit-taking institution eligible for Visa membership. It performed processing activities similar to those performed by acquiring banks ("merchant banks" in the court's parlance) on the latter's behalf. Faced with having to discharge the acquirers' burden of paying away interchange without the benefit of receiving any as an issuer, it complained that Visa's "Issuer Reimbursement Fee (IRF)" – i.e. the scheme's default interchange – was prohibited price fixing by Visa for its member institutions and that it was in any event set intentionally high to discourage competitors such as NaBanco.[369] The claim was rejected by the court. NaBanco's appeal failed.

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366 596 F.Supp. 1231, 1237. The debit card, which was developed subsequently, likewise provides this facility.

367 By the time of the case, however, the majority of credit card transactions were automated, "so that the banks' and merchants' computers actually credit each other's computerized accounts." 779 F.2d 592, 594.

368 596 F.Supp. 1231, 1238.

369 596 F.Supp. 1231, 1239-1241.

In pursuit of its claim of price-fixing, Nabanco argued that interchange was essentially a price fixed for the discounting ("factoring") of transactional paper within the scheme. On that basis, the acquirer would be seen as giving a discount to the issuer when on-selling to the latter the claim for payment against the cardholder, based upon the "paper" which it had purchased from the merchant. The court did not adopt that analysis – in our view correctly. The term "merchant discount" – although widely used – is itself liable to confuse.[370] The merchant, when accepting a credit card and a signed slip from the cardholder in lieu of payment, does not itself extend credit to that customer.[371] It acts rather from the outset entirely in reliance (indirectly) on the payment guarantee from the issuer to the acquirer, and (directly) from the acquirer to itself (the merchant), provided by the rules of the scheme and underwritten by the latter.[372] Interest is charged solely by the issuer. The merchant may not add interest to the retail price, and then discount the interest-bearing paper to its acquirer. Indeed, scheme rules prevent any surcharge to the cardholder – a rule which we discuss below. At no stage in the integrated combination of transactions within the scheme does the acquirer appear to obtain a claim for payment which it could choose to assert directly against the cardholder, but which it elects to on-sell to the card-issuer instead. The artificiality of the "discounting" analysis is thus apparent. There is no sequence of truly independent discounting transactions which the scheme merely co-ordinates.

6.6.3 Interchange is not a price for service

Just as the nature of interchange is not well analysed by treating it as an issuer's discount on its purchase of a payment claim from the acquirer, so too interchange is not properly to be regarded as the issuer's price to the acquirer for a service supplied to the latter.[373]

The European Commission noted in its 2002 decision concerning Visa:[374]

> Visa does not consider its MIF [multilateral interchange fee] as a price for specified services provided by issuers to acquirers or merchants. Rather it considers the MIF as a transfer between undertakings that are cooperating in order to provide a joint service in a network characterised by externalities and joint demand. The MIF is, according to Visa, necessary as a financial adjustment to the imbalance between the costs associated with issuing and acquiring and the revenues received from cardholders and merchants.

---

370 Even if it were accurate to see the process as one of "discounting" (which it is not), the expression "merchant discount" would be misleading: the more appropriate expression would be "acquirer's discount". In our view the correct expression is rather merchant service charge. As explained above, this is the charge paid by the merchant for the acquirer's service supplied under the auspices of the card scheme.

371 *A fortiori*, this must apply in the case of debit card transactions.

372 See e.g. MasterCard, First Submission, page 47: "... [T]he system provider, such as MasterCard, ... is not a party to the payment transaction, but provides the framework of co-operation between the parties that permits the transaction to take place and, in certain circumstances guarantees the transaction."

373 Standard Bank initially submitted that interchange "is simply a price set in the market for issuer services." (SBSA, October 2006, First Submission, p 54.) Cf also Nedbank, October 2006, First submission, Document 3, page 30. We do not consider it correct to characterise interchange as a price for services. Nor is it true that interchange is set in the market.

374 OJ L 318, p 19, 22.11.2002 (para 14).

As the court in *NaBanco* concluded:[375]

> In the VISA "joint venture," both issuer and merchant banks perform essential roles, and both perform necessary tasks for the benefit of each other, which must be performed if the basic payment service is to be offered.

The "services" within the scheme flow in both directions. Each participant depends upon the co-operation of the others. As Dr Koboldt put it, presenting for MasterCard at the hearing on 18 April 2007,

> the notion of a payment for services provided to acquirers by issuers is meaningless and misses the point that the demand for the services of a payment [scheme] is determined by both customers, as cardholders, and merchants, and that the role of interchange is balancing that demand.[376]

6.6.4 The nature of the joint venture in "open" (four-party) schemes

The true nature of interchange follows from the nature of the joint venture which a four-party card scheme entails. We accept the submissions to the effect that a four-party payment scheme is essentially a "co-operation enabling" joint venture.[377] By virtue of the scheme, issuers and acquirers (together with the scheme owner) jointly provide interdependent services to cardholders on the one hand, and to merchants on the other.

Nevertheless the idea that there is "joint supply" and "joint demand" should not be exaggerated. Intrinsic to the operation of the four-party schemes is that there is – within and in conjunction with the co-operation enabling arrangement – a competition of independent suppliers. And in each inter-connected set of transactions, once embarked upon, there are distinct supplies.

The district court in *NaBanco* explained:[378]

> …[P]rofits and losses are not specifically shared among the various VISA members, nor is there any commingling of management functions. Furthermore, to the extent possible, each member engages as an independent unit in economic competition with other VISA members with respect to various aspects of their common venture. …
>
> The fact that VISA members have integrated to the extent of agreeing on the terms of interchange, but have not fully integrated and still compete for cardholders and merchants, is typical of pro-competitive joint ventures and serves to maximize VISA's competitive potential. …

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375 596 F.Supp. 1231, 1260.

376 Transcript, p 46.

377 See e.g. Von Weizsäcker, *Economic Analysis of the MIF*, 2004, MasterCard, October 2006, First Submission, Annex L. "I consider that the best way to view the relationship between the issuer and the acquirer is as co-operating members of a joint venture, since they both need to coordinate the input from the other to provide credit card payment services to their customers. On this basis the issuer and the acquirer are jointly providing a service to their customers, namely 'enabling payment from the cardholder to the merchant' and, as in the three-party example, there is both joint production and joint demand." (P 4.)

378 596 F.Supp. 1231, 1253.

And further:[379]

> Assuming that VISA cardholders want unplanned and rapid access to merchants anywhere, regardless of whether their own bank signed a particular merchant, and that VISA merchants want unplanned and rapid access to each cardholder who enters their shop, regardless of whether the merchant's bank signed the cardholder, then some before-the-fact agreements must be made. The principal purpose of these agreements with member banks does not appear to be to improperly fix prices as NaBanco asserts but rather to provide a service which each member bank could not alone provide, namely, universal payments service which ensures that a VISA card will be honored by any merchant regardless of which bank issued it so long as that merchant displays the VISA logo on its door.

Although interchange is sometimes referred to as a mechanism needed in order to address a “market failure”, that might give rise to misunderstanding. The market cannot, by the independent action of the different players, bring about the co-operation for which a four-party card scheme exists. Interchange is necessary to such a joint venture. Only indirectly, therefore, can it be said to be connected with market failure.

6.6.5 Rules to enable co-operation

Mr Munson of MasterCard sought to explain the necessity of interchange by considering what a new four-party scheme, without any pre-existing “interchange”, would have to determine in order to bring together separate issuers and acquirers in off-us transactions between cardholders and merchants. The first question a would-be issuer or acquirer would ask (so he argued) is what amount it would have to pay when settling a transaction. In respect of (say) a R500 purchase, the scheme would have to determine the amount payable by the issuer to the acquirer – the “settlement amount”. This could be equal to, less than or more than the base amount of the transaction.

> … What is this differential between the settlement amount and the amount of the transaction which by the very nature of the business we easily see must be set. Well, frankly you can consider it just to be another definition of interchange. Interchange is a difference between the base amount of the transaction and how much the issuer pays the acquirer. If the issuer pays the acquirer the base amount [R500], that is the equivalent of a zero interchange fee. If the issuers pays the acquirer R495, that is the equivalent of [receiving] a 1 per cent interchange fee. And if he pays R450 that is the equivalent of a 10 per cent interchange fee. If he pays R505 that is the equivalent of a negative [1 per cent] interchange fee and if he pays R550 that is the equivalent of a negative 10 per cent interchange fee.
>
> So even without intending to set interchange fees, given that the issuer and the acquirer have to know what is their financial responsibility to the other side of the business, or what is the benefit there are going to receive from the other side of the business, we have to set this differential and frankly by definition, this differential is nothing more or less than the interchange fee.
>
> There is no escaping this, it must be set, and if you say to issuers and acquirers nobody is going to set your interchange fee they would not participate in your business. … [A]fter having … understood it and decided that you are going to set this settlement differential, you have to ask yourself, what am I going to set it at? Am I going to set it at R495, R450, R505, R550, where do I set it?

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379 596 F.Supp. 1231, 1254.

> In order to set that fee, first of all you are going to have to know something about the nature of the business. You are going to have to know things like, are you going to have a payment guarantee for merchants? How soon are merchants going to get paid, is it going to be immediate settlement with the merchants or is it going to be a delayed settlement? What are the benefits to the cardholder, what benefits [is] the cardholder going to get? Will the cardholder get an interest-free period? These things have to be established and have to be understood because they in fact are going to impact the initial allocation of costs as between the issuer and the acquirer. How much money it is going to cost the acquirer to participate in the system is going to depend on some things like, who has the risk for credit losses and fraud losses. Is there an interest-free period and a myriad of other things.
>
> So the first thing you have to take into account is the initial allocation of the cost of the system on both the issuing and acquiring side. Moreover you have to also ask yourself, having set that fee at R495 or R450 or R505 or R550, is that proposition for the issuer, a viable proposition? Will the issuer be able to offer these products and services at prices that cardholders will be willing to pay, and will the acquirer be able to offer its services to merchants at prices that the merchant will be willing to pay?
>
> Perhaps if you set the settlement differential at R550 as opposed to R500, perhaps it will be too expensive and cardholders would not want to use those cards and perhaps if you set it at R450 on the other side, merchants will not want to use the cards. So in setting this fee you are going to have to take into account the demand conditions that the issuer faces on its side of the business and that the acquirer faces on its side of the business.
>
> So even though it was not your initial intention to balance demand you are in fact going to have to look at exactly the same kind of facts and circumstances. … [A]t the end of the day you are going to engage in the very same decision-making process as if you started up intending to balance demand. So where does that leave us?
>
> I would propose that even if you do not want to call this thing interchange, you still need to make a determination as to what is the obligation of the issuer to the acquirer and in effect you will have to set something that makes it very much like an interchange fee, and I would suggest further that even though it is not your intention to balance demand, if you are going to set this differential at a level that gives you a viable business and of course for your shareholders, you will want to grow this business as large as possible. …
>
> [Y]ou do not need to believe that an interchange fee is necessary because in fact it is absolutely incontrovertible if there needs to be some decision taken as to the relative obligations and benefits of the issuer and acquirer and whatever you call it, it is comparable to interchange, and even if you do not believe that we are about balancing demand, when you see what we do you will realize that we have to engage in the very same process that some of you claim to be balancing demand would have to engage in.[380]

The trouble with presenting the argument in this way is that it obscures a key analytical component which ought to be kept distinct, and so begs a question. A four-party scheme, in order to function, would indeed have to impose rules upon its issuing and acquiring participants regarding their respective rights and obligations in many respects – notable examples being the incidence of liability where fraud occurs, and the time for settlement. With obligations and risks come costs. Therefore rules determining the incidence of particular obligations and risks within the scheme also determine the incidence of costs. It does not necessarily follow from this, however, that the scheme needs to be able to determine a “settlement amount” that is greater or less than the cardholder’s payment obligation to the merchant (the basic transaction amount).

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[380] Transcript 18 April 2007, pp 16-20.

The assertion of the need to do so turns out to rest upon the unspoken assumption of an imbalance in the incidence of costs which the issuing and acquiring participants cannot be expected to recover simply by their own direct charges to cardholder and merchant respectively. This is the key element that has to be demonstrated in any analysis. *If there were no need to achieve balance by a redistribution of revenue or a reallocation of costs between acquirer and issuer, there would be no need in fact either for "interchange" or for a variable "settlement amount"*.[381]

The case for interchange in four-party schemes, in order to be analytically rigorous, has to be based directly on the inherent need for a balancing payment between acquirers and issuers in circumstances where, without this payment, one or the other would in the ordinary course prove unable to meet its costs from its own direct revenues and make a normal profit.

6.6.6 Revenue allocation in a two-sided market

The case for the necessity of interchange rests essentially on analysing the four-party card payment model as an instance of a "two-sided" market.[382] A number of participants in the Enquiry submitted helpful explanations of two-sided market theory.

Absa, for example, stated:[383]

> Two-sided markets are those markets in which businesses need to attract two distinct groups of customers in order for either set of customers to be willing to participate in the market. There are a number of different examples of such markets of which two are:
>
> - Shopping malls (retailers andshoppers).
> - Yellow pages or newspapers (readers andadvertisers).
>
> What is important to recognise about each of these markets is that the demand by one side of the market will be affected by the number of customers on the other side of the market. That is, the markets are characterised by "indirect network effects". Network effects arise where the value of being part of the network varies depending on the size of the network. Typically they arise where the value of being part of the network increases as the size of the network increases. The "indirect" label indicates that value of being part of the network increases as the size of the "other side" of the market increases. For example:
>
> - Shoppers prefer a shopping mall with more retail outlets and retailers prefer a

381 Mr Munson's identification of a "settlement amount" with interchange is nevertheless instructive – so that if interchange is to be subject to regulation (see below), it will be necessary to ensure that a scheme cannot render a regulatory determination nugatory by altering the "settlement amount", or indeed by any substantial reallocation in the incidence of costs between the issuing and acquiring sides of the scheme without the approved interchange being adjusted correspondingly. Furthermore, his analysis implicitly acknowledges that all the costs in the system are relevant to a rational determination of interchange. We shall return to this aspect when discussing appropriate interchange methodology below.

382 "Two-sided (or more generally multi-sided) markets are *roughly* defined as markets in which one or several platforms enable interactions between end-users, and try to get the two (or multiple) sides "on board" by appropriately charging each side. That is, platforms court each side while attempting to make, or at least not lose, money overall." Rochet and Tirole, 2004, *Defining Two-sided Markets,* p 1.

383 Absa, March 2007, Second Submission, Access and interoperability, pp 13-14.

shopping mall with more customers.

- Both readers and advertisers prefer a newspaper with higher circulation: readers because then they can discuss the editorials with colleagues (direct network effects); and advertisers because then their advertisements are seen by more readers.

…[I]f prices on one side of the market are set only with reference to the customers on that side, and not with reference to the customers on the other side of the market, the overall market will be inefficiently small because the benefits from the first side that accrue to the second side are not taken into account.

Prices need to be set according to the overall market rather than to the two individual sides in isolation. The consequence of this is that prices are not necessarily symmetric and that the prices on one side of the market are not necessarily related to the costs incurred on that side of the market. Again, a series of examples from other markets makes this clear:

- Shopping mall owners might charge retailers for the cost of parking facilities (through their rent) rather than charging customers for parking so as to encourage lots of customers to come to the mall.

- Yellow pages or free newspapers are offered to readers at zero price while those who advertise in them have to pay. (Those who advertise are willing to pay to do so because they gain access to the readers and there are more readers when the price that readers face is zero.)

In each of these cases it is clear that the prices faced on one side of the market will not simply be determined by the cost incurred on that side of the market but rather the price will be determined taking into account the effects on both sides of the market.

In many of these cases, there is one provider who serves both sides of the market. For example, the newspaper owner can assess the relative values to readers and advertisers and decide upon the price to charge each side including whether there should be a subsidy or transfer from one 'market' to another.

Payment cards as a two-sided market

In the case of payment cards, the two sides of the market are represented by cardholders and merchants. The more merchants which accept a particular type of payment card, the more valuable it is to cardholders and the more cardholders that use a particular type of payment card, the more merchants will want to accept it.

The availability of debit and credit cards benefits consumers and merchants alike. If credit cards involve an interest-free period, credit cards provide cardholders with more flexibility to structure their repayments and thus enable them to make larger purchases from accepting merchants than would otherwise have been the case. Merchants also gain substantial benefits from the payment guarantee in respect of cardholders who take advantage of extended credit. They can sell goods to consumers who may not have funds in their current accounts (hence would be unable to pay with their debit cards), but without taking on the risk that these consumers would be unable to pay. This risk is taken by the credit card issuing bank. … Merchants rank the payment guarantee as one of the most beneficial aspects of accepting credit cards.

As in any two-sided market, there is a problem of allocating the costs of a card system across the two sides of the market (cardholders and merchants), to get the balance right in order to maximise the combined value to both sides. This is a problem faced by the three-party or proprietary schemes such as American Express and Diners International, but these schemes are free to decide how to set prices on either side of the market. In a four-party card system, the interchange fee is the tool that allows costs to be shifted from one side to the other, in order to get the right balance to maximise the combined value of the system to both sides.

> Interchange fees of this type result in lower cardholder fees (and/or greater cardholder benefits) on the issuing side. Lowering cardholder fees and/or increasing cardholder benefits will increase the number of cardholders and the use of payment cards; the benefits to merchants from these effects can outweigh the effects of higher merchant service charges.

Although this explanation refers to the "shifting" of costs from one side to the other, what is in fact shifted by means of interchange is *revenue*.[384] The costs stay where they arise or are allocated by specific rules of the scheme. Having regard to the revenues which participants on each side are able to raise by pricing to their own customers, the transfer of revenue from one side to the other by way of uniform interchange produces *in effect* an adjustment of average net costs – or rather of average net profit – between them.[385]

Crucially, interchange has the purpose of affecting prices charged to end users on the acquiring and the issuing sides of the two-sided market, and thus to bring into balance the two separate supplies and the two separate demands. In this way, "optimal" output of the "joint product" of the scheme is sought to be attained.[386]

There is "strict complementarity" of demand in a card scheme – i.e. two demands always have to be matched.[387] It follows that the lower of the two demands always determines the maximum output of the scheme. Thus if, for example, customers in aggregate wish to use a scheme's cards for purchases amounting to R200m in value, while merchants are willing to accept that payment method for only R100m worth, the actual usage of the cards is restricted to the latter quantum. If, on the other hand, merchants' aggregate demand is higher than that of cardholders, it is again the lower demand which will govern usage and scheme output.

Because of the disparity in the demand of the end users, interchange – in order to be effective – will have to operate so as to place more of the burden on the less elastic side of the market.[388] It appears that the bulk of the costs of a card scheme fall on the issuing

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384 "Interchange transfers revenues so that both issuing and acquiring are competitive businesses with incentive to attract more cardholders and merchants." (Visa, June 2007, Second Submission, document B (third part), p 18.) "The role of the interchange fee in a four-party system is to allocate revenues between acquirers and issuers." (Von Weizsäcker, *op. cit.*, p 2.)

385 MasterCard explains the purpose of the interchange as "a transfer of revenue, an allocation of costs and a balancing of demand between the issuer and acquirer…" in the interest of achieving "optimal service delivery… to merchants and cardholders". (MasterCard, October 2006, First Submission, p 7.) Dr Koboldt said: "Interchange is clearly affected by how costs are initially distributed between issuers and acquirers, but it is not linked to costs of services provided by issuers to acquirers." (Transcript 18 April 2007, p 55.)

386 "[M]any businesses operating in two-sided markets charge prices that result in earning profits disproportionately from one side. Adobe for example gives away the Acrobat software for reading and charges for the Acrobat software that does the writing. Presumably, this maximizes deployment of the reading software, creating greater utility for those that create documents; which, in turn, results in more documents being created that can be read with the software, creating greater value for readers, etc. It is not a matter of fairness or cost recovery, but of maximizing output for the benefit of all participants – if each side in a two-sided market were restricted to pricing based on the direct marginal cost of providing the service, or inversely based on elasticity of demand on that side, the overall product usage would not be optimized and all participants would receive less value, or the product might not succeed at all. As a consequence social welfare also would be sub-optimal." (Visa, June 2007, Second Submission, document R.)

387 See Transcript 18 April 2007, pp 47-48 (Dr Koboldt).

388 See e.g. Rochet and Tirole, 2001, *The Economic analysis of the interchange fee in payment card systems.* The optimal

side.[389] At the same time, experience has identified the merchant as having a less elastic (i.e. a less fickle) demand, and thus being willing to bear a greater price burden – and so make a greater contribution to the covering of total costs – than the cardholder. Interchange serves indirectly, but nonetheless effectively, to regulate the distribution of the total price burden of the scheme between the two. This is one of the reasons why the schemes introduced their "no surcharge" rules: in order to prevent merchants in the scheme from reallocating their allotted part of the price burden over to the card user.

Dr Koboldt, drawing on a seminal 1983 analysis by Baxter,[390] provided the diagram which is reproduced below. It illustrates at an abstract theoretical level how the maximum number of transactions in a card scheme is achieved by adjusting the prices charged to merchants and cardholders respectively according to their respective demand elasticities, within overall parameters determined by the point at which aggregate scheme costs intersect aggregate demand. Interchange in a four-party scheme, by transferring revenue from the suppliers on the one side to the suppliers on the other is intended to place each in a position to price its supply to the end user at a level which achieves the optimum balance and thus maximises total scheme output.[391]

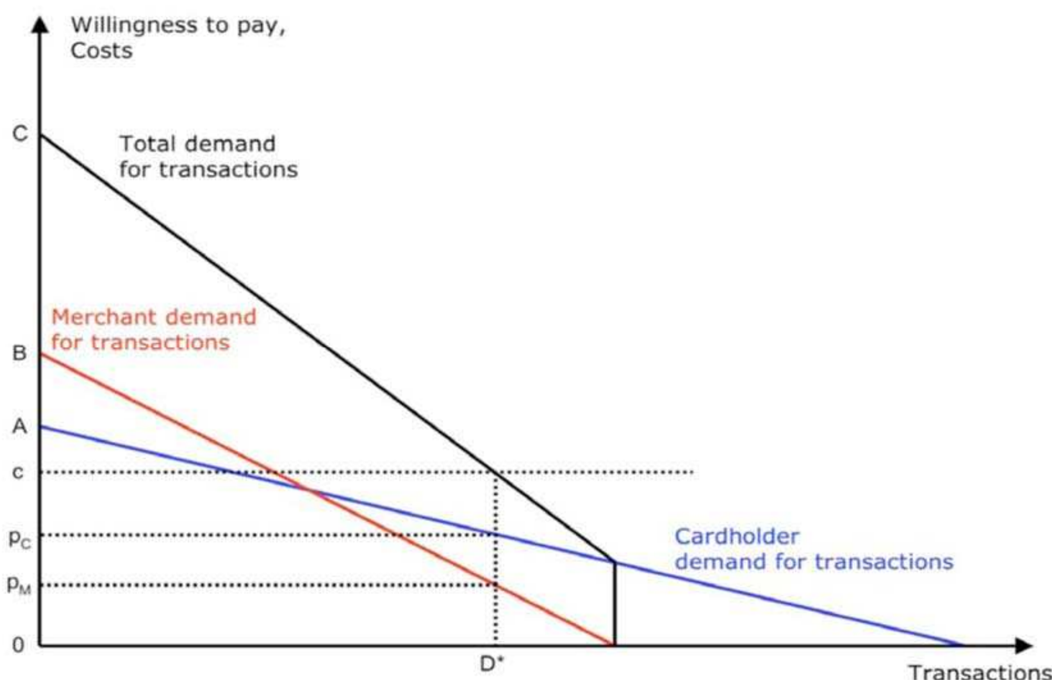
price structure in the system is determined by the transfer payment required between the suppliers in order to sustain the provision and demand for the service. The price structure thus refers to the division or distribution of the total costs and total revenues in the market. See Roson, 2005, *Two-sided Markets: A Tentative Survey.* Review of Network Economics, Vol.4, Issue 2.

389 In the *NaBanco* case the district court, after a trial of more than nine weeks, accepted that "up to 88% of total system costs" fell at that time on issuers. (596 F.Supp. 1231, 1260.) See also footnote 393 below. We do not have independent evidence of the current cost distribution in South Africa or anywhere else, and we do not accept that all the costs which are conventionally treated as issuing costs are truly integral or necessary to the functioning of a card scheme as a payment system (see further below). Nevertheless, the point seems uncontroversial at a general level. Wherever interchange operates in the card payment environment, it flows from acquirers to issuers.

390 W.F. Baxter, "Bank exchange of transactional paper", 1983 *Journal of Law and Economics* 26.

391 "[F]rom the point of view of the four-party system, there is an optimal level of charges (which follows from an optimum level of interchange fee) which is business volume maximising." (Von Weizsäcker, *op. cit.,* p 2.)

Figure 5 Baxter's model for maximising scheme output



In the next part of this chapter we examine some limitations of the analysis presented in this model. For the moment, suffice it to say that it does demonstrate the inter-connected nature of the supplies and demands that come together in card payment schemes, and that the pricing on the two sides needs in principle to be capable of being adjusted so that both the supplies and the demands are effectively matched.

We accept that this matching cannot reliably be achieved by market forces operating independently on the two sides so as to render interchange unnecessary. The argument for leaving it to market forces alone would be that, if acquirers were simply left to recover their costs from merchants, and issuers their costs from cardholders, any resulting imbalance as between demand for card usage on the one hand and card acceptance on the other hand could be overcome by merchants either giving a discount, or charging a premium, to customers using cards. However, as Dr Koboldt observed,

> … this requires that the merchant can differentiate those prices without great problems. Now in practice we observe that merchants do not differentiate prices. They do not surcharge widely, even where they are allowed to. They do not offer cash discounts even though they are allowed to, and that is to do with the fact that given the difference in the cost and benefits of accepting different forms of payment, it is simply not worth their while to do that.

In other words, it would require a considerable difference in the advantage or disadvantage to merchants in accepting a payment by card in order to trigger the mooted balancing

mechanism via the market. The dependence on such a considerable difference means that the needed balancing would not effectively be attained at all.

This point is reinforced (we would add[392]) when – assuming the absence of interchange, and therefore the full cost burden of card issuing being passed directly to the cardholder – it is taken into account that cost differentials as between cards and cash may be relatively small for the merchant and relatively large for the cardholder.[393] Thus the merchant might well be indifferent to the customer's choice of payment medium, and so be unwilling to differentiate in price, while the cardholder might need to be offered a substantially lower price by the merchant in order to be willing to bear the added cost of using the card instead of cash. Therefore the market mechanism, operating purely on the outer ends of the two-sided market, would not in principle suffice to achieve the balance necessary for the viability of the scheme.

Absa testified:

> Our economists tell us that it would be pure coincidence if the best allocation of cost for the system as a whole was one in which acquirers covered their costs … only through merchants' service charges and issuers covered the full amount of their costs through cardholders' fees.[394]

Dr Koboldt put the matter this way:

> [I]t would be pure co-incidence, it would be a fluke, if the … initial allocation of issuer costs and acquirer costs would exactly correspond to the optimal structure of prices, and if it does not, you have a problem.[395]

In a three-party scheme, as we have seen, the scheme owner (being both issuer and acquirer) can simply adjust the pricing on the two sides itself. In the case of an "open" or four-party scheme, however, the existence of a mechanism for revenue transfer – i.e. interchange – is in principle necessary in order to achieve the pricing adjustments.[396]

In *NaBanco*, in the USA, the court concluded that agreement on Visa's interchange fee (referred to as the "Issuer's Reimbursement Fee", or IRF) was necessary for the scheme to market its product and be an effective competitor.[397] It was

> … necessary to achieve stability and thus universality; that to require exchange at par or

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392 However, cf also Dr Koboldt, Transcript 18 April 2007, pp 62-63.

393 It has been suggested that issuing costs may make up as much as 95% of total costs (before interchange), so that if they had to be fully recovered directly from cardholders this would make cards much more expensive for cardholders to use. See Transcript 18 April 2007, pp 90-92.

394 Transcript 17 April 2007, pp 69-70.

395 Transcript 18 April 2007, p 54.

396 See generally Rochet and Tirole, "An Economic Analysis of the Determination of Interchange Fees in Payment Card Systems", *Review of Network Economics*, vol 2, issue 2, June 2003, 69-79, at 71-75.

397 596 F.Supp. 1231, 1253. Visa, June 2007, Second Submission, document B (third part) p 3: "Properly we mean 'Interchange reimbursement fees' when we use the term 'Interchange'."

> remove the fee to permit negotiations for interchange charges among issuer and merchant banks would result in loss of competitiveness and chaos with the eventual destruction of the enterprise.[398]

During the present Enquiry, the view that interchange is necessary in the four-party card payment environment was confirmed in much testimony. Nedbank, for example, stated that while "in the ATM world one can see that direct charging appears to be a technically feasible alternative to interchange," interchange is essential as a balancing mechanism to ensure interoperability in the four-party payment card market generally.[399] Standard Bank was of the same view.[400]

According to the latter, not only would the elimination of interchange dramatically reduce cardholder demand and card usage in general and threaten the existence of the more desirable open schemes;[401] the cost would become prohibitive for many debit card carriers.[402]

> MRS NYASULU: … We know for a fact that in the micro-lending environment, consumers have always been aware that they were charged much more than the average South Africans, but the Hobson's choice comes in not having another choice. The question I am having is, are we assuming then that despite the crime, despite their knowledge of the charges, consumers would still decide not to go for payment cards?
>
> MR FERGUS: I would say that many of them in the debit card environment, particularly, would not be able to afford the charges that would be allied to transactions and would then migrate to cash.[403]

FNB likewise confirmed the necessity of interchange, saying that without it "we would not have had this interoperable system that we have in front of us today."[404]

While other mechanisms could theoretically be devised to achieve balance,[405] no practical alternative was advanced which could function effectively in a truly open scheme.[406]

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398 596 F.Supp. 1231, 1263.

399 Transcript 19 April 2007, pp 49-50.

400 "There is a fundamental difference between a three-party scheme and a four-party scheme. An open scheme demands an exchange of value between the participants, and a closed scheme, Diners or AmEx, is non- dependent in the same way." (Mr Fergus, Transcript 19 April 2007, p 81.)

401 Standard Bank, Exhibit OO, slide 6.

402 Transcript 19 April 2007, p 99. "[I]t is obvious that a broader share of the population have debit cards than have a credit card, and many of those users would not be prepared to pay fees that would become necessary to fund the system if interchange was eliminated and the cost was moved solely to the cardholder, to one side of the value chain." (Mr Fergus.)

403 *Id.*, p 100. This particular testimony, however, while arguing for the necessity of interchange, could be taken to imply that current charges levied on cardholders for debit card transactions are themselves necessary. That is something we are unwilling to accept without clear proof, on the mere say-so of interested parties. Moreover, Standard Bank itself indicated that in view of increased scale efficiencies since 2002, a downward revision of interchange is probably warranted. (SBSA, First Submission, October 2006, p 60.)

404 Transcript 19 April 2007, p 112 (Mr Jordaan).

405 Nedbank, March 2007, Second Submission, Access and Interoperability, p 43.

406 For example, an adjustment of cost allocations by the schemes would not seem to provide a satisfactory alternative.

Standard Bank defended interchange as "the most effective method of dealing with the complex relationships involved in four-party card systems."[407] This is in all probability correct.

It also seems clear that, in principle at least, the need for an interchange mechanism in the four-party payment card environment is not ended when the market becomes "mature" – when, in other words, just about everybody has cards and just about every merchant accepts cards. The widespread issuing of cards does not guarantee that cardholders will continue to use them. Likewise, the widespread acceptance of cards would not automatically be sustained. The market remains two-sided. There remains a need for revenue to be reallocated – or at least the possibility for it to be reallocated – so as to overcome disproportions in the incidence of costs, relative to the demand elasticities and pricing, on the two sides. Only in this way could the necessary matching of the two supplies and the two demands be reliably continued.[408]

6.6.7 Default, multilateral and bilateral setting of interchange

We accept that – at least in the absence of regulated compulsory rates – it would not be possible to sustain a four-party payment scheme on a viable scale without being able to provide default rates of interchange for the settlement of transactions between acquirers and issuers within the system that would apply where there is no agreement.[409] MasterCard explained that "default terms are needed in order for a four-party scheme to operate, and a default interchange fee is an important element of these terms."[410]

Confidential: MasterCard

This is the only way in which new participants could join without having to negotiate separate agreements with every other participant (of which there are today tens of thousands), and existing participants continue without renegotiations with all the others from time to time. It hardly needs stating that this would be utterly impractical and absurd.

Where interchange is set by agreement, the agreements are usually multilateral, applying a uniform rate to domestic card transactions of the same type, with default rates applying in international (including intra- or inter-regional) card transactions. Often, bilateral agreements between participants are permitted in place of the multilateral or default rates.

Although scheme rules allocate certain costs to the issuing or acquiring sides respectively, most costs of issuing and acquiring are intrinsic to the issuing and acquiring activities. Thus the ability of a four-party scheme to allocate the incidence of costs is itself inadequate as a balancing mechanism. Moreover, if costs may legitimately be allocated by the schemes, it would seem arbitrary to deny similar legitimacy to an allocation of revenues.

407 SBSA, October 2006, First Submission, p 55.

408 See Transcript 18 April 2007, pp 204-210; also Transcript 19 April 2007, p 105. FNB pointed out that the demand imbalances are different, depending on the immaturity or maturity of the market, but that even when the market matures there will still be (cost and) demand imbalances. (Transcript 19 April 2007, p 116.) See also Nedbank, March 2007, Second Submission, Access and Interoperability, pp 43-45; Absa, March 2007, Second Submission, Access and interoperability, p 15.

409 Cf Visa, June 2007, Second Submission, document B (third part) p 17; document L p 1.

410 MasterCard, October 2006, First Submission, p 7.

SARPIF, representing the large retailers,[411] argued for bilateral agreements on the grounds that by its very nature a uniform interchange rate between the banks is anti-competitive. "Banks that are more efficient should be able to offer lower rates to merchants and customers."[412] Plausible as it may seem, this approach to the setting of interchange levels between banks does not adequately comprehend the competitive dynamics that are involved. Indeed, in our view, it rests ultimately not upon the public interest but upon the self-interest of large merchants who would expect to gain an extra trading advantage over the small by having more scope to assert their countervailing power when negotiating merchant service charges with the big banks. We consider that the power of the banks in relation to interchange needs to be addressed in a different way in order truly to protect the consumer.

In March 2006 FEASibility reported to the Competition Commission that in general both the large banks and the smaller banks already in the system argued that interchange fees should be set on a multilateral basis.[413] This has been amply confirmed during the Enquiry.

Absa argued cogently that a multilateral process for setting interchange fees has a number of definite advantages over bilateral agreements.[414]

> *A reduction in transaction costs* – Arrangements need to be in place between all acquirers and issuers. The number of arrangements that need to be agreed (together with associated costs) would increase exponentially as the number of issuers and acquirers increases. For example, the experience in relation to the recent negotiation of the AEDO / NAEDO agreements demonstrated the inefficiencies associated with bilateral agreements as these negotiations necessitated the individual negotiation of in excess of 72 individual agreements.
>
> *A reduction in barriers to entry* – Because of these transaction costs, a system of bilateral arrangements would be likely to be a barrier to entry to new small players. Indeed, the FEASibility report notes that the burden of such negotiations would be particularly great on small players as they typically only have one payment system official rather than a fully staffed department. A multilaterally determined interchange fee removes the need for these additional transactions costs to be incurred.
>
> *A reduction in difficulties for small players with lower bargaining power* – Setting interchange fees on a multilateral basis means that all players face the same conditions irrespective of their market strength or bargaining power. Setting interchange fees on the basis of bilateral agreements will inevitably mean that those firms that have bargaining power will negotiate better deals than firms that do not have bargaining power.
>
> *A reduction in time to market for new entrants* – Where interchange fees are set on a bilateral basis and small firms do not have bargaining power, the negotiation process of agreeing the interchange fees may prevent new entry. This would not be a deliberate decision but an inevitable consequence of the time and resource constraints imposed by the need to make hundreds of bilateral agreements across all of the payment systems. From Absa's perspective

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411 As at 06 January 2007, according to information submitted by SARPIF, its members were BP (with 600 retail outlets), Caltex (1,100), Clicks (665), Edcon (998), Foschini (1,300), Massmart (706), Metro (495), Mica (Supergroup) (186), Pick 'n Pay (576), Shoprite Checkers (850), Spar (1,250) and Woolworths (275).

412 SARPIF, October 2006, South African Retailers Payment Issues forum Submission of Information, p 5.

413 *The National Payment System and Competition in the Banking Sector*, p 30. See also p 174: "In general, smaller players indicated support for the multilateral approach, especially if it could be based on some fair evaluation of costs. The big banks also favoured this approach for practical reasons."

414 Absa, March 2006, Second Submission, Access and interoperability, pp 15-16.

> it would be essential to make agreements with other large players since these have the most significant impact on Absa's business. Hence it would be necessary to prioritise these negotiations and agreements ahead of those with other smaller firms that have less impact on Absa's business.

Confidential: Absa

> *Promotes efficiency* – depending on the methodology used to calculate the multilateral interbank fee (for example costs only captured from the most efficient banks)[415] it may promote less efficient banks to become more efficient.

Standard Bank argued on similar lines that, where interchange is bilaterally negotiated, this allows greater scope for "the undue negotiating power of the large volume players". On the other hand, a multilateral approach –

> … is a "small volume" and "new bank" friendly model in that an average industry price is set which incentivises players with economies of scale without excessively penalising small volume banks, thereby maintaining interoperability and promoting competition.[416] …
>
> In the case of card interchange, a bilaterally determined interchange level runs the risk of discouraging new entrants and/or small players, for at least two reasons. Firstly, there is the likelihood that the differences in volumes will result in small banks having to pay higher interchange than the larger banks and discourage new issuers from entering the market.[417] Secondly, the complexity and large number of negotiations required would pose a significant barrier to entry into the card market. In a single interchange model, small players effectively enjoy the benefits of the negotiating power of the larger players, and new entrants can enter the market without having to engage in a wide range of costly and time-consuming bilateral negotiations.[418]

Standard Bank also submitted that a multilateral implementation of interchange is "the only workable approach".[419] Bilateral arrangements are "a very complicated and ineffective way of reaching agreements," says Absa's Mr Volker.[420] In Nedbank's view, a bilateral fee-setting process in which every issuer and every acquirer agrees the principle/scope and the level of the interchange fee on a separate basis with every other issuer and acquirer "is not feasible for maintaining the necessary balance within payment systems."[421] In the view of FNB, "bilateral negotiations of interchange fees are not sustainable."[422]

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415 For reasons dealt with below, we consider that an interchange methodology which takes into account average costs is more likely to promote competitive efficiencies.

416 SBSA, October 2006, First Submission, p 20. FNB agrees that bilateral processes "can threaten the interoperability of the payments system." FRB, October 2006, First Submission, p 70.

417 Cf also FRB, October 2006, First Submission, p 70: "In its UK inquiry the Office of Fair Trading accepted that MasterCard's multilateral interchange arrangements are preferable to bilateral arrangements as they increased the ease, and reduced the costs, of entry into the MasterCard scheme' and 'reduced transactions costs as compared to a situation where every acquirer and issuer had [to] come to agreements on interchange fees bilaterally' (Investigation of the multilateral interchange fees provided for in the UK domestic rules of MasterCard UK Members Forum Ltd, Companion Paper to the decision, 6 October 2005."

418 SBSA, *id.*, p 62.

419 *Id.*, p 59.

420 Transcript 17 April, p 141.

421 Nedbank, March 2007, Second Submission, Access and Interoperability, p 63, read with p 60.

422 FRB, October 2006, First Submission, p 69.

MasterCard agreed:

> Bilateral interchange fee setting has onerous time and cost considerations. It is, from a practical perspective, virtually impossible for each bank in South Africa to enter into bilateral negotiations and reach agreement with every other bank in the country in order to set the applicable interchange fee.[423]

The flexibility of the four-party model and its ability to develop across national boundaries depends precisely on participating issuers and acquirers *not* having to negotiate and agree terms directly with each other. And if only bilateral agreements on interchange were to be permissible, then what would justify the myriad other terms and conditions essential to the viability of these schemes being set on a uniform basis?

Standard Bank observed:

> Given technological advances and scale efficiencies that have accrued since 2002, we would expect that a revised calculation would recommend a further downwards revision of card interchange. Banks however face the dilemma that the co-ordinated effort required to conduct a revised study may be viewed as a contravention of the Competition Act, and so the industry has been reluctant to do the study on a joint basis, even though it may lead to a reduction in card interchange.[424]

However, that view was evidently based on an interpretation of section 4(1)(*b*) of the Competition Act that was not endorsed by the Supreme Court of Appeal in *American Natural Soda Ash Corporation and another v Competition Commission and others* 2005 (6) SA 158, decided in May 2005. In light of that judgment, if the multilateral setting of interchange within a four-party scheme is reasonably necessary for the viability of the joint venture, then in our view it should be regarded as legitimate.

We have concluded that interchange is indeed necessary and legitimate, at least in principle. Likewise necessary and legitimate in principle would be a multilateral process designed to arrive rationally at the levels of interchange reasonably necessary for effective functioning of the scheme.[425]

But is our conclusion regarding the necessity of interchange in principle sustainable in view of the fact that payment card systems evidently operate successfully in some countries without interchange, and the fact that banks have been making profits on card issuing in South Africa even without taking into account interchange receipts?

6.6.8 The absence of interchange in some countries

The EU Interim report on payment cards stated that “POS interchange fee arrangements between banks in open payment card systems are not an intrinsic feature of these

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[423] MasterCard, October 2006, First Submission, p 8. See also pp 101-102.

[424] SBSA, October 2006, First Submission, p 60.

[425] We deal in due course with the question of appropriate methodology for such a process.

systems."[426] The report referred to four countries which do not to have any interchange fees for debit card POS transactions – the Netherlands, Denmark, Finland and Luxembourg. The European Commission, in its December 2007 decision concerning MasterCard,[427] also mentions Norway in this regard, arguing that "today the highest card usage per capita exists precisely in those EEA Member States where card schemes operated without a MIF for decades (Norway, Finland and Denmark)".[428]

The contention therefore is that interchange is not in fact necessary for the successful operation of "open" or four-party payment card schemes. If this were true as a general statement,[429] then it would refute the conclusion reached in the *NaBanco* decision in the United States and would warrant a full formal investigation by the South African Competition Commission into whether existing default or other multilateral interchange arrangements between issuing and acquiring banks contravene section 4(1)(*b*) or alternatively section 4(1)(*a*) of the Competition Act.

On closer examination, however, it appears that the absence of interchange fees in the European domestic debit card schemes referred to can be explained by unique acquiring arrangements set up historically in each country, whereby revenues raised on the acquiring side are nevertheless able to be applied to support card issuing. While it is beyond the scope and resources of the present Enquiry to delve fully into the facts concerning the operation of card schemes in those countries, the information made available to us or gleaned from public sources does indicate that the general case for the necessity of interchange (and thus its legitimacy in principle) in open card schemes is robust enough to survive the examples given.[430]

In **Finland** the Pankkikortti debit card scheme provides a card that is uniquely co-branded with an international credit card logo, such as Visa or MasterCard.[431] This allows cardholders to choose whether to use the Pankkikortti debit card function or the branded credit card

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426 EU Interim Report I: Payment Cards. Sector inquiry under Article 17 regulation /2003 on retail banking. 12 April 2006, p 26.

427 "The European Commission has decided that MasterCard's multilateral interchange fees (MIF) for cross-border payment card transactions with MasterCard and Maestro branded debit and consumer credit cards in the European Economic Area (EEA) violate EC Treaty rules on restrictive business practices (Article 81)." See IP/07/1959, Brussels, 19 December 2007.

428 European Commission MEMO/07/590, Brussels, 19th December 2007, p 5.

429 The European Commission states in general terms that "Open card schemes such as MasterCard's can operate without a MIF". (*Id.*)

430 The European Commission itself has stopped short of concluding that interchange is prohibited *per se*. "The Commission's decision [announced on 19 December 2007] addresses solely MasterCard's multilateral intra-EEA fallback interchange fees for MasterCard and Maestro branded payment cards. This decision does not cover interchange fees in general and it does not prohibit interchange fees as such." (*Id.*, p 6.) Moreover, it appears to recognise that revenue transfer from acquirers to issuers may well be necessary as a "balancing mechanism" in an open four-party scheme, but that this could take forms other than interchange. (*Id.*) See also IP/07/114, Brussels, 31st January 2007, p 1: "The Commission is not arguing for zero interchange fees; however, their operation in some payment networks raises concerns."

431 MasterCard, October 2006, First Submission, p 90.

function when making a purchase. Issuing banks are required by law to operate as acquirers for the Pankkikortti debit card scheme. So far as the credit card aspect is concerned, there is only one acquirer in Finland, namely Louttokunta, which pays a commission to the issuing bank for every co-branded card issued. Thus the issuing banks receive a share of acquiring revenue, and at the same time the issuing of Pankkikortti cards is subsidised. Thus the Pankkikortti example does not provide persuasive support for the argument that truly open four-party schemes can develop commercially without interchange or an effective equivalent.[432]

In **Denmark**, the Dankort debit card system was developed by the banks in a joint venture.[433] The majority of Dankort cards are co-branded with Visa, enabling them to be used outside Denmark.[434] Historically Dankort has been based on a single acquiring institution, namely Payments Business Services (PBS) which was set up by the Danish banks. Via PBS (subsequently converted into PBS Holding A/S), the banks own Dankort. In addition to being the sole acquirer for the Dankort system, PBS is the main acquirer for the international card brands. The fact that the issuing banks own PBS and Dankort would enable acquiring revenue to flow by way of profits to the issuing side.[435] However, according to MasterCard, Dankort operates at a loss because regulation has unduly limited the amount of the merchants' annual subscription (there being no transaction-based merchants' service charge).[436] In the view of MasterCard the Dankort scheme is not sustainable commercially and survives as a national debit card scheme by virtue of regulatory pressure on the banks. While we are not in a position to comment on this evaluation, it does seem clear that it would be unsound to rely on the Danish case as disproving the need for an interchange mechanism in commercially viable open, i.e. four-party, schemes.

Norway is a world leader in the use of payment cards. In 2006, more than 200 transactions per Norwegian were conducted using payment cards issued in that country.[437] Norway is also notable for its early and widespread preference for debit cards. Debit cards are used for around 94 per cent of transactions concerning cash withdrawals and POS purchases.[438]

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432 MasterCard also says in its First Submission, October 2006, p 91: "It must also be pointed out that as part of the Single European Payments Area ("SEPA") migration, the Finnish banks are reviewing the future of Pankkikortti and are considering migrating to four-party payment systems with interchange as a fundamental feature." According to the Nordic competition authorities, "A likely outcome of implementing SEPA in Finland is that the national bank card will cease to exist. According to the Finnish Bankers' Association, national bank card schemes will not be developed to deliver cards for Europe-wide users. Banks operating in Finland will offer their customers card products corresponding to bank cards in line with the SEPA-framework." (*Competition in Nordic Retail Banking*, 1/2006, pp 57-58.)

433 Denmark's National Bank. *Payment systems in Denmark*, 2005.

434 Roundtable on Competition and efficient usage of payment cards, Denmark, 6 June 2006,

435 See FRB, March 2007, Second Submission, Position Paper: Interchange, p 5.

436 MasterCard, October 2006, First Submission, pp 87-88.

437 Norges Bank, *Annual report on payment systems*, 2006, p 14. In 2004, when the number of transactions per Norwegian was approaching 200, comparable figures for the UK and Switzerland were roughly 100 and 50 respectively. (Enge and Owre, "A retrospective on the introduction of prices in the Norwegian payment system", *Economic Bulletin* 4/06 (Vol. 77), p 167.)

438 Norges Bank, *op. cit.*, p 14.

How did this come about? The development of the card payment system, together with the coordination of issuing and acquiring, was evidently highly centralised from the outset. Oil companies were the first to introduce payment cards. The first bank-operated card payment project took place in 1983/84, after the Norwegian Banking Association had entered into framework agreements with oil companies on the use of banks' cards (ATM cards) in the oil companies' terminals.[439] The Norwegian Savings Banks Association also entered the picture. In 1986, the banking associations and the retailer organisations entered into an agreement of intent concerning the installation of point-of-sale terminals in shops, leading to signed agreement in 1987.[440] Norges Bank engaged actively in the work to increase coordination.[441]

In 1990 the banking associations established a single domestic debit card scheme under the name "BankAxept". According to Norges Bank, "BankAxept is the Norwegian debit card solution."[442]

> 5.5 million BankAxept cards have been issued …. These are often combined with international cards with a debit function, often Visa. A total of 4.6 million BankAxept cards in Norway have a debit function linked to an international card system. A VISA part and a BankAxept part of a card may be regarded as two functions. Therefore, the number of functions … will be higher than the physical number of debit cards.[443]

Today, BankAxept is run by BBS,[444] which is the Norwegian banks' payment clearing house, and is a joint venture, wholly owned by the savings and commercial banks.[445] All cards in the BankAxept system operate on-line to the issuer.

There is no explicit interchange, the system being based on direct pricing to cover costs on the issuing and acquiring sides.[446] Card users in Norway have evidently been prepared to shoulder the issuing costs, despite the alternatives of cash and cheques. Crucial in this regard has been the planned and centralised nature of the system.

> Extensive integration as a result of the merging of previously separate card networks, and

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439 Enge and Owre, *op. cit.*, p 167.

440 *Id.,* p 167.

441 *Id.*

442 *Norges Bank, op. cit.,* 2005, p 18.

443 *Id.*, 2006, p 14. About 3.5 million cards with credit functions are registered in Norway. (*Id.*) Their usage, however, is obviously very limited by comparison with debit cards.

444 Bankenes BetalingsSentral AS.

445 The shares provide equal rights to dividends. The company's after-tax results for 2006 show a surplus of NOK 80.7 million. It is proposed to allocate NOK 66 million to dividends. BBS, Annual Report, 2005, p 24.

446 See Enge and Owre, *op. cit.*, p 169. A deliberate decision was made not to have merchants subsidise cardholders. "Cost surveys carried out by Norges Bank in 1994 and 2001 showed that a substantial share of the total costs associated with the BankAxept system have been covered through prices charged to consumers. In most other countries, the bulk of the costs associated with card systems is borne by merchants." See also ESA – Response case 52824 – ESA retail banking sector enquiry - card payments. Available at Norwegian Financial Services Association (FNH): www.fnh.no.

> expansion of the range of services to include cash withdrawal have paved the way for economies of scale and network economies in the card payment system. Norges Bank regards this coordination as the deciding factor behind the high use of cards in Norway.[447]

Nevertheless:

> In order to encourage the use of services in a two-sided market, banks may choose to charge one side of the market less than its share of actual costs would imply. This may be used strategically, and the pricing may be varied over time in order to achieve growth in the side of the market that is most important for the further growth of the network. The appropriate price structure in the years ahead will therefore depend on the price sensitivity of the various services offered by banks, and what is regarded as most important for further growth in the use of cards.[448]

It thus appears that the Norwegian success was not brought about simply or even essentially by market forces, but that market realities may nevertheless in future lead to revenue transfers within the system in order to cater for cost and demand imbalances on the two sides of the market. The Norwegian example, instructive though it is, would therefore not seem to refute the case in principle for the existence of an interchange mechanism in a truly open four-party scheme.

In the **Netherlands**, the debit card system named PIN, together with electronic purses (named Chipknip) and credit cards are the electronic payment instruments most generally used. Consumers are, as a general rule, not charged for POS transactions, and direct charging is limited to annual contributions for the possession of a debit card. Merchants, however, charge a small fee (a surcharge) for small debit card transactions. The only national payments facility, Interpay, owned by the eight major banks that are both shareholders and customers, offers virtually all payment processing services. Interpay's primary function is processing customer transfer orders and computing the resulting interbank positions (clearing). It also switches, authorizes and processes all debit card transactions.[449]

The CEO of Interpay has explained that, while interchange fees for Interpay's debit card transactions were set at zero, the shareholder banks were paid yearly dividends from Interpay, based on the number of debit card transactions undertaken by them annually, to reimburse them for their authorization costs – i.e. as if interchange fees were paid to them as issuers. Interpay in turn charged merchants for the acquiring services, taking into account the costs incurred by issuers.[450]

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447 Enge and Owre, *op. cit.*, p 168.

448 Enge and Owre, *op. cit.*, p 170.

449 Roundtable on Competition and efficient usage of payment cards, The Netherlands, 6 June 2006.

450 "Interchange on debit and credit cards – What role do authorities play?" Kansas City conference, 2006. Interpay was the sole acquirer of merchants for the acceptance of PIN. From March 2004, Interpay's contracts with merchants have been transferred to the banks. Banks have requested an exemption from the Dutch competition authorities with respect to the introduction of a multilateral interchange fee. It is not known whether it has been approved. In 2005 Interpay transferred the ownership of the payments products, PIN and Chipknip, to a new company called Currence, owned by the same eight banks. Since its establishment, banks must obtain a license from Currence in order to issue and acquire collective payments products. Currence is the sole institution in the Netherlands that can grant access to new

Thus, once again, the example of the Netherlands would not seem to support the view that interchange would be unnecessary for the commercial development and functioning of an open four-party scheme.

In **Luxembourg** the local debit card scheme, Bancomat, has a single acquirer – Cetrel – which is wholly owned and controlled by the banks in that country.[451] According to MasterCard,

> Cetrel performs all of the acquiring processing, issuing processing and switching services on behalf of the banks. Under such an integrated structure, the role played by interchange fees in an open four-party payment system is performed by the "revenues" distributed by Cetrel to its shareholders, which are the issuing banks. Consequently, the "revenues" distributed to shareholders constitute *de facto* interchange fees and are in fact similar to the "dividends" distributed under the Interpay scheme of the Netherlands. Therefore, here too, although ostensibly operating without interchange fees, the same financial result is achieved, albeit on a far less transparent basis, and at the expense of banks which are not owners of Cetrel.[452]

Furthermore, as MasterCard explains, the costs borne by banks are allocated within the Bancomat scheme in such a way that two-thirds are borne by acquiring banks and one-third by issuing banks.[453] This allocation evidently redistributes costs from the issuing to the acquiring side, in place of the reallocation of revenues from the acquiring to the issuing side which would be achieved by interchange.

6.6.9 The profitability of issuing without interchange

Earlier in this chapter, figures were presented showing that – at least in the case of major banks providing data, and at least in recent years – issuing would have remained profitable even without interchange revenue.[454] On the face of it, this might seem to refute the conclusion that interchange is necessary for the viability of four-party card schemes.

There are at least two reasons why such a view would not be sound. First, the data is insufficient to enable any clear conclusion to be drawn regarding the longer-term probabilities for rates of return on investment in this regard, in which the position of smaller issuers would also have to be considered. Therefore it cannot be concluded that, in the absence of interchange arrangements, the banks concerned or other banks would have engaged in issuing (or acquiring) under the four-party schemes, either to the extent that they have done so or at all, or that they would continue to do so in future.

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participants. Since 2005, merchants pay acquiring banks a transaction fee and cardholders make annual contributions for the use of PIN cards, while banks pay Currence a licence fee for the participation in the system. Switching and clearing are solely carried out by Interpay and participating banks pay issuing and acquiring fees for these services. (Roundtable on Competition and efficient usage of payment cards, The Netherlands, 6 June 2006.)

451 MasterCard, October 2006, First Submission, p 88.

452 *Id.*, pp 88-89.

453 *Id.*, p 89. MasterCard cites ECB Blue Book 2001, Luxembourg, p 323.

454 See Table 14 above.

Secondly, and more fundamentally, the profit figures for issuing would not in themselves weaken the general case explained above for a balancing mechanism within an open or four-party system. They might go to show that prices on the issuing side have in fact been sustained by the banks at an excessive level, despite the claims that competition between issuers coupled with demand elasticity holds these prices down. The figures might also show that the level of interchange has been excessive, given the revenues which issuers have been able to extract independently of interchange (and the underlying merchant service charge). Nevertheless, in our opinion, the cogency of two-sided market theory is such that it justifies a permanent mechanism for the determination of interchange, notwithstanding that the particular determination at a particular time could result in a zero – or theoretically even a negative – interchange rate.

6.6.10 Conclusion on the necessity of interchange

Based on everything put before us, and in the absence of any other evidence, we are willing to accept the necessity of interchange in principle in four-party schemes. While interchange has been shown to be necessary, and a mechanism for interchange accordingly legitimate, it does not follow that every methodology for determining interchange, and every level of interchange consequently arrived at and implemented, would be justified also. It is important to ensure that the theoretical case for the necessity of interchange does not serve as a smokescreen for an impermissible exercise of market power, whether by the schemes or by their participating institutions.

FNB, in arguing the need for interchange, stated:[455]

> Economic theory teaches that where externalities or spill-over effects occur, these should be compensated for by a subsidy or a tax, in order to internalise the externality. For example, inoculation against a contagious disease benefits not just the individual but also society, which is a spill-over benefit. If some individuals cannot afford the inoculation then they should be subsidised to take account of the spill-over benefit. Similarly, in the case of card payment networks, the main spill-over benefit is that merchants benefit from increased numbers of cardholders, and accordingly would be prepared to pay a portion of the issuing costs in order to internalise these benefits. That is exactly what the interchange fee accomplishes, thereby improving net welfare within payment systems.

Subsidies and taxes are not the legitimate domain of the market; they belong in the domain of public power. The argument so formulated does not show the necessity of interchange, and thus its legitimacy. What it advances is the alleged legitimacy of four-party schemes – these mighty combinations of financial institutions, issuing, acquiring and profiting for themselves as best they can – using their power to the full to determine the “tax” which should be imposed on merchants for receiving the benefits of the scheme, and the “subsidy” which should consequently flow to issuers to support their issuing businesses.[456] It is an

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[455] FRB, March 2007, Second Submission, Position Paper: Interchange, p 4.

[456] This would be the “privately imposed sales tax” against which Carlton and Frankel (*supra*) warned.

argument for pricing the acquiring services to merchants up to the maximum which the degree of market power exercisable by these schemes and their participating institutions can sustain. We cannot endorse such an approach.[457]

While accepting the necessity of interchange in principle, we nevertheless consider the setting of interchange to be open to the danger of abuse which may harm competition and the consumer. It is rightly a focus of public concern, and of scrutiny by public authorities.

6.7 The potential for abuse of interchange and the need for regulation

In this chapter we do not analyse card pricing to consumers. Cards are in many instances bundled with other banking products. If there is market power in relation to the pricing of the bundles, then that power extends to the included cards. Indeed, the network effects generated by payment card systems may serve to enhance the degree of banks' market power in respect of the bundles in which the cards are included.

6.7.1 The non-neutrality of interchange

"Neutrality" would imply that changes in interchange fees have no real effect on social welfare. In particular, if interchange fees were neutral, then it would not be possible for card associations to increase their profits on an uncompetitive basis by collectively increasing interchange fees. There would then be no reason either for competition authorities to be concerned, or for any other regulatory intervention to occur.

Von Weizsäcker (in a paper submitted by MasterCard) argues that the level of interchange applied in a four-party scheme cannot influence the level of the total service charge (the acquirer's merchant service charge plus the issuer's cardholder service charge) because of the competition between the members of the scheme on the acquiring and issuing sides.[458] Accordingly, interchange would be "neutral" in its ultimate effect on prices. However, this is contrary to the view of other experts on the subject and is contradicted by the evidence of Dr Koboldt – who testified for MasterCard at the hearing on 18 April 2007 – as well as by common sense.

Rochet and Tirole say:[459]

> *Neutrality in payment systems*. The choice of an interchange fee paid by the merchant's bank,

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457 We discuss this further in the next section of this chapter, where we deal with unsatisfactory aspects of the current methodology of interchange.

458 Von Weizsäcker, *op. cit.,* p 19. Carlton and Frankel had argued on similar lines in their 1995 article, "The Antitrust Economics of Credit Card Networks," *Antitrust Law Journal*, 68, pp.643 – 668. Using the idea that interchange is price-"neutral", they contended that interchange is consequently unnecessary in four-party payment card schemes. We have dealt with this notion above, showing why market forces operating independently on the two sides of the market cannot in fact be relied upon to match the different supplies and demands.

> the acquirer, to the cardholder's bank, the issuer, is irrelevant if the following conditions are jointly satisfied: First, issuers and acquirers pass through the corresponding charge (or benefit) to the cardholder and the merchant. Second, the merchant can charge two different prices for goods or services depending on whether the consumer pays by cash or by card; in other words, the payment system does not impose a no-surcharge-rule as a condition for the merchant to be affiliated with the system. Third, the merchant and the consumer incur no transaction cost associated with a system of double prices for each item.

In South African conditions, none of these conditions is satisfied.[460] First of all, the competition between acquirers is oligopolistic – and so is the competition between issuers.[461] Accordingly, we can have no confidence that benefits are or would be fully passed through to all consumers of the card payment services on each side.[462] Second, the schemes do operate a "no surcharge" rule to prevent merchants from charging cardholders more than the ordinary advertised price, or more than the price charged to customers using other payment methods.[463] Third, even in the absence of such a rule, the added costs to merchants of having to differentiate in price would deter them from doing so, with the result that there would in any event be scope for interchange, and hence merchant service charges, to be raised above the level warranted in a notionally competitive market.[464]

To support the case for the necessity of interchange, Dr Koboldt argued that merchants do not adjust prices for customers using different means of payment even when they are free to do so. International experience has confirmed this: "merchants typically do not pass through differences in costs and benefits of accepting different forms of payment in the form of different retail prices".[465] The "coherence" of merchant prices as between different means of payment rests primarily on the added cost of administering price differentiation.[466] In our view it must also involve to a significant extent the fear of the merchant of alienating and losing customers by such differentiation, with possible consequences going far beyond the loss or gain of the immediate sale.[467] The same arguments in this regard that support the necessity

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459 Rochet and Tirole, (2004) *Defining Two-Sided Markets*, p 10. See also the earlier study by Gans and King (2003), "The Neutrality of Interchange Fees in Payment Systems", *Topics in Economic Analysis and Policy*, Vol 3 Issue 1.

460 Indeed, the "neutrality" model assumes perfect competition in both the issuing and acquiring markets, as well as in all the markets in which merchants compete for cardholding customers. In fact, perfect competition exists nowhere.

461 Cf generally Carbó-Valverde (*et al)*, *Market Power and Willingness to Pay in Network Industries: Evidence from Payment Cards Within Multiproduct Banking*, University of Granada, FEG Working Papers Series, No. 1/07, 2007.

462 To the extent that some consumers – notably the better-off – are more assiduously courted by the banks in their competition for customers, the likelihood is that the benefits flowing to the issuing side as a result of interchange, to the extent that such benefits are passed on, would be disproportionately passed on to those consumers, thus leaving the effect on aggregate consumer prices resulting from interchange to be borne disproportionately by the poor.

463 We consider separately below whether such a rule is legitimate, and we conclude that it is.

464 Gans and King have argued that the mere removal of restrictions such as the "no surcharge" rule would be a sufficient condition to avoid any regulatory concerns about the setting of interchange fees. "For there to be such concerns, regulators must also believe that there are restrictions binding cash and credit prices together. There is no social gain to having specific price regulation of the interchange fee if constraints that bind cash and credit prices are eliminated." *Op. cit.,* p 12. This argument seems naïve. It fails to appreciate that the coherence of cash, debit card and credit card prices would be sustained by factors independent of card scheme restrictions.

465 Exhibit MM1, slide 7.

466 *Id.*, slide 8.

467 In Australia, where the rule against surcharging was abolished in 2003, only 12% of very large merchants and only

of interchange go to show the potential for its abuse.

6.7.2 Do market forces limit card interchange so it cannot be abused?

In Figure 5 above, the "Baxter model" showed that maximum card scheme output would occur at a point where the aggregate costs of the scheme coincide with the aggregate demand of cardholders and merchants for scheme card transactions, and that this outcome can only be achieved by adjusting prices to cardholders on the one side and prices to merchants on the other so that their respective demands are indeed matched at this optimum point.

However, the graphic illustration is static, and it merely assumes the slope and position of the various demand curves. Dr Koboldt acknowledged that there is not a single, static point of balance at which scheme output is maximised through interchange in order to allocate net costs within the scheme in correspondence with the demand elasticities on the two sides. Network effects are dynamic effects, and the result is that the demand curves on the two sides would change.[468] Thus, for example, as more cards are issued and cardholders seek to use them at merchants, the merchant demand curve would change in response. It must follow in our view that there is scope for manipulating interchange, albeit within limits, so as to bring about a sustained increase in the price burden which merchants are willing to bear, and thus maximise revenue to scheme participants who are both issuers and acquirers, as well as to the scheme itself.

It has been shown above that interchange effectively sets a floor for price competition in the acquiring market. At the same time, thanks to "price coherence" – thanks to the non-"neutrality" of interchange, in other words – competition from other means of payment (such as cash) would not adequately prevent the abuse of interchange by four-party schemes and their participants. The question therefore turns to whether (a) divergent interests of issuers and acquirers within the schemes or (b) competition between the schemes themselves would have this preventive effect.

Because interchange provides a stream of revenue to issuers, issuers have an obvious interest in maximising interchange. There is, of course, a constraint on this – namely that interchange, by affecting the service charge payable by merchants to their acquirers, must not so curb merchants' willingness to accept payment by card that the overall negative impact on issuers' revenue would be greater than the per transaction gain.[469]

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around 2% of small merchants applied surcharging for card over cash transactions according to a report of the RBA in 2006. See *Payment System Board Annual Report*, 2006, p 13. See also Transcript 17 April 2007, p 55.

468 See Transcript 18 April 2007, pp 176-180.

469 Cf Transcript 17 April 2007, pp 51-53. Thus "higher is not always better for banks." Absa (Mr Stillman), Transcript 17 April, p 138. There "can well be the case where you hit the spot where the interchange fee is too high, because … you give up what you lose on the merchants' side". *Id.*, p 140.

Merchants' willingness to accept payment by card can be increased – the elasticity of their demand can be lowered – by network effects. These network effects follow upon an increase in the relative number of cardholders, an increase in the number and value of transactions in which cardholders wish to pay by card, and an increase in the number of customers that might otherwise shop elsewhere or forego the purchase should their wish to pay by card fail to be facilitated. The pressure upon merchants generally to accept cards can thus be increased by the manipulation of factors which incentivise the take-up and use of payment cards by cardholders – factors which incentivise the customers of issuers, in other words.

The card schemes (including the three-party and the four-party schemes) have an obvious interest in maximising the issuing and use of cards, as well as concomitant card acceptance.[470] In the case of the four-party schemes, this interest is naturally shared by issuers and may extend to acquirers as well. Where an acquirer is not also an issuer, the acquirer's interest would simply be in maximising transaction volumes and values while keeping to a minimum the burden in costs falling on the acquiring side and having to be passed through ultimately to merchants by way of the merchant service charge. The four-party schemes have taken care to avoid a conflict of interests between acquirers and issuers within their schemes, by ensuring that only substantial issuers are permitted to acquire. In South Africa, the main issuers are also the main acquirers: the big four banks.[471]

In the development of the card schemes it seems to have been recognised that, generally and strategically, relatively more would be gained by an emphasis on incentivising cardholding and usage by cardholders than on incentivising merchant acceptance.[472] The potential leverage throughout the network is greater where the incentives are applied on the cardholder side. Given a merchandise price that is ordinarily the same for card and cash transactions, the advantage of the card to the cardholder is essentially that of convenience and security – until other benefits for the cardholder are added. The convenience and security may itself be provided free of charge (or apparently so) by making the transaction costless to the cardholder. Other benefits, such as "loyalty" points or "rewards" for spending, may readily be added. The linking of these to the seemingly painless extension and take-up of credit through the issuing and use of credit cards, and a significant "interest-free period", adds greatly to the attraction. By incentivising the take-up and use of cards by cardholders, the card schemes and their issuing and acquiring participants are able to enhance the network effect which renders merchant demand less elastic and increases the price-burden

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470 Card scheme owners' revenue is to a large extent related to transaction volumes through the scheme: Transcript 18 April 2007, pp 146-147.

471 Even where there is a divergence of interests between acquiring and issuing, international experience suggests that established levels of interchange would not be lowered as a result. Datamonitor says: "In theory issuers and acquirers in Europe can agree bilateral interchange fees. This seldom happens though because there is little incentive for an issuer to set a fee lower than the MIF [multilateral interchange fee] or for an acquirer to agree a fee higher than this level." (Visa, June 2007, Second Submission, document T, p 49.)

472 There are occasional exceptions to this, as in the case of the South African banks' decision over debit card interchange in 2003 (see above), when the main barrier to card usage was identified as reluctance of smaller merchants to accept cards.

which merchants are willing to bear. These are further reasons why we cannot accept that interchange simply settles, and must settle, at a level reflecting spontaneous competitive forces in the issuing and acquiring markets respectively.[473]

In their competition to attract issuing institutions and expand their cardholder base, the four-party schemes have their own interest in seeing interchange at the highest sustainable levels. There is no reason to think that competition between schemes will tend to push interchange levels down.[474] If anything the incentive would be to compete them upwards, or at least hold them at established levels even as transaction volumes and values rise and unit costs fall. This conclusion is supported by the view of Frankel and Shampine in "The Economic Effects of Interchange Fees", 73 *Antitrust Law Journal* (3/2006), 627-673. Dealing with the effects of inter-system competition on the level of interchange, they observe at 651-652:

> Competition between card brands is ineffective at constraining interchange fees because a network with lower fees gets fewer sales. If one network were to set its interchange exactly at a theoretically efficient level while its rival offered a slightly higher interchange fee, issuers would prefer the network with the higher fee unless the fee was so much higher that merchants refused that brand. Consumers would have no incentive at the point of sale to avoid the more expensive brand if price coherence prevailed, and the issuer would have an incentive to market more heavily or enhance rebates for consumers using the more expensive brand. Ultimately there is little to prevent each network from increasing the interchange fee to the same level that a monopoly association would choose if consumers are loyal to particular cards.[475]

It is significant that Mr Munson of MasterCard – bringing all of that scheme's international experience to bear – was unable to maintain a consistent argument to the contrary. Having at first emphasised that issuers themselves would not want interchange to be "too high" because they know that by so doing they would shrink the size of the system,[476] he went on to admit that there is "short term pressure" in the competition between schemes for issuers' business for them to give issuers higher interchange.[477] Indeed, he added:

> I can tell you in personal experience that, when issuers tell us what they think interchange

473 Cf e.g. Von Weizsäcker, *op. cit.* p 20.

474 It is sometimes argued that blending of interchange fees might weaken inter-network competition, which may also lead to higher acquiring fees. However, this argument fails to appreciate that inter-scheme competition over interchange paradoxically tends to raise rather than reduce the interchange fee.

475 As Dr Koboldt correctly pointed out (Transcript 18 April 2007, pp 149-150), one would not know how much above the theoretically efficient level the interchange level could be set before it reached the level at which even a notional monopoly association would lose more than it gained. Nevertheless that caveat only serves to confirm the general statement. Frankel and Shampine note that "a network may have to increase its fee only in modest increments so it does not get too far out in front of other brands and risk losing merchants." (P 652.) In this way, competition between networks would tend gradually to raise interchange to the point at which further increases became unprofitable. We do not accept the assertion of Dr Koboldt that there "are equally incentives downwards" (Transcript 18 April 2007, p 152). However, he is surely right in observing that "competing three-party systems would have the very same incentive to set merchants' charges too high and reduce cardholder charges." (Transcript 18 April 2007, p 171.) "We would not expect three party schemes to price significantly lower to the merchants, and if they do not, they price higher, despite not having an interchange fee." (*Id.*, p 172.) This seems to us all the more reason to be concerned about the potential pricing effects of interchange setting within four-party schemes.

476 Transcript 18 April 2007, p 22.

477 *Id.*, p 25.

> should be in those circumstances in which we set interchange fees, they rarely say "please reduce my interchange", and they frequently say "I need more interchange to have more competitive products, to lower prices to card holders to help you grow your business". So yes, there is a short-term pressure and an intense pressure to raise interchange fees.[478]

He then sought to counter-balance this by emphasising again the issuers' need to be able to offer their cardholders a card which enjoys merchant acceptance. This is so especially when new cards are issued. Thus MasterCard – and the argument would apply likewise to other schemes – has an interest in not giving in to the pressure from issuers to raise interchange too high.[479]

Nevertheless, Mr Munson acknowledged that MasterCard had gained an advantage in Australia, where a regulatory intervention by the Reserve Bank initially produced a result which permitted a slightly higher rate of interchange for the MasterCard scheme than for Visa.[480]

> Quite frankly we were thrilled with this. It was about a two basis point [0.02 per cent] differential, but I can tell you that a two basis point interchange differential over a sustained amount of time is a competitive advantage, it helps you win business. And so, in the first couple of years of this process, MasterCard had a slight, but significant competitive advantage, based on the way that the Reserve Bank had set up this system.

Despite all this, says MasterCard, the fact is that interchange levels have tended to come down internationally.[481] This may be true of absolute levels – we do not have adequate data to confirm it [482] – but the real question is whether interchange has come down *relative to reductions in issuing costs*.[483] Without a positive answer to this question, the fact that some

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478 *Id.*

479 *Id.*, pp 25-27.

480 *Id.*, p 32. See also *id.*, p 147. This important admission radically undermines Mr Munson's earlier protestation (*id.*, p 28) to the effect that, if MasterCard were to set a higher interchange level than Visa's, it would simply lose merchants and so also cardholders to Visa.

481 This was asserted, for example, by Dr Koboldt, Transcript 18 April 2007, p 151. Mr Fergus of Standard Bank went so far as to state: "In the last 20 years that I have been involved in interchange, it has only gone in one direction, downwards." Transcript 19 April 2007, p 77.

482 We have some evidence to the contrary. Visa International's main default interchange rates (1.6% electronic and 2% paper) "have not changed for a number of years from being set in the early 1990s." (Visa, Second Submission, June 2007, document K.)

483 As Mr Fergus put it, "If you have greater volume going through the scheme, … you would expect that the scheme would become more efficient and over time the costs would reduce." (Transcript 19 April 2007, p 78.) A greatly over-simplified hypothetical example should suffice to illustrate in an elementary way the consequent effect that should be expected on the absolute level of interchange. If, in an average transaction, total costs of 100 are incurred in the proportions 20:80 on the acquiring and issuing sides respectively before interchange, an interchange fee designed (say) to balance those costs evenly would amount to 30, leaving each side with net costs of 50 to recover from its own customer. If, say, through automation and increases in transaction volumes, total costs of an average transaction were halved to 50, and the proportion between acquiring and issuing costs remained the same, then interchange having the same simple purpose would fall to 15, leaving each side with net costs of 25. If we assume instead that, given different demand elasticities, the level of interchange is designed to load the cost burden disproportionately onto (say) the acquiring side, and if that disproportion were to remain unchanged while average transaction costs came down, interchange would still come down correspondingly. The mere fact that interchange has come down would tell us nothing about the presence or absence of disproportion in the net cost allocation itself, or the extent of it. It would not assure us that there is no distortion in the market produced by the manipulation of interchange. Furthermore, if interchange were to fall at a lower rate than the rate of fall in average transaction costs, interchange in relative terms would be *rising* not falling. Thus the mere fact that interchange rates may have come down would in no way refute the analytical argument which suggests a tendency for interchange to rise to its sustainable maximum.

interchange levels may have come down would not refute the argument that inter-scheme competition will tend to hold interchange to the maximum levels which a monopoly association could theoretically sustain.

6.7.3 The nature of the potential abuse

Dr Koboldt argued that

> …increasing interchange can either reduce or increase total demand for the services of payment system …. [For example], as the interchange fee increases, total system output increases if previously cardholder demand was less than merchant demand and therefore there was merchant demand that eventually went unsatisfied. So [in that case] the transaction volumes increase if you increase interchange fee. You get to the point where you have got it right, that is where the demand is balanced. If you increase interchange fees further, total system output would fall. [484]

At a general theoretical level this is unexceptionable, but it says nothing about the potential to manipulate upward the point at which the "balance" of cardholder demand with merchant demand is achieved at the expense of the latter. More telling is Dr Koboldt's further explanation that it is wrong to look at interchange fees in the same way as you would look at a price.

> Increasing the price normally, unless we have really perverse demand conditions, reduces demand. Increasing interchange fees may increase demand, depending on what the original starting point is. If you have a situation where there is insufficient cardholder demand, increasing interchange fees will lead to an increase in total system output.[485]

It must follow that, provided the limits of merchants' endurance are not exceeded, it would pay schemes to maximise interchange and utilise the extra revenues to expand cardholder demand. Because of the scope for manipulation of interchange, and for raising the floor for merchant service charges in this way, we have to be very wary of the idea that "optimal" (i.e. maximum) card scheme output is the same as the output which would be optimal for society, or indeed that which a notionally competitive market would allow.

Capitec submitted:

> Interchange should ideally be at a level which is sufficient to cover the processing cost. It should not be the main driver behind the acceptance of a new product as it should be as price neutral as possible (not be the main area of income) and not be treated as a profit centre in its own right.[486]

Mr Stassen confirmed this position during the hearings. In his opinion interchange on credit card transactions in South Africa is relatively high and is being treated as a profit centre – i.e. as a main area of income by other providers.[487] In our view, if interchange functions in this

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484 Transcript 18 April 2007, p 57.

485 *Id.*, p 58.

486 Capitec Bank, October 2006, First Submission, p 11.

487 See Transcript 4 April 2007, pp 42-45.

way it will constitute an abuse of the power that is facilitated by the four-party joint venture. That should not be allowed.

The schemes and several banks participating in the Enquiry naturally placed emphasis on the positive benefits for all participants in a payment card network. Clearly if the benefits to a merchant of accepting payments by card were to be eclipsed by the cost incurred in doing so, then the merchant's acceptance of cards would cease. But to price the benefit to the merchant up to that point is to price at a level which even a monopolist could not breach. Within limits set by the inequalities of property in a market system, the point of competition is to enable resources to be allocated through a price mechanism which matches production and distribution to wants. The "value proposition" (utility) of payment cards to the merchant provides no justification for pricing the acceptance of cards above an optimally competitive level.[488]

Even if it is so that merchant service charges in South Africa are comparable to those paid in other countries,[489] this would not dispose of the question whether, either here or in other countries, interchange arrangements are nevertheless serving, or may in future serve, to keep these charges above their potential competitive minima.

It was suggested by Mr Jordaan of FNB that the public, as consumers, would have no more interest in interrogating the level of interchange than in interrogating the level of (say) the rental costs incurred by Pick 'n Pay.[490] If consumers did not like the prices they were being charged, for example for soap powder, they could always switch to buying it from Checkers. Competition in the retail market thus adequately protected consumers, and it was unnecessary for them to concern themselves with the costs incurred by the supplier in making the supply. However, this is not an apt comparison, as was observed at the time.

> ADV PETERSEN (of the Panel): I have a problem with the comparison between the consumer's interest or lack of interest in the rental paid by Pick 'n Pay, or the costs that have gone into producing a packet of soap powder, and the issue of interchange in this network. … Let me [accept] for argument's sake that interchange is necessary and that all that we are concerned about is how it is arrived at and perhaps by whom. Now, the theory behind it is the balancing of demand in a two-sided market where independent market forces on those two sides will not produce a proper harmony.
>
> The first point of distinction with Pick 'n Pay's rental or the soap powder is that this is going on within a massive, very important network – an unusual joint venture which is not a fully integrated joint venture, but one which allows competitors, independently providing part of the combined product to be linked up. Where all of us – and it is at an immature stage, [so it] is going to be more the case [in future] – are affected by this network several times a day, the interchange that has been set … is entering as a uniform cost into acquirers' costs and would logically find its way down into merchants' costs and ultimately into consumer prices. … [S]o something that is agreed by many enterprises or set in common for many enterprises is

488 Cf in this regard the argument advanced by FNB (FRB, March 2007, Second Submission, Position paper: Interchange, pp 8-9).

489 Transcript 18 April 2007, p 9 (Mr Munson).

490 See Transcript 19 April 2007, p 133.

> finding its way into the price paid by the consumer.
>
> At the same time you have the theoretical possibility which we have explored over the past days that it could be manipulated – one of the parties presenting was unhappy with my use of the word “manipulate” so let me say it could be delicately adjusted – so as to make it painless for example for a credit card holder to take up and use a credit card. Painless initially, not painless later when the interest has to be paid on the credit debt, but painless to take it up and use it – so much so that you can boost demand on the issuer side, the cardholder side, and then exploit the network effects, making it more and more difficult for merchants to refuse, in other words increase the inelasticity or captivity of merchants on the acquiring side and thereby jack up the aggregate revenue to the optimal point [for the scheme].[491]

No effective answer to these points has been provided. Indeed, there was significant support for the view that interchange can be manipulated by or within a scheme in order to maximise the aggregate revenue of its participants, and that this should not be left to happen. In this regard the following was said during the hearing of Absa:[492]

> MR VOLKER: I think that the principle sounds right. I think that is why we in our presentations did say that we would support an independent methodology in structure to determine that. I think if the system is left to its own devices … it could open itself to abuse and misuse.[493]
>
> MR STILLMAN: If I may just add to that. I mean I think it is well recognised in the economic literature that the use of the interchange fee can have very strong pro-competitive beneficial effects. It is also noted in the literature and I think it was picked up by the European Commission in its review, that in some circumstances interchange fees could be used also … as a means of shifting revenues from one side to the other to enhance the profitability of the banks. So there are different possible effects of interchange fees and I can appreciate your desire to try to figure out how to sort through them and see what the drivers are. … I do not want to anticipate questions …, but I think if one does think about that issue of shifting costs from one side … to the other, it is very important to take on board differences in levels of competition in acquiring and issuing, in which direction those differences in levels competition might point to in terms of the implications of interchange fees, and I ….(indistinct) … that it is probably the opposite of the implication that the Technical Team suggested in its earlier presentation,[494] i.e. under circumstances in South Africa if anything I would think [that] … the competition considerations, the differences in degrees of competition might argue in favour of lower interchange fees.
>
> …
>
> MR NORTON: … What has been called into question is the level of interchange and I think the Absa proposal is one which says we are very happy for the level of interchange to be interrogated thoroughly and for an independent third party to do a thorough and detailed analysis of the levels of interchange and if post that analysis the nett result is that interchange levels should come down as was the case in [2003] when interchange levels were reduced post the Edgar Dunn study, then Absa is more than happy to accept that position, and I think we are very much in favour of an objective independent assessment, to [address] your concern which is, as I understand it, that interchange is effectively a mechanism for concerted practice by banks to ramp up revenue. We are very happy for an independent third party to have a very cold hard look at that issue and make sure that that concern is not one which

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491 *Id.*, p 136-139.

492 Transcript 17 April 2007, pp 133-136.

493 See also *id.*, pp 173-174 (Mr Volker): “I think if we can agree on an objective set of criteria that address the fundamental requirement for balancing the two sides of the market and have a mechanism as well to ensure the effective and objective and transparent implementation of that methodology, we should hopefully minimise misuse or manipulation to a large extent.”

494 It is not clear precisely what Mr Stillman was referring to here.

comes into question.

> … [T]he concerns that were expressed in Australia were the lack of a regular review of interchange levels and the lack of a full methodology and I think absolutely from an Absa perspective we are in favour of both of those in relation to interchange.

Standard Bank also acknowledged that the setting of interchange could potentially be abused, although with some qualification.

> MR BODIBE: I am asking you … to what extent can the scheme abuse the [in]elastic demand from the side of the of the merchant?
>
> MR FERGUS: I think that is why you actually do need an independent expert who is controlling the process and you need some regulation from within the country to ensure that this does not happen. … [I]f you had issuing and acquiring balance between the banks the risk would be there. If you have got big differentials in issuing volumes and acquiring volumes there is no logical economical argument that I can think of why that would happen, and I really do not think Nedcor are going to agree blindly to give Standard Bank significant sums of money because they think it is good for Standard Bank, which is what they would be doing in agreeing to a high interchange.[495]

An important element in the potential for abuse of interchange lies in the fact that, in South Africa, large issuers also dominate the acquiring market.[496] The effect of disproportions between banks' issuing and acquiring businesses is an aspect which deserves exploring.

To understand the dynamics involved, it is best to begin with a notional firm whose issuing business is small relative to its acquiring business.[497] The larger a firm's acquiring business relative to its issuing business, the greater will be the proportion of its own cardholders' transactions that are likely to be "on-us". On-us transactions are comparable to transactions in a three-party scheme: no interchange is payable to any other firm.[498] Since, in these transactions, the firm *qua* acquirer receives the interchange component contained in the merchant service charge and retains it *qua* issuer, it will have no interest in a lower interchange so far as these transactions are concerned. However, its relatively large acquiring base will also mean that it is engaging as acquirer in a relatively large proportion of transactions involving other issuers' cardholders, and in doing so will be obliged to pay away interchange to those issuers. Its relatively small issuing base means that its interchange receipts from off-us transactions by its own cardholders will be relatively few, and so it will probably be a net payer of interchange.[499] This could well give it, on balance, an interest in keeping interchange down. The alternative of enlarging its relative cardholder base by

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495 Transcript 19 April 2007, pp 78-79.

496 Cf the 2000 report by the Reserve Bank of Australia (RBA) and the Australian Competition and Consumer Commission (ACCC), "Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access", which pointed out that banks had no incentive to lower interchange fees because they were both issuers and acquirers. See Visa, Second Submission, June 2007, document T, p 17.

497 Nedbank is a notable example of such a firm (Transcript 19 April 2007, pp 6-7); hence the mention of it by Mr Fergus in the passage quoted above.

498 Transcript 17 April 2007, p 34, pp 51-52.

499 Cf Transcript 19 April 2007, p 7, p 32.

aggressively competitive issuing would be retarded by the relative lack of interchange revenue with which to sustain such a drive. Its competitive position is disadvantaged when compared with large issuers having relatively smaller acquiring businesses.

In the case of large issuers with smaller acquiring businesses the dynamics of advantage are the converse. A relatively greater proportion of their cardholders will be entering into off-us transactions, and thus generating net interchange revenue for the issuer. Meanwhile the issuer's on-us transactions generate internal "interchange" revenue as well.[500] If interchange is a source of profit to the issuer – i.e. not merely a necessary means of cost redistribution and recovery – the result would tend to chill competition in the supply of acquiring services and raise merchant service charges above a notionally competitive level.[501] Moreover, the profit component in interchange would tend to reinforce big-player advantages also on the issuing side.

If (as we think probable) there is any significant degree of market power over merchants in the supply of acquiring services, generated in particular by network effects, then a higher than necessary level of interchange could readily be sustained to the advantage of the big issuers. Because the profit component in such a level of interchange would flow to the big issuers in on-us as well as off-us transactions, and because of the disincentives to growing a large acquiring base without a corresponding issuing base, there would be a tendency for big issuers to increase their hold also on the acquiring market and narrow the scope for profitable acquiring by independents. Thus interchange, in particular when taken together with scheme rules weighted against non-issuers or smaller issuers acquiring, has considerable potential to restrict and distort the market for acquiring services.

The non-transparency of interchange is itself a crucial reason convincing us that interchange cannot safely be left to market forces, or to setting by private interests alone. The applicable level of interchange in respect of any particular card payment is only partially known to merchants; it is experienced only indirectly through the merchant service charge. In that form it is passed on into consumer prices. It is unknown to the cardholder, yet enters into consumer prices which the cardholder also pays.[502] The supposedly "free" service to the

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500 Transcript 17 April 2007, p 34, pp 51-52.

501 The argument that margins are tight in the market for acquiring services has previously been addressed by showing how interchange operates as a floor for price competition anyway. The argument based on "tight margins" is further weakened when it is observed that that market is dominated by firms which are also major issuers. For them, in on-us transactions (as is the case with three-party schemes), there is ultimately no separate "margin" on the acquiring side. In off-us transactions they are the recipients, as issuers, of the interchange component of the acquirer's merchant service charge. In on-us transactions they are the recipients of the interchange component of their own merchant's service charge. Any element of profit in this component is a profit which they extract and retain in their dual capacity as acquirer and issuer.

502 Transcript 17 April 2007, p 47, pp 109-112. "I think the perception from a credit cardholder is such that he perceives a transaction to be free, where most consumers are not aware that there is a charge to the retailer". Absa (Mr Volker), *id.,* p 112. Since a lot of the effect of interchange is concealed, it does not advance the case of the card schemes to refer to contented consumers.

cardholder is subsidised by the merchant [503] – but ultimately at the consumer's expense.[504] By way of interchange arrangements, a non-transparent element of profit is being extracted by the issuing bank from the customer (or from the particular customer along with all other customers, whether they use cards or not) via a component of a "merchant's fee" that is funded ultimately through a hidden increment in the purchase price of the merchandise.[505]

6.7.4 Unsatisfactory methodology

The *Nabanco* court in 1984 found that Visa's credit card interchange fee was reasonably cost-related, and approved the methodology used as being "careful, consistent, and within the bounds of sound business judgment."[506] There appears to have been no consideration, however, of the appropriateness or otherwise of the cost elements included in the setting of interchange, from a competition policy point of view, or of the precise role of the business judgment concerned.

Visa and MasterCard have each developed their own methodology for the setting of interchange and generally describe their processes in different ways. Both employ costing studies, but differ as to the identification of relevant costs and the use made of them in arriving at interchange levels. It must be borne in mind that interchange has to reconcile not only imbalances in cost on the two sides of the market, but also imbalances in the elasticity of merchant and cardholder demand – i.e., in the different ability or willingness of the end customers on the two sides to bear the costs of the co-operation enabling service which the joint venture provides.

In the case of credit cards, MasterCard's costing study is "really a proxy for measuring merchant demand".[507] This proxy is created by selecting certain costs on the issuing side. Visa evidently uses a more comprehensive costing methodology.[508] MasterCard's debit card

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503 As Mr Volker acknowledged in answer to Mr Bodibe, interchange is a mechanism to subsidise cardholders. (*Id.*, pp 81-82.) One may add that it is not only the cardholding customer that is subsidised by interchange, but also the business of the bank issuing cards. Moreover, the subsidy to cardholder tends to go to those least needing it – the credit-card holders whose spending is supported by a component of the merchants' service charge, paid for ultimately by all consumers.

504 "I think irrespective of which payment instrument is used, the consumer does ultimately pay. So I think our view is that there is a variety of payment instruments that can be selected by the consumer and whether it is cash or cheques or credit or debit card there is a cost associated with that instrument to the merchant and to the cardholder so none of those options are free in themselves." Absa (Mr Volker), Transcript 17 April 2007, p 82.

505 There is an inherent non-transparency in interchange. In addition, there may be actual secrecy. In its decision on the Visa exemption in 2002, para (15), the European Commission noted (OJ L 318, p 19, 22.11.2002, para (15)): "Visa has in the past considered the level of the MIF and the way in which it is determined by the Visa EU Board as a business secret, not to be disclosed by the Visa members to their clients. Therefore, acquiring banks which in practice pass on to merchants the interchange fee that they have to pay to the issuing bank in part or in whole, were not permitted to inform merchants about the level of the MIF. Therefore, merchants have not been made aware of the exact components of the MIF in their merchant fee."

506 596 F.Supp. 1231,1261-1262.

507 Transcript 18 April 2007, p 27.

508 However, in terms of the exemption negotiated with the European Commission in 2002, and which expired on 31 December 2007, Visa agreed to limit interchange on a basis which applied a costing methodology essentially

costing methodology is also more comprehensive. Both schemes, however, ultimately apply a business judgment to the setting of the resulting interchange levels. In Visa's case, merchant demand is evidently assessed solely by way of this business judgment.[509] MasterCard, on the other hand, explains that

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> attempting to quantify merchant demand for credit cards is extremely difficult and MasterCard's lengthy experience is that the best means to arrive at an approximation is to utilise, as a point of departure, a proxy which references costs.[510]

A remarkable thing, however, is that the proxy methodology takes into account only certain of the issuer's costs, while ignoring the acquirers' costs altogether. Thus, where credit card interchange is concerned, no attempt is made to actually assess the imbalance of costs on the two sides of the market. Nor is the elasticity of cardholder demand ever established.[511]

It seems clear that the object of the exercise is simply to estimate the maximum share of total scheme costs which merchants can be expected to bear, and – subject to the cautionary judgment which comes from business experience – to arrive at a maximum interchange rate which as nearly as possible will exploit this limit without breaching it.

In its very origins, credit card interchange was based upon information regarding the merchant service charge which acquiring banks were able to levy. In the *NaBanco* case, the US Court of Appeals noted that when, in 1966, Bank of America expanded its three-party system nationwide by licensing local banks, and thus becoming a four-party system, a variable interchange fee system was created.

> Each merchant-signing bank was required to inform the card-issuing bank of either the actual or average merchant discount it charged. The fee was based on this information.
>
> After the original BankAmericard network expanded, the variable interchange fee system did not work effectively. A for-profit nonstock-membership corporation, NBI, was therefore formed in 1970. NBI's board of directors adopted a new uniform fee system, the IRF, in late 1971.

corresponding to the "proxy" approach used by MasterCard. Visa has not disclosed much specific information about its cost studies where its own preferred methodology is concerned. Visa's Interchange rates are set at a level "to optimise the payment service". (Visa, June 2007, Second Submission, document B (second part) p 3.) They take account of cost studies, market review, product development, and incentives. (*Id.*) There is activity-based costing at the member and country level. (*Id.*, p 4.) A sample is used to represent the entire payment system (issuing and acquiring). A consistent framework has been applied globally for over 25 years. (*Id.*) The cost studies isolate Visa payment cards from others (*id.*, p 5), by which we understand that the costs specific to the Visa scheme are able to be identified. Visa seems to use regional data for costing studies, which are related to historical and projected costs and revenues of member institutions in that region. Through this the "cost imbalance" on the issuing and acquiring sides respectively are calculated, and subsequently a "cost calculated rate" necessary to redistribute the costs between issuers and acquirers is arrived at. This rate is then used as one of the inputs into the setting of interchange fees by means of a business judgement. (Visa, June 2007, Second Submission, Annexure L.)

509 "There is a misconception in the market that Visa's methodology solely comprises a cost study. Looking at a member's input costs is only a small part of the review process, if at all where data is unreliable, prohibitively expensive to collect or unobtainable. This is where a market review is used to determine how to structure the Interchange rates in order to encourage the fullest use of the system. Market forces play their part…" (*Id.*)

510 MasterCard, March 2007, Second Submission, p 22. MasterCard normally employs EDC to conduct the costing exercises.

511 "We don't actually do a comparable study on the cardholder side": Transcript 18 April 2007, p 27 (MasterCard).

NBI became VISA in 1977.[512]

Visa has evidently been refining its business judgment on this matter ever since.

The theoretical rationale provided for the MasterCard proxy is that, if it were not for the scheme, merchants would have to bear the cost of extending credit themselves to their customers through an in-house card scheme.[513] The idea is that they should accordingly be willing to bear the comparable costs within the scheme. Thus the proxy, in broad terms, includes three main components: the issuer's processing costs, the issuer's payment guarantee (against cardholder default or fraud),[514] and the interest-free (or "free funding") period granted by the issuer to the cardholder. [515] We shall consider these elements further below.

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MasterCard's debit card cost study is fundamentally different from that of credit cards, and uses a more comprehensive approach [516] to calculate the costs involved in the provision of debit card services to the two sides of the market. It is said that this approach is more closely aligned with the theory justifying interchange, but requires a considerable amount of expense, time and commitment of resources to carry out.[517] Because the debit card is integrally related to the provision of banking services, more costs and functions need to be taken into consideration. Credit cards are typically viewed as a product in their own right, whereas debit cards are seen as a generally used device to obtain access to the customer's bank account.[518]

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These points are not without merit, yet presented simply in this way they tend to give the subject of interchange setting an exaggerated appearance of objectivity. Ultimately, the key reason for the more comprehensive cost study adopted for debit card interchange seems to be that there was no accumulated business experience regarding the extent of the price burden that merchants would be prepared to bear in the debit card stream, and (as

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512 779 F.2d.592, 595.

513 See e.g. Von Weizsäcker, *op. cit.,* p 19.

514 Visa says that the merchant receives a 'payment guarantee' from the acquiring bank. (Visa, Second Submission, June 2007, document S, p 6.) However, the issuer guarantees payment to the acquirer. Thus when the cost of the payment guarantee is considered it refers to "the promise of the issuing bank to honour payments made by the acquiring bank". (*Id.*)

515 MasterCard, March 2007, Second Submission, p 24. The following costs are excluded from the costing study: marketing and account acquisition and setup costs, loyalty retention programmes, cardholder billing and payment processing, customer relations and promotions etc. No profit margin is included in the costing studies, and the averaging of various members' costs provides an incentive to the issuers to improve their performance. (*Id.*, p 29.) This was essentially the approach used in South Africa by EDC in 2002/2003, and which is evidently being used again now.

Confidential: MasterCard

516 This is called a full cost or "Baxter" approach or an end to end cost study. (MasterCard, Second Submission, March 2007, p 23; Transcript 18 April 2007, p166.)

517 MasterCard, March 2007, Second Submission, p 23.

518 MasterCard, October 2006, First Submission, p 106. Thus the cost to the customer of other means of accessing the account also have to be considered.

MasterCard put it) "a proxy for merchant demand is not easily identifiable".[519] Accordingly, business judgment as to sustainable interchange has required a more extensive cost study as an input into decision-making.

The fact that the credit card proxy is designed to identify an "upper bound" for merchant service charges was explicitly acknowledged by Dr Koboldt:[520]

> In practice directly measuring merchant demand is very, very difficult and proxies can be used, and a suitable proxy for an upper bound of what merchants should be expected, reasonably be expected to be prepared to pay for cards is essentially what it would cost the merchant to self-provide a similar payment system, noting of course that only the very largest merchants would be able to do that.
>
> So it's the cost of self-providing a card payment system that the merchant would have to incur, which is what the cost study is measuring. It is measuring issuer cost but by doing that it is not measuring costs of services provided by issuers to acquirers, it is rather trying to figure out what it would cost merchants if they were to provide a similar card payment system to their customers, so if merchants became issuers what costs would they have to incur? They would have to incur funding the interest-free period, they would have to incur some processing costs, they would have to write off fraud losses, they would have to write off credit losses and so forth, and those are the cost components, issuer cost components which essentially proxy the willingness to pay of merchants, the amount that merchants can reasonably be expected to be willing to pay for the services provided by the card payment system.

Although Mr Munson denied that the goal of MasterCard in setting interchange was to find "the maximum point at which merchants will continue to take the card",[521] he was obliged to concede as "a fair point" that the methodology used was to establish an upper bound on what merchants would bear.[522] This was plainly stated in Dr Koboldt's Exhibit MM1, slide 11.[523] Not surprisingly, therefore, MasterCard would usually set interchange at or below this upper bound.[524]

It was suggested to Mr Munson that, by setting interchange at or near the "yellow line" of what merchants would bear, the schemes were not promoting cards as replacements for cash as vigorously as they might.[525] In his answer he indicated that while cash and debit cards could be considered true substitutes, cash should not be seen as a good comparison with the credit card. "One of the important differences between credit cards and other forms of payment, especially cash and debit, is the availability of long term revolving credit line and

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519 MasterCard, March 2007, Second Submission, p 76.

520 Transcript 18 April 2007, pp 69-70.

521 *Id.*, p 157.

522 *Id.*, pp 157-158.

523 Mr Munson said he would not necessarily use the same language, "but nevertheless, you are attempting to establish a number at or below which, you were comfortable that your acceptance will not suffer." (Transcript 18 April 2007, pp 159.)

524 The approach with new card technologies, where the immediate aim might be to secure merchant acceptance, the approach could well be different and interchange could be set significantly lower. (*Id.*, p 160.)

525 *Id.*, p 162.

in some cases the availability of the short term or the interest-free period."[526] Dr Koboldt pointed out that anyway the proposition involved "a rather one-sided view of a two-sided problem", in that a drive to replace cash by increasing card usage would still require balancing the price to cardholders and to merchants, and not simply applying all the incentives on the merchant side.[527] This latter answer seems correct.

Nevertheless, the use of a proxy in the cost calculations of credit card interchange fees raises several concerns. Whatever may have been its justification at the outset of credit card issuing, the idea that merchants would instead have to provide their own in-house store card and credit system is now surely quite artificial. Dr Koboldt himself stated that this would be realistic only for very largest merchants.[528] Yet merchants of all sizes are being induced, via interchange and the resulting merchant service charges, to bear such a burden. Nor is the benefit to merchants of an increased turnover thanks to credit cards really pertinent to their willingness to pay. As Pick 'n Pay submitted,[529] virtually all merchants nowadays accept plastic generally because to refuse to do so would lead to a loss of turnover. From the merchant's perspective the debit card now functions in large measure indistinguishably from the credit card.

FNB submitted:

> The correct methodology for calculating interchange is that both demand and supply (cost) factors should be taken into account, as this appears to be correct according to economic theory. The use of the MasterCard "proxy" approach does however yield comparable results, as it implicitly accounts for demand-side factors.[530]

We are unable to accept that view.

It is stated in theory[531] that interchange fees can be positive, negative or zero. The proxy specified in the MasterCard / EDC cost studies is predefined and identifies several issuing costs upfront, not allowing for negative or zero outcomes to occur. The development of a comprehensive costing methodology for debit cards shows that it is feasible to measure all relevant issuing and acquiring costs. In our view the specification of a proxy, whether as a representation of the imbalance of costs or of the imbalance in demand elasticities in a payment card system, lacks coherent justification.

As Capitec pointed out:

> Debit cards have better risk management features than that of credit cards; credit cards

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[526] *Id.*, pp 163-164.

[527] *Id.*, pp 165-166.

[528] *Id.*, p 69.

[529] Pick 'n Pay, October 2006, Submission of information, p 5.

[530] FRB, March 2007, Second Submission, Position Paper: Interchange, p 10.

[531] Roche and Tirole (2001), *An Economic analysis of the interchange fee in payment card systems.*

> normally offer better fee structures to its users. Client fees could possibly start reflecting the true cost of transacting and risk, which could see an increase in credit card fees. Individuals may lose the marketing benefits on their credit card purchases if that cannot be funded from interchange.[532]

Put differently, the question to be addressed is why credit card interchange should not be limited essentially to what is needed to enable it to function as a means of payment (like the debit card), leaving the costs of credit extension to be charged directly and competitively to the borrower.

The vast majority of South Africans holding credit cards – some 80 per cent – do pay interest on their transactions.[533] The remaining minority make use of the "interest-free period" and discharge their debt to the issuing bank before that period expires. Where the debt is not discharged in time, there is no interest-free period: the cardholder is treated as having drawn on the revolving credit facility from the outset and interest is charged from the date of the transaction.[534] In the vast majority of cases, therefore, the issuing bank receives revenue through a high rate of interest as well as receiving interchange.[535] At the same time, the interest-free period for the remainder (the "transactors") is being funded by merchants, willingly or unwillingly via interchange. Like a mirage, the interest-free period also serves as an attraction to those credit card users who prove unable to repay timeously (the "revolvers"), and who are thereby more easily drawn into high-interest bearing debt. Merchants derive increased turnover from all forms of credit extended to retail customers, not merely from credit on credit cards. No adequate justification has been advanced for imposing on merchants this cost of credit extension by banks, or for permitting this particular form of credit extension to be privileged in the market-place in this way.[536]

Absa observed that the removal of interchange would (*inter alia*) reduce the availability (i.e. the issuance) of credit cards particularly for higher risk consumers.[537] This is because the lenders' costs would have to be recovered directly from the borrowers themselves. By logical extension, the same must apply if the level of interchange were to fall relative to the cost of extending the credit. The implication is clear: under the present arrangements merchants are being required to pay, by way of interchange, towards the cost of extending credit to bank customers in various categories of risk, without having any part in assessing and deciding whether they would themselves wish to assume that risk. The artificiality of using the

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532 Capitec Bank, October 2006, First Submission, p 12.

533 Transcript 17 April 2007, p 62.

534 *Id.*, p 64.

535 See *id.*, pp 62-63.

536 Absa acknowledged that credit cards compete with all lending products. (Transcript 17 April 2007, p 114, Mr Sweeney). Nedbank acknowledged that the 55 days' interest free credit on credit cards "is a real saving in comparison to cash or debit card because the money stays in the account and if you are a borrower you save interest and if you are a depositor, you would earn it." (Transcript 19 April 2007, p 21, Mr Shuter.)

537 Transcript 17 April 2007, pp 70-71.

interest-free period as well as the full cost of the payment guarantee (i.e. including the cost of debtors' defaults) [538] in determining the level of credit card interchange is, in our view, manifest. Moreover, since credit card interchange – like all interchange – enters ultimately into consumer prices, it must follow that cash and debit card customers are being compelled to shoulder part of the banks' costs of lending to the better-off, and so subsidising the latter.[539]

According to Visa, its interchange fees internationally address only the "payment service".[540] A distinction is specifically drawn between the "payment service" and the "financing service".[541] This would suggest that the interchange fees do not address the costs of credit extension – but on closer examination that appears not to be so. Visa says that revolving loans and cash advances are excluded from the scope of interchange.[542] It goes on to say, however, when dealing with the interchange exemption granted to it by the European Commission in 2002, that the permitted "benchmark" costs which have formed a ceiling for its average interchange have included not only processing and the payment guarantee, but also the free funding period.[543]

Under Visa's own methodology the study of issuing costs identifies the costs of processing, of the payment guarantee, and of "funds".[544] Visa says that "finance charge revenues, as well as the underlying cost to fund revolving cardholder receivables, clearly go with the financing service".[545] But it seems arbitrary to limit in this way the allocation of costs to the

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538 Concerning the "payment guarantee", the EC noted in 2002 (OJ L 318, p 20, 22.11.2002): "In the present decision [concerning Visa], this term is used to describe the promise of the issuing bank to honour payments to the acquiring bank, even those which turn out to be, *inter alia*, fraudulent or for which the cardholder ultimately defaults, on condition that the merchant undertakes all the security checks necessary to enable the issuing bank to promise payment. As concerns default losses, only losses occurring during the free-funding period are to be included in the MIF cost study."

539 The "subsidy" or "tax" issue is not disposed of by arguments over the relative social cost of cards and cash. The costs of money-lending are not to be confused with the costs of the payment medium. In any event, the full social benefits of innovative products depend upon their being made available, as soon as is reasonably possible, at the lowest prices that a truly competitive market can secure. As we have noted earlier in this chapter, it is the monopolist who can continue pricing up to the cost of the old substitute when the costs of the new product fall and a lower price would thus be possible.

540 Visa, June 2007, Second Submission, document B (second part) p 7.

541 *Id.*, document R, p 5.

542 *Id,* document B, p7.

543 *Id.*, document B (second part) pp 9-10. Visa was permitted freely to set interchange rates within the cap. (*Id.*) The free-funding period in respect of credit cards is described by Visa as "the time between when the acquirer is paid [by the issuer] and the time when either the cardholder pays the bill in full, or the bill is rolled over into the credit card facility." For debit cards the free-funding period is "the time between the actual purchase and when the amount is debited to the cardholder's account." (Visa, June 2007, Second Submission, document S, p 6.) The "free funding period for cardholders" was defined in more detail by the EC in its 2002 decision as follows: "This corresponds, for deferred debit cards, to the cost of any time difference between payment to the acquirer and debiting of funds from the cardholder's current account. For credit cards, it corresponds only to the cost of any time difference between payment to the acquirer and the time when either payment must be made by the cardholder, or the balance of the credit card bill rolled over into the extended credit facility, to which a rate of interest is applied (that is, it does not include any costs arising from the granting of extended credit to cardholders). For debit cards, it represents only the processing time necessary to debit the transaction to the cardholder account; for deferred debit and credit cards it represents also the extra interest-free period before which payment must be made or extended credit used." (OJ L 318, p 20, 22.11.2002.)

544 *Id.,* p 11.

545 *Id.,* document R, p 6.

financing service, thus treating the costs of the interest-free period enjoyed by non-revolving cardholders as if they were intrinsic to the "payment service" and not to the "financing service" at all.[546]

Included in Visa's study of issuers' costs will be the costs of applications, marketing, clearing, risk, fraud, authorisations, "etc".[547] Nothing is said about acquirers' costs at this point.[548] Later, however, it appears to be recognised that relevant acquirers' costs will include communications and terminal, processing, merchant customer service and merchant "affiliation".[549] As a description of a methodology, all this is far from clear.

We do not doubt that interchange in order to balance cardholder and merchant demand, might legitimately – both in the debit and credit card streams – factor in some part, not only of issuers' processing costs where these exceed what cardholders may be expected to bear, but also of the savings to merchants through certainty of payment and protection against cardholder fraud.[550] Nevertheless, lack of transparency in the whole process, coupled with the scope for abuse, mean that the public is not adequately protected by the current methods of setting interchange.

In assessing merchant sensitivity to the cost of accepting cards, Visa recognises an increasingly complex segmentation between, for example, groceries, fuel, airlines, other travel and entertainment, and "card not present" (as in internet) transactions. In other words, the elasticity of merchant demand is assessed according to market segment.[551] MasterCard similarly has a variety of interchange rates internationally. This degree of sophistication in interchange setting has not yet come to South Africa, but could be expected to do so as the payment card market matures.

The degree of market power over merchants already attained by the four-party schemes can be expected to grow. Currently, ultimately, everything comes down to a judgment call by the schemes or their participating banks collectively regarding the extent of the costs which can

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546 Moreover, the interest-free or "free funding" period should not be regarded as if it were an unalterable fact of nature. We note that in Australia the period is much shorter than in SA, averaging between 16 and 23 days for various types of cards compared with our 50-55 days. See *id.,* document U, p 34.

547 *Id.* Marketing would appear to include "Loyalty and incentives programmes: see *Id.,* document B (third part) p 18.

548 *Id.*, document B (second part).

549 *Id.*, document B (third part) p 18.

550 We note, however, that merchants in South Africa argue that there is in effect no unconditional payment guarantee given the acquiring bank's right to make charge-backs directly to the merchant's account. This, so it is said, leaves the dispute resolution to take place between merchant and the cardholder, which results in huge fraud costs to merchants every year. It is also suggested that the "payment guarantee" on debit cards is irrelevant, since debit card transactions involve direct access to pre-funded accounts. (See SARPIF, October 2006, South African Retailers Payment Issues forum Submission of Information, p 2 and p 4; Pick 'n Pay, October 2006, Submission of information, p 3 and p 5.) Given our recommendation of an independent, objective and transparent interchange setting process under regulatory supervision, we have not considered it necessary to pursue these and other issues of detail.

551 See *id.*, pp 24-25. Cf also *id.,* document R, p 4. Interchange will also vary, for example, according to the card technology and its effect on volumes, risks and costs. (Cf *id.,* document B (third part) p 27.)

be loaded, via interchange, onto the acquiring side and thus onto merchant service charges. In our view this is a far from satisfactory state of affairs.

6.7.5 Illegitimate benefits would extend to three-party schemes

Most of the first submission by American Express to the Enquiry consisted of an eloquent defence of interchange within the four-party schemes, and a warning against interfering with it.[552] This seemed somewhat curious, considering that American Express, like Diners Club, is a three-party scheme in which interchange plays no direct part. Nevertheless the three-party schemes do have a distinct interest in the level of the merchant service charges that are levied in the four-party schemes, and thus indirectly an interest in the level of four-party interchange too. Their interest would be in their rivals' merchant service charges being high rather than low.

In the first place, the four-party schemes' merchant service charges provide a benchmark in relation to which the three-party schemes' own competing merchant service charges can be set. Thus, where a premium card is offered, the merchant can more readily be persuaded to pay a premium service charge as compared with the four-party "norm".

Secondly, to the extent that high interchange fuels four-party card issuing, there is a general expansion of the market within which the three-party schemes can promote their cards as a second card for the convenience of the better-off.

It follows that, if interchange in the four-party schemes is set at higher than necessary levels, then the illegitimate benefits would flow – indirectly – to the three-party schemes as well.[553]

6.7.6 The need for regulation

In our view interchange has the character of a necessary evil. Where its necessity is shown to exist, it still needs to be kept as low as is reasonably possible. The difficulty is to find the means of securing that outcome in the public interest in a way that does not compromise the effective functioning and further development of card and other non-cash and paperless payment systems.

Interchange arrangements, as we have seen, are themselves a substitute for a market mechanism. As Dr Hawkins expressed it during the hearings,[554]

> … if you are replacing a mechanism or perhaps substituting a mechanism that the market

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552 American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking. We have dealt with the substance of the arguments at various points in this chapter with reference to other sources, and it is unnecessary to repeat them.

553 See also footnote 475 above.

554 Transcript 17 April 2007, p 43.

> itself does not naturally appear to generate, then the question is begged as to who should be making decisions about what those replacement fees should be, and is it appropriate that it is actually left to those who benefit from the scheme to do that setting?

For the reasons set out above, interchange should clearly not be left to be set privately by those actually or potentially benefitting from it.

Mr Munson of MasterCard – while opposing any regulatory intervention – acknowledged that, generally speaking, there are three possible ways of setting interchange.

> The banks can set the fee themselves, the scheme operator (MasterCard in our case) can set the fee, or some third party either appointed or approved by a regulatory agency or the regulatory agency itself, could set the interchange.[555]

In the next part of this chapter we consider the problem of appropriate regulation of interchange – a subject on which a great deal of constructive input was made by a number of participants in the Enquiry.

Here we would merely note that competition law is obviously not designed for such purposes. A specific statutory framework to enable and enforce the envisaged regulatory process will be required. That is a matter for the Competition Commissioner to take up with other appropriate authorities in the light of this report.

However, competition law is not left impotent in the face of the challenge posed by interchange. Accepting the necessity of interchange in principle does not mean that any particular methodology of arriving at interchange is justified. If the methodology actually employed can be shown to have an illegitimate purpose, then in our view there would probably be the setting of a restrictive trading condition in contravention of section 4(1)(*b*) of the Competition Act. It might also be possible to demonstrate anti-competitive effects, and a consequent contravention (in the alternative) of section 4(1)(*a*). Although the issues are complex, an investigation with a view to such enforcement should be considered if the regulatory remedies which we propose are not adopted or are inordinately delayed.

6.8 Interchange in other payment streams

6.8.1 Introduction

In South Africa we have 16 payment streams governed by the applicable PCH agreements. Of these, six payment streams necessitated attention during the Enquiry with respect to the interbank arrangements that are in place. Prime among them has been interchange in the payment card environment – the one to which the preceding sections of this chapter have been devoted. Although many other payment streams may also utilise interbank fees,[556]

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[555] Transcript 18 April 2007, p 20.

[556] According to Standard Bank, "... certain payment streams in South Africa (e.g. EFT) exhibit interbank

particular concerns arise in the electronic funds transfer (EFT) and early debit order (EDO) streams which warrant attention in this chapter.[557]

6.8.2 Electronic funds transfer (EFT)

In the realm of interbank EFT, interchange makes its appearance under the name of a "homing fee". The justification for a homing fee in an EFT transaction is said to be based on the two-sided nature of the market for such transfers, which in principle may require a balancing payment in off-us transactions.

The direction in which interchange flows in EFT transactions differs according to the type of EFT transaction initiated. There are two types of EFT transactions: EFT credit transactions[558] and EFT debit transactions.[559] In the case of an EFT credit transaction, interchange flows from the paying side to the receiving side; in the case of an EFT debit transaction, it flows in the opposite direction. Stakeholder banks in both cases argue that interchange is vital for the viability of the payment stream.

In both instances, the market appears be truly two-sided, so that a balancing payment could in principle be necessary to reallocate revenue between the two sides. However, the need for a non-zero rate of interchange – the need for an actual flow of interchange in one direction or the other – must still depend on an inability of the service providers on one side or the other to collect sufficient revenue by independent pricing to end users who have a demand for the service.

If total revenues collected on either side were not sufficient at least to cover total costs associated with providing such a service, together with normal profit, the service would obviously not be provided. This then would necessitate a transfer of revenue from the side with a strong (or "inelastic") demand and subsequent surplus of revenue, to the side with an inability to cover costs due to a very elastic demand. If, however, the costs are sufficiently

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interchange/carriage fee, whereas internationally the same payment streams typically do not have interbank interchange/carriage fees. This is predominantly due to the existence of float in these international systems through which banks earn float interest in lieu of interbank interchange/carriage fees. As the international payment systems migrate to the more advanced South African model of same day clearing and settlement and hence same day value, this float income will disappear. Payment streams that currently do not exhibit interbank interchange/carriage in international systems will likely reflect the South African system over time out of necessity to ensure the continuance of interoperability in an economically feasible manner." (SBSA, October 2006, First Submission, p 53.)

557 The applicable PCH agreements with respect to the clearing of these transactions are those relating to: Authenticated early debit order payment instructions (AEDO), Non-authenticated early debit order payment instructions (NAEDO), Credit card debit payment instructions, Debit card payment instructions, EFT credit payment instructions, and EFT debit payment instructions.

558 The definition for an EFT credit transaction in the EFT credit payment instruction PCH agreement is given as: "… a payment instruction issued by the payer to the paying participant to transfer funds from the account of the payer to the account of a beneficiary at the beneficiary participant, and which is delivered for clearing to the PCH system operator." (P 6) The paying participant and the beneficiary participant are the two relevant banks.

559 The definition for an EFT debit transaction in the EFT debit payment instruction PCH agreement is given as: "… an electronic payment instruction to a paying participant to make a payment, issued by the collecting participant or by its customer on behalf and ostensibly under the mandate of the customer of a paying participant." (P 6) The collecting and paying participants are the two relevant banks.

covered through the extraction of revenue on either side without rendering demand ineffectual, the flow of revenue or the balancing of interests would not be required. If interbank interchange arrangements are not strictly necessary for the functioning of the market, they ought not to be allowed, because they involve agreements between competitors which entail inherent dangers for competition.

If, apart from such a strict necessity, it would be socially beneficial and welfare maximizing to support and increase by collective measures the demand for a particular means of payment by manipulating the basis for the prices charged on the different sides of the market, then this needs to be done by incorporating that payment stream into the regulated structure and methodology for the setting of interchange fees which we have proposed in Section 6.9 of this chapter below. It should not be left to be determined by the banks (or other possible future clearing house participants) among or between themselves.

According to the information submitted to this Enquiry, interchange ("homing") fees in the EFT payment streams were uniform at least until 2006. How exactly such uniformity was arrived at is unclear. The uniform interchange fees for EFT debit and EFT credit transactions agreed and applied as between participating banks in the past, are set out in the table below.

Table 15 EFT debit and EFT credit interchange or homing fees

Date	EFT debit	EFT credit
1998	R0.115	R0.225
2002	R0.135	R0.275
2003	R0.19	R0.34
2004	R0.23	R0.36

Confidential: Nedbank

Source: Banks' Submissions in response to a request for information on 8 October 2007

Absa's submission shows that it negotiated bilateral agreements with FNB, Nedbank, Habib Overseas, African Bank, Capitec, Teba Bank, Investec, ABN Amro and Standard Bank with effect from 1 July 2006.[560] The fees negotiated by Absa with effect from 1 July 2006 resulted in a uniform interchange fee applicable between the relevant banks of R0.28 on EFT debit transactions and R0.38 on EFT credit transactions.

Confidential: Absa

It is clear that there has been a consistent increase in the interchange fees paid on EFT transactions over time. Yet it is far from clear that, as transaction volumes have increased, average transaction costs would have warranted the fee increases. As with payment card interchange, agreed charges which enter into the cost structure of service provision ultimately find their way into consumer prices. Any unnecessary sheltering of cost

560 Absa, October 2007, Banking Enquiry – Response to data and information request, p 8.

components from effective competition needs to be eliminated.

We now move on to discuss EFT credit and debits transactions in turn.

EFT credit transactions

An EFT credit transaction is an electronic transfer of funds, initiated by the paying customer, instructing the paying bank to transfer funds from the account of the payer to the account of a beneficiary at the beneficiary bank. These transactions are mainly salary payments.

In an EFT credit transaction, the beneficiary of the transfer is ordinarily unwilling to pay a fee to his or her bank (the beneficiary bank) for the receipt of payment, or at least to agree in advance to be debited a fee for such receipts. There is said to exist a very elastic demand for the service,[561] indicating that an increase or an introduction of a fee might drastically decrease the quantity of the service demanded. In this instance, the inability of the beneficiary bank to charge its client necessitates the extraction of revenue from the client initiating the transaction (i.e., the paying client) and a consequent transfer from the paying bank to the beneficiary bank in order to cover the costs associated with the beneficiary side.

We accept that there would be customer resistance, and probably rightly so, to the levying of a fee on the beneficiary side. We doubt, however, that the problem is essentially one of "elastic demand", since increasingly employees are required by their employers to have bank accounts into which their wages and salaries may be electronically paid.[562] Once they have a bank account, and especially if they are required to have one, there will be a significant degree of customer captivity.[563] It might well be inappropriate on those grounds too for the beneficiary bank to charge the customer for such receipts. We would accept that in these circumstances an interbank payment of interchange (a "homing fee") from the paying bank to the beneficiary bank is legitimate.

However, as with all interchange in our opinion, the process and methodology for the setting of this fee warrants incorporation into the transparent and objective regulatory scheme which we propose.

Figure 6 and Figure 7 illustrate the flows involved in an EFT credit transaction and EFT debit transaction respectively:

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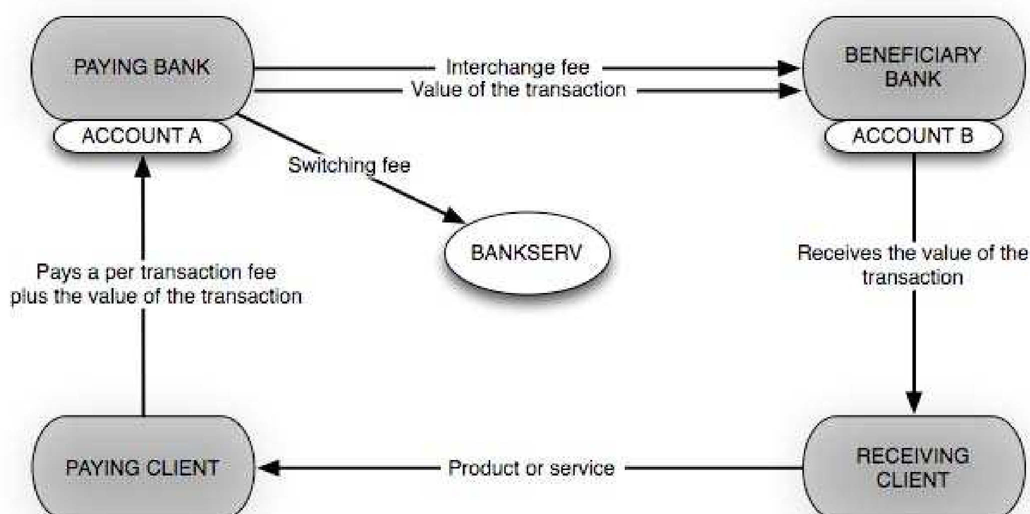
561 Standard Bank, March 2007, Access and Regulation, p 41.

562 Transcript 3 November 2006, p 102 (Financial Sector Campaign Coalition; Mr Kholisile).

563 The general basis for this conclusion is analysed in the chapter of our report dealing with market power in retail banking.

Figure 6 EFT credit transaction



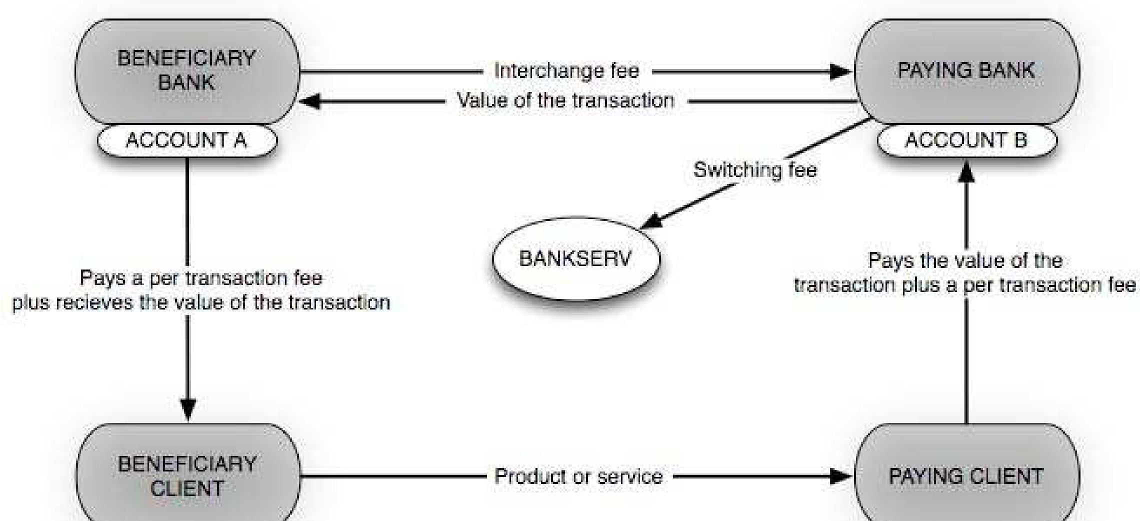
In an EFT credit transaction (see Figure 6), funds are “pushed” by the payer (with the help of the paying bank), to the beneficiary (with the help of the beneficiary bank). A typical example of an EFT credit transaction is where an employer pays salaries into the accounts of its employees. Here the paying client (the employer) pays a per transaction fee plus the value of the transaction to its bank (Bank A) and the value of the transaction plus the interchange fee is paid to Bank B. The full value of the transaction is reflected in the account of the receiving client (the employee).

EFT debit transactions

In the case of an EFT debit transaction, the beneficiary “pulls” or draws the funds by prearrangement with the payer (again on each side assisted by the relevant bank). An example would be a debit order obtained by a corporation from its customer for payment of services such as a cell phone contract. In this case, the paying client agrees that the value of the debit order will be pulled from his or her account periodically.

Each month (say), the value of the debit order and the transaction fee will be drawn from the customer’s account at Bank B. In turn, Bank B pays over the value of the debit order to Bank A, where the cell phone company has its account. Bank A ensures the value is paid into the cell phone company’s account, and would typically charge a transaction fee for doing so. Bank B (the paying bank) receives an interchange fee while also charging its own customer for its trouble (see Figure 7).

Figure 7 EFT debit transaction



An EFT debit transaction takes place when the beneficiary bank (technically called the collecting participant) issues an electronic instruction to the paying bank (the paying participant) to transfer funds to it, for the credit of the beneficiary's account and for the debit of the payer's account. In doing this, the collecting bank acts upon an instruction from its account-holder, the beneficiary, relying on an authorisation which the payer has provided to the beneficiary to serve as an order to the paying bank.

Typical examples of this would be the debit orders obtained by corporations from their customers for payment of services such cellphone contracts, life insurance and medical scheme contributions. In many instances these corporations require their customers to have a bank account and to sign a debit order on the account as the obligatory method of payment. Accordingly, once again, we have a reinforcement of the general basis for a significant degree of captivity of the ordinary individual customer in the retail banking relationship.[564]

It is argued that the paying customer and bank are usually far more resistant to the use of this payment method (i.e., the debit order) than the beneficiary customer and bank.[565] That may well be so, but it does not follow in the circumstances that customer demand is elastic, given the degree to which customers of big corporations have no choice but to sign debit orders or forego crucial services. There has been an increased uptake of EFT transactions, evidently fuelled by the requirements of the corporate clients initiating the transactions.

According to data submitted by Bankserv, the volumes of EFT debit transactions from 2003

564 See footnote 563 above.

565 SBSA, April 2007, Second Submission, Access and Interoperability, p 43.

to 2006 increased as follows:

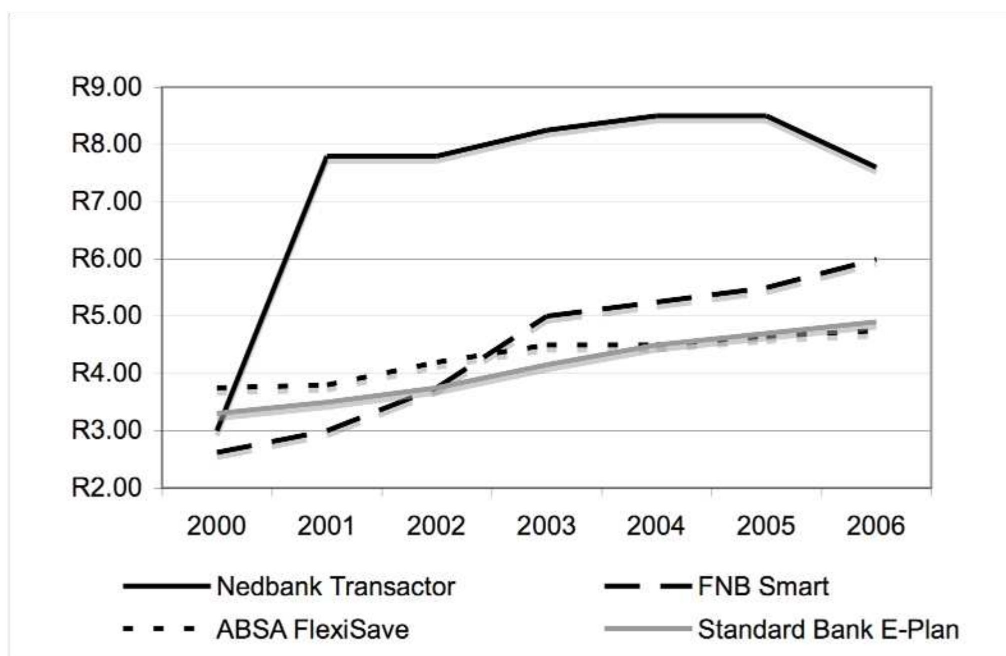
Table 16 Volume growth of EFT transactions

2003	2004	2005	2006
7.57%	6.34%	9.94%	10.43%

Source: Bankserv, submission 27 November 2006

The interbank homing fee (interchange) is said to be necessary to balance the interests in the services provided to the different end users, and transfer revenue in order to cover the associated costs. We do not consider this contention to have been proved. In contrast to an EFT credit transaction, the banks on both sides of the transaction can and do charge their customers for the service which they provide. Higher transaction volumes should have caused average processing costs to fall. Yet charges levied on those paying by debit order have risen. The graph below illustrates the increase in the debit order fees applied by the big four banks to entry level savings accounts – i.e. to the customers on the paying side.

Figure 8 Debit order fees on big four banks' entry level savings accounts



Source: InfoChoice data

Why then have an additional flow of revenue across from the collecting to the paying side? Why, at least, has this flow not diminished? In fact, as we have seen, the interchange or "homing" fee paid from the beneficiary bank to the paying bank has increased steadily – by 100 per cent per transaction over nine years.[566]

Clearly, we would have to be concerned that the elimination of the homing fee (interchange)

566 See Table 15 above.

on EFT debit transactions might translate simply into lower bank charges for the corporations requiring payment by debit order and correspondingly higher charges being levied on customers on the paying side as banks continue to utilise their market power over the latter. However, the latter charges may well be kept at or near the bearable maximum anyway, and it cannot be assumed that banks would be able simply to raise their processing charges for paying debit orders without limit or resistance. An investigation in any event into excessive pricing or, failing that, a regulatory intervention might then be warranted.

It would be naïve to suppose that customers on the paying side are currently being helpfully subsidised by fees charged by banks to the corporations in whose favour these customers sign debit orders. Those corporations are generally able to recover their costs by their own charges to their customers. Thus if the corporations' bank charges are inflated, the ultimate customer ends up paying anyway. The key difference is that it is non-transparent. If the paying banks are able – by agreements on interchange – to extract additional revenue from the collecting side, it is very doubtful that this is or would be used to ameliorate the position of the paying customers. The paying banks and the collecting banks are the same institutions. They have a mutual interest in creating a common cost-floor for their charges to corporate customers on the collecting side, which cannot readily be competed away in the face of those corporations' countervailing power, and which transforms itself into revenue in their own hands as paying banks. By means of this interchange, a partial shelter against price competition is created. We have analysed this dynamic earlier in this chapter when dealing with merchant service charges. The same logic applies here.

Having this uniform and common cost component on the collecting side has the related effect of privileging the collecting banks in competition with bureaux for the provision of debit order processing services to corporate clients. In this way they further distort the market. The banks are already at an advantage in being able to bundle their processing services with the actual payment-collecting service that is unique to them as banks. In accepting debit orders via bureaux for collection, the banks are able to charge a fee including the interchange (or homing fee) component. In offering their own processing services directly to the collecting customers (the corporations), the banks (which are also paying banks and thus retain the homing fees in all on-us transactions) have a revenue stream denied to bureaux, and which they can use to discount their processing charges to the corporations. If interchange (and thus the homing fee) is to be seen as providing a subsidy, then in all probability it is the banks which are being subsidised in the EFT debit stream.

Thus, in our view, even though EFT debit transactions meet the basic criterion of a two-sided market, the actual necessity of interchange in this payment stream has not been demonstrated. We are not in a position to say conclusively, on the basis of the information voluntarily submitted to us, that it has been proved *not* to be necessary. Consideration should therefore be given by the Competition Commissioner to initiating a complaint with reference to section 4(1)(*b*), and alternatively section 4(1)(*a*) of the Competition Act, in order

formally to investigate a possible contravention or contraventions arising from the past and current interbank arrangements in respect of interchange in this stream.

As regards to the future, if interchange is to be levied in relation to EFT debit transactions, then it ought to be included within the regulated process which we recommend for interchange generally, and so be subject to the participatory procedures involved in arriving at and implementing an appropriate level of interchange. The first step in this process would be to establish whether interchange in this stream is necessariy at all.

6.8.3 Early debit orders (EDO)

The introduction of the early debit order (EDO) system in 2006 has created two new payment streams – authenticated early debit orders (AEDO)[567] and non-authenticated early debit orders (NAEDO)[568]. These are governed by two separate PCH agreements.

AEDO and NAEDO transactions function like EFT debit transactions, but get processed early in the morning on the designated date or dates. As FNB explains, the EDO system "services a niche of debit order payers and beneficiaries who require a debit order which runs immediately after the salary or income credit is received into the account."[569] The AEDO system was designed for micro financiers and requires the authentication of the debtor and the debit order through the use of a card and PIN. The NAEDO system in comparison was designed for banks' own payment collections and for those of large corporations, including insurance companies, and requires no authentication because of the mandate obtained in the agreement with the borrower.[570] However for a number of reason enumerated below, it appears that the NAEDO stream is favoured by most users.

The South African Reserve Bank's National Payment System Department stated in its Directive No. 1 of 2006:[571]

> 1.3.3 In the recent past banks have allowed, for collection purposes, practices whereby certain persons' payment instructions have been granted preferential treatment over others. These preferential practices have taken place using various mechanisms

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567 The definition for an AEDO transaction in the relevant PCH agreement refers to: "… a payment instruction issued by the cardholder which payment instruction is to be processed at a future date." (PCH agreement, Authenticated early debit order payment instructions (AEDO), p 3.)

568 The definition for a NAEDO transaction in the relevant PCH agreement refers to: "… a payment instruction authorised by the payer to be issued on his instruction for payment on a future date or dates." (PCH agreement, Non-authenticated early debit order payment instructions (NAEDO), p 3.)

569 FRB, Response to request for information, EDO and EFT Debit Order Rules, August 2007, p 2. "Credit tracking", which allows for extended re-processing of these "early debit orders" where credits to the payer's account have been delayed, is described in the section on Penalty Fees in the chapter of this report on Costing and Pricing.

570 Presentation on EDO by Mr de Swardt, CEO of Intecon / ALLPS, furnished by PASA on 5 September 2007. Slide 5 and 6.

571 *Government Gazette* 28546, General Notice No. 231 of 2006, 24 February 2006.

including sorting-at-source[572] and the abuse of the ATM system.[573]

1.3.4 The Reserve Bank considers the above preferential practices as contrary to the efficiency, effectiveness and neutrality of the NPS. Therefore, the Reserve Bank, in conjunction with the banking industry and relevant stakeholders, has agreed on the principles for the collection of debit payment instructions in EDO PCHs.

Micro-lenders, who provide small loans to lower-income clients, prefer repayment through debit orders because of the increased risk in this segment of the market.[574]

AEDO transactions are debit card-based,[575] and are authenticated at the time of electronic contract registration by production of the card and entry of the cardholder's PIN. In this way the borrower's debit card is used to issue a series of future dated electronic payment instructions.

NAEDO transactions, in contrast, are based simply on a signed mandate from the debtor, authorising the future-dated payments. The NAEDO user (the creditor) applies for and obtains a user code.

Acquiring in the AEDO stream is done in conjunction with a Customer Service Provider (CSP).[576] Three service providers, appointed by the participating acquiring banks, are prominent in the provision of EDO services: NuPay facilitates transactions for Absa,[577] Information Technology Consultants (Pty) Ltd ("Intecon") for Mercantile and Mycomax for Bank of Athens.[578] The CSPs ensure that the micro lender is equipped with a POS device and that the payment instructions are routed through the system.

According to information published by Mycomax, the main practical differences between AEDO and NAEDO are as follows:[579]

AEDO and NAEDO each have its own niche in the market…..

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572 "Sorting-at-source" is defined in the directive as "the process whereby the beneficiary of payment instructions sorts each paying bank's payment instructions together and then submits those payment instructions directly to each paying bank, where the proceeds of such payment instructions are credited to an account in the name of the beneficiary." See the chapter on Access to the Payment System.

573 The reference to the abuse of the ATM system is evidently a reference to the practice of some micro-lenders taking possession of borrowers' debit cards and PINs in order to make ATM withdrawals themselves on the borrowers' bank accounts as soon as credits to those accounts came through.

574 Presentation on EDO by Mr de Swardt, CEO of Intecon / ALLPS, furnished by PASA on 5 September 2007.

575 According to information published by NuPay (https://www.nupay.co.za/np_aedo.html), credit card and combination cards are not accepted, and a maximum installment value of R5,000 is permitted.

576 SBSA, March 2008, Further questions for Standard Bank, p 3. This relationship between acquiring banks and CSP does not exist in the NAEDO stream (except for Absa, see next footnote).

577 Absa is a significant shareholder in NuPay. Until May 2008, NuPay also facilitates NAEDO transactions for Absa, after which acquiring will be done via Absa's electronic banking (Absa, March 2008, Response to additional questions, p 3). NuPay clearly dominates processing in the AEDO stream with a reported 79% of all transactions passing through NuPay (PASA, March 2008, EDO Statistics).

578 Other service providers are also in the market.

579 www.mycomax.com:81/mycomax/edo.php

> The general perception is that AEDO is more of a hassle because you need the client to be present with his Bankcard and PIN in your office at the time of granting the loan. On the other hand, the benefit is that the client mandates his transaction by swiping his card and entering his PIN. This brings a major benefit: the payment can't be reversed by the client after you have received the funds in your merchant account.
>
> In contrast to the "more of a hassle to load" AEDO transactions, NAEDO might seem more streamlined and effortless to implement. You don't need additional computer hardware or terminals (Card readers) to load payment transactions. Your client authorizes the payment by simply signing a paper NAEDO mandate. The mandate includes the bank account number, branch code and deduction amount for a particular date. The major disadvantage of NAEDO is its reversibility. A payment can be reversed for a period of up to 40 days after it has been processed. This means the client can request his bank to reverse the payment after you have received it in your merchant account!

According to information published by service provider Intecon / ALLPS,[580] the interchange structure in the EDO system is based on separate bilateral agreements between acquiring and issuing banks relating to so-called "billable components" of the interchange fees.

It appears that the interchange in the EDO market has been set at a much higher level than for EFT transactions (see further below). Interchange is payable by the acquirer (collecting bank) to the issuer (paying bank) in each case. The initial "contract registration" is billable in the case of AEDO only. "Successful transaction payment received", "Unsuccessful transactions", "Tracking per day" and "Recall of transactions in tracking" are billable in respect of both AEDO and NAEDO. A "Disputed Fee Charge" is billable only in respect of NAEDO.[581]

The participants in the EDO streams as furnished by the banks are contained in Table 17.

580 "EDO Billing Principles".
http://www.allps.co.za/Docs/Communication/English/ALLPS%20Communication%206%20Oct%202006.pdf

581 *Id.* One of the major differences between AEDO and NAEDO lies in the fact that on NAEDO, the payer has the ability to dispute the payment(s) received. In such instance payment(s) received will be reversed against the account of the micro financier." A dispute fee per payment "will be an additional levy against the account of the micro financier." AEDO, on the other hand, "does not entertain disputes or reversals on funds received." *Id.*

Table 17 Participants in the EDO streams

Institution	AEDO Issuing	AEDO Acquiring	NAEDO Issuing	NAEDO Acquiring
Absa	✓	✓	✓	✓
African Bank	-	-	✓	✓
Bank of Athens	✓	✓	✓	✓
Capitec	✓	-	✓	✓
FNB	✓	-	✓	✓
Mercantile Bank	✓	✓	✓	✓
Nedbank	✓	-	✓	✓
SBSA	✓	-	✓	✓
Teba Bank	In progress	In progress	In progress	In progress

Source: Banks' Submissions, March 2008.

In the AEDO stream, Absa, Mercantile and the Bank of Athens are the only banks offering acquiring (i.e. collecting) services; all the other participating banks are issuers only. As acquirer, Absa processes the majority of transactions.[582] In the NAEDO stream, more banks participate in both issuing and acquiring. Confidential: Absa

The interchange fees bilaterally agreed on for successful AEDO transactions have resulted in *ad valorem* fees being paid away by the acquiring (i.e. collecting) banks to the issuing (i.e. paying) banks. As illustrated in Table 18 for Absa, the bilateral agreements between banks on interchange fees for successful AEDO transactions involve a variety of rates. The applicable interchange fees on unsuccessful AEDO transactions are flat fees ranging between R1.00 and R1.50 per transaction.[583] Confidential: Absa

The interchange fees paid for successful NAEDO transactions range between R3.00 and R12.00 per transaction and are generally higher than in the AEDO stream.[584] Unsuccessful transactions in this stream, like those in the AEDO stream, attract a flat interchange fee ranging from R1.00 to R1.50. Confidential: Absa

The bilateral agreements in respect of all these components have resulted in a complex array of different interchange fees being paid by the acquiring banks to the issuing banks. As

582 According to PASA, in December 2007, Absa processed 77% of successful AEDO transactions, through its CSP partner, NuPay (PASA, March 2008, EDO Statistics). Confidential: Absa

583 ABSA, October 2007, Response to data and information request, Annex B. Also see SBSA, October 2007, Information request regarding "Interchange fee data", and FRB, October 2007, Data and info request.

584 *Id.* This depends on which issuing and acquiring banks are participating in the transaction. These fees also seem to take on various forms (either a flat fee, a stepped fee, an ad valorem fee, or a combination of both).

an example of this, the table below reflects the AEDO interchange fees negotiated by Absa with various other banks.

Table 18 AEDO interchange fees paid by Absa

AEDO transactions						
	SBSA	**FNB**	**Nedbank**	**Mercantile**	**Bank of Athens**	**Capitec**
Successful transaction	0.65% Min R1.50 Max R6.50	0.60% Max R6.00	0.65% Min R2.00 Max R6.50	0.55%	0.60% Max R6.00	0.70% Min R3.00
Unsuccessful transaction	R1.50	R1.00	R1.00	R1.00	R1.00	R1.00

Confidential: Absa FRB SBSA Nedbank

Source: ABSA, October 2007, Banking Enquiry – Response to data and information request.

Because of this interweave of bilateral interchange fees applicable to the EDO stream, we shall simplify the picture in order to facilitate a comparison between the interchange fees relating to the AEDO and NAEDO streams respectively. For purposes of illustration, SBSA is used as the paying bank (i.e. issuing bank), and Absa as the beneficiary bank (i.e. acquiring bank). This results in an interchange fee being paid from Absa to SBSA.[585] As depicted in Figure 9, interchange fees in the NAEDO stream are clearly significantly higher than in the AEDO stream.

585 All the other banks' bilaterally negotiated interchange fees differ only marginally, but follow the same trend at approximately the same level as for the fees depicted in Figure 9.

Figure 9 Interchange fees for AEDO and NAEDO transactions

Confidential:
Absa
SBSA

Source: Absa and Standard Bank Submissions, October 2007.

The interchange fees charged on EDO transactions are thus significantly higher than the flat R0.23 uniform interchange fee applicable to ordinary debit order transactions (EFT debit transactions, see Table 15 above). This is puzzling as the processing required in both the EDO and EFT stream appears to be very similar and the value added services in the EDO stream – such as tracking – are all being charged for separately. Mercantile stated that:

Confidential:
Absa

> The major issuers have contended these are justified based on the amount of development done to facilitate the EDO payment streams, and the additional overhead on systems due to the extra processing required dictated by the timelines involved in providing feedback to acquiring banks.[586]

However, the "feedback" mentioned here evidently relates to the optional tracking service offered by the paying bank for which the beneficiary pays specially. It would therefore seem to be irrelevant to the basic interchange fees payable, and its inclusion in the alleged justification for those fees merely clouds the issue.

The standard two-sided market argument for higher interchange fees in a particular payment stream is that this will serve to enable the recipient of the interchange revenue to price in such a way to customers on its side of the market so as to attract them to the service. In the EDO streams both the recipient (user) – such as the micro lender – and the paying customer – whose account is being debited – pay for the service. So both sides of the market are charged for the service, as is the case for EFT debits. Despite higher interchange in the EDO environment than for ordinary EFT debit orders, the prices paid by paying customers to the issuing (i.e. paying) banks seem broadly to be the same, irrespective of the payment

[586] Mercantile, March 2008, Competition Enquiry Questions and Answers, p 4.

stream being used.

According to Absa, the paying customer bears the same cost for regular debit order[587] transactions as for successful NAEDO transactions, and is thus unaffected by the difference in the underlying interbank interchange fee structures applicable to the two payment streams. For AEDO transactions, the fees are set at the same level as for POS NuPay[588] transactions and may result in a slightly lower fee paid by the paying customer than for a NAEDO transaction.[589]

FNB, Nedbank, Standard bank and Mercantile submitted that the fees charged by them to paying customers for successful EDO transactions do not differ from the charges made for ordinary debit order transactions.[590] Capitec submitted that its charge for successful EDO transactions is slightly more, at R3.50, compared to a successful ordinary debit order charge of R2.25.[591]

The difference between charges for successful EDO transactions and ordinary debit order transactions, if there is any, is not disclosed in the banks' pricing brochures provided to customers.

The only set of customers in the system that appears to be affected directly and substantially by the EDO pricing regime are the beneficiary customers – e.g. the micro-lenders – who bear the increased user fees, in part because of the increased interchange fee applicable. Currently, there is no transparent and objectively quantified basis for the interchange fees agreed between the banks, or for the user fees charged.

Micro Finance South Africa (MFSA) submitted to the Enquiry data reflecting user fees payable by the beneficiary customers in respect of successful AEDO and NAEDO transactions respectively.[592] For purposes of illustration in Table 19, we have selected from that data the AEDO and NAEDO fees charged to users by NuPay, because of Absa's

Confidential: Absa

[587] On the Silver current account the NAEDO transaction attracts the same fee as for internal debit orders on current accounts. For Mzansi, FlexiSave and Mega Save accounts this equals the fee set for regular debit orders. NAEDO transaction fees range between R4.50 and R4.75 per transaction on these accounts (Absa, March 2007, Second Submission, Part A Data Request, pp 18-23). Confidential: Absa

[588] The payment stream used in the past for micro lending transactions and which has been replaced by EDO. For Mzansi and Flexisave accounts, the AEDO customer fee is lower than the NAEDO fee. However, for other types of accounts, an ad valorem component may result in the AEDO fee for a specific transaction size being greater than the NAEDO fee. Confidential: Absa

[589] Absa, March 2007, Second Submission, Part A Data request, pp 18-23. This is because the AEDO transactions replaced the POS NuPay transactions. The successful AEDO transaction fee is set between R2.30 and R2.50 for Mzansi, FlexiSave and Mega Save accounts and at R2.10/R0.58/R12 for the Silver current account. Confidential: Absa

[590] Nedbank, March 2008, Supplementary Submission, p 4, FRB, March 2008, Response to Request for Additional information, p 9 and Mercantile, March 2008, Competition Enquiry Questions and Answers, p 4.

[591] Capitec, March 2008, Further questions for Capitec, p 2.

[592] Micro Finance South Africa, November 2007, AEDO/NAEDO requested information.

dominance in the AEDO stream.[593] The interchange fees used in the table are those payable by Absa to Standard Bank, in terms of the agreement between them, for AEDO and NAEDO transactions. The net revenue indicated is the net revenue on the acquiring (Absa) side.

Confidential: Absa

Table 19 Interchange fees and user fees for successful AEDO and NAEDO transactions

Transaction Value	AEDO interchange fee[594]	NAEDO interchange fee	AEDO User fees for successful transactions	NAEDO User fees for successful transactions	AEDO Net revenue[595]	NAEDO Net revenue
R100.00	R1.50	R3.00	R2.28	R7.98	R0.78	R4.98
R200.00	R1.50	R7.00	R4.56	R7.98	R3.06	R0.98
R300.00	R1.95	R7.00	R6.84	R7.98	R4.89	R0.98
R400.00	R2.60	R7.00	R9.12	R7.98	R6.52	R0.98
R500.00	R3.25	R7.00	R11.40	R7.98	R8.15	R0.98
R600.00	R3.90	R7.00	R13.68	R7.98	R9.78	R0.98
R700.00	R4.55	R7.00	R15.96	R7.98	R11.41	R0.98
R800.00	R5.20	R7.00	R18.24	R7.98	R13.04	R0.98
R900.00	R5.85	R7.00	R20.52	R7.98	R14.67	R0.98
R1,000.00	R6.50	R7.00	R22.80	R7.98	R16.30	R0.98

Confidential: SBSA

Source: Banks' Submissions, October 2007 and MFSA November 2007

Absa states that on AEDO transactions, the split of the user fees between Absa and NuPay is approximately 50/50. On NAEDO transactions, NuPay receives a rebate of R0.85 for successful transactions. The user fees paid by the beneficiary customers to NuPay range between 1.7 per cent and 2.2 per cent *ad valorem* for successful transactions, of which Absa receives 1 per cent and NuPay receives between 0.7 per cent and 1.2 per cent.[596] Our calculations using this information result in the revenue per transaction received by the respective parties as reflected in Table 20.[597]

Confidential: Absa

Confidential: Absa

Note that the outcome for Absa is understated in every case where the transaction is on-us. Here Absa will not pay away interchange and will also receive income from the paying consumer by way of a fee for the EDO service. This is discussed further below (see Table 21).

Confidential: Absa

593 The information provided to the Enquiry does not show a significant difference in the fees charged to the customers of the other service providers. In actual fact, user fees for RealPay and NuPay in the NAEDO stream are identical.

594 This is the interchange fee applicable to successful transactions.

595 Net revenue = user fee for successful transactions – interchange fee.

596 Absa, March 2008, Response to additional questions, p 3. No comparable information is available for Intecon and Mycomax.

597 Again, for purposes of illustration, the amounts of interchange payable by Absa are assumed to be those payable to Standard Bank.

Table 20 Share of user fees for successful AEDO transactions

Transaction Value	AEDO User fees for successful transactions (charged by NuPay)	AEDO revenue per transaction retained by NuPay	AEDO revenue per transaction received by Absa	AEDO interchange payable from Absa to SBSA	AEDO net revenue per transaction received by Absa
R100.00	R2.28	R1.28	R1.00	R1.50	R(0.50)
R200.00	R4.56	R2.56	R2.00	R1.50	R0.50
R300.00	R6.84	R3.84	R3.00	R1.95	R105
R400.00	R9.12	R5.12	R4.00	R2.60	R1.40
R500.00	R11.40	R6.40	R5.00	R3.25	R1.75
R600.00	R13.68	R7.68	R6.00	R3.90	R2.10
R700.00	R15.96	R8.96	R7.00	R4.55	R2.45
R800.00	R18.24	R10.24	R8.00	R5.20	R2.80
R900.00	R20.52	R11.52	R9.00	R5.85	R3.15
R1,000.00	R22.80	R12.80	R10.00	R6.50	R3.50

Confidential: Absa SBSA

Source: Absa, Response to additional, March 2008

It should be emphasised that the data in Table 20 exclude any amounts payable by users for credit tracking. Where the user opts for credit tracking, that could increase the total fees payable significantly.

In their submission MFSA stated that:

> The banks determine the cost of EDO independently of the users, i.e. microfinanciers. Since EDO is designed to facilitate payments across the banking network, the banks – under the guise of the NPS – set the price and are not required to disclose the structure.[598]

As Table 19 reveals, typical user fees for successful AEDO transactions are much higher than those for successful NAEDO transactions. Thus, for example, where a transaction value of R1,000 is concerned, the AEDO user may well pay R22.80 when the NAEDO user is paying R7.98. For repayments greater than R350, NAEDO is better value. It is partly for this reason that micro lenders appear to be shifting to NAEDO.

Confidential: Absa

FNB justified higher AEDO user fees as follows:

> AEDO offers merchants additional value adds when compared to NAEDO, particularly the protection against repudiation of transactions, due to the authentication of the transactions and thus tends to be priced higher to merchants.[599]

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598 Micro Finance South Africa, October 2006, MicroFinance South Africa Enquiry into Competition in Banking, p 2.

599 FNB, March 2008, Response to Request for Additional information, p 7.

Even at this general level the explanation is unsatisfactory, given that many of the users in the AEDO stream – i.e. smaller micro financiers and non-banks – appear to be opting for the less expensive NAEDO. Moreover, we have no reason to think that pricing by major banks in this area is any more cost-related than in others considered in this report. The levels of pricing, and especially the much higher prices charged to users without significant bargaining power – namely those in the AEDO stream – are most probably the result of banks' ability to exercise market power. Additions of "value" (utility) for the consumer provide no justification for an above-competitive price.

At the levels of interchange and user fees now applied, especially in the AEDO stream, it is not surprising that acceptance of this new and clearly more advanced payment method on the beneficiary side has been retarded. Capitec submitted that with regard to the NAEDO stream, "Monthly EDO volumes are currently approximately 10 per cent of EFT volumes."[600] The acceptance and response to the more expensive AEDO stream paints an even bleaker picture. According to PASA, in December 2007, only 3.744 million NAEDO transactions and 0.385 million AEDO transactions were processed through Bankserv.[601] This is insignificant compared to the 28 million EFT debit transactions processed through Bankserv in October 2007.[602]

Another factor hindering participation in the AEDO stream was mentioned by Mercantile:

> The reason why we participate in both the AEDO and NAEDO payment streams is that AEDO has limited access to accounts that can be accessed via the Bankserv debit card switch, whilst NAEDO allows for much broader access to accounts. This is a technical issue apparently not foreseen at the time of developing the AEDO stream.[603]

Information submitted by FNB with regard to NAEDO charges to beneficiary customers, shows that the NAEDO user fees charged by FNB to beneficiary customers range between R3.29 and R7.24.[604] Even though this is still high in comparison to ordinary debit order fees,[605] the NAEDO user fees seem to bear a relationship to the bilaterally negotiated level of interchange paid away by FNB to other participating banks of a flat R3.00.[606] In the AEDO stream, however, there is no identifiable relationship between the interchange fees and the substantially higher user fees charged.

Confidential: FRB

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600 Capitec, March 2008, Response to further questions for Capitec, p 3.

601 PASA, March 2008, EDO Statistics.

602 Bankserv, November 2007, Data submitted to the Enquiry.

603 Mercantile, March 2008, Competition Enquiry Questions and Answers, p 2.

604 FNB, March 2008, Response to Request for Additional information, p 8. FNB does not provide EDO services in conjunction with a service provider. This fee ranges between R3.50 and R6 for the other banks that submitted user fees charged to beneficiary customers (SBSA, Absa, Capitec).

605 The user fees for ordinary debit order fees range between R0.41 and R6.86 for beneficiary customers (*id.,* p 9).

Confidential: FRB

606 FRB, October 2007, FRB data and info request, p 10.

The value added services that EDO offers beneficiary clients and the specialist support and infrastructure required to run the systems could well justify higher user fees compared to previously used systems. But the extremely high EDO user fees currently charged to the beneficiary customers (especially AEDO customers) compared to ordinary debit order user fees clearly impact on the success of this payment stream and the clear preference of customers for the latter. Capitec explained that:

> The EDO service is deemed a value added service over EFT and a decision was taken to charge the EDO transactions at a slightly higher rate than EFT debits…
>
> To be able to process these unique EDO features and to meet the tight Service Level Agreements for EDO places a burden on processing capacity at the bank.
>
> EFT on the other hand carries a lower fee and is processed at the end of a business day where we have a little more time to complete processing. It is [a] simple process that is done in a batch processing mode during the night window of the bank. Much less strain is put on the operators.
>
> A client has a choice of EDO or EFT mandates and the price differentiation is intended to act as a disincentive to issue EDO mandates when a normal EFT would suffice…
>
> Users should use EDO selectively and use EFT for the more established consumers… the operational pressure on banks to complete processing on time is already high. Should the EFT users move large volumes to EDO it could create pressure on banks' processing capacity and will require further investment in capacity to meet the early morning SLAs [Service Level Agreements].[607]

It seems thus that the reluctance of banks to accept and use this more sophisticated payment system – which clearly contains significant benefits for consumers,[608] and in which the banks have invested substantially – is reflected in the pricing to the end users, disincentivising the use of this payment method.

The pricing structures seem to only serve the best interest of the participating banks. Absa (taken together with NuPay) receives considerable fees for being the major acquirer in the AEDO payment stream, but is required to pay away, in the form of the interchange, only a small part of the revenue extracted from the beneficiaries (users).[609] It is unclear as to why no other participating banks have entered into the market in the provision of a competitive service.[610] If effective competition existed in the provision of AEDO transactions, one would expect the high user fees to be undercut.[611]

Confidential: Absa

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607 Capitec, March 2008, Response to further questions for Capitec, p 3.

608 Paying customers have hitherto not generally been charged for unsuccessful EDO debits and can thus save significantly on the penalty fees charged on rejected debit orders. See *id.,* and also the chapter on Penalty fees; Absa, March 2008, Response to additional questions, p 4 and Nedbank, March 2008, Supplementary submission, p 4.) FNB charges an unsuccessful fee of R2.65, significantly lower than its dishonour fee for ordinary debit orders, while SBSA intends charging the standard dishonour fees to paying customers. See costing and pricing chapter on penalty fees

Confidential: FRB

609 See Table 19.

610 According to MFSA, all three of the participating acquiring banks and service providers charge very high user fees.

611 Also see the chapter on Market Power.

In contrast, payments between banks and users of the NAEDO stream seem considerably lower and less complicated,[612] whilst participating issuing banks extract more revenue through higher interchange fees.

In the table below, the user and customer fees and the interchange are shown for both an AEDO and NAEDO transaction of R500, between Absa and Standard bank clients. In an on-us transaction where both end-users bank with the same bank, interchange would not be paid away, however, we have assumed in our example that two banks are involved. Total revenue extracted from both end-users in the AEDO stream is R16.70 and increases with the value of the transaction, whereas for NAEDO, the amount is R13.33, for all transactions up to R1000, whereafter the interchange increases by R5.00.

Confidential: SBSA

Table 21 Fee and revenue split for AEDO and NAEDO – R500 transaction

AEDO	
Absa (and NuPay)	SBSA
User fee charged - R11.40	Customer fee charged – R5.35[613]
Interchange paid from Absa to SBSA – R3.25	
Total revenue per transaction – R8.15	**Total revenue per transaction – R8.55**
Total revenue extracted – R16.70	
NAEDO	
Absa (NuPay)	SBSA
User fee charged - R7.98	Customer fee charged – R5.35
Interchange paid from Absa to SBSA – R7.00	
Total revenue per transaction – R0.98	**Total revenue per transaction – R12.35**
Total revenue extracted – R13.33	

Confidential: Absa SBSA

Source: Pricing Brochures, 2008.

The AEDO transactions require authentication, hence removing some of the risks out of the system. However, given the equality in the processing and functioning of the two EDO payment streams, the disproportionate revenue extracted in the AEDO stream on the acquiring side in comparison with the non-authenticated NAEDO transactions, seems unjustifiable.

The process of negotiating EDO interchange fees bilaterally seems not to have produced any pro-consumer competitive benefits. If anything, it tends to confirm the general analysis given above – namely that bilateral interchange setting serves to accentuate market power.

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612 The user fee seems to be the same regardless of the value of the transaction.

613 E Plan account, 2008 pricing brochure

In our view, the interchange fees applicable to EDO transactions ought to be brought within the transparent and objective regulatory scheme which we propose for payment cards and other payment streams where it would be appropriate. Once again, establishing the necessity of interchange in the payment stream concerned would be fundamental to the process.

That process will also help clarify the extent to which banks' pricing to users in these streams is in excess of costs, and whether a specific investigation into excessive pricing, either under the Competition Act or consumer protection legislation, is warranted.

6.9 Appropriate regulation of interchange

6.9.1 International experience

Where the setting of interchange is not regulated, competition authorities are left with an unending predicament in their attempts to address the abuses, or potential abuses, identified above. The point at which interchange ceases (or would cease) to operate purely as a legitimate balancing mechanism to enable the necessary co-operation in a four-party payment system, and begins to function as a centre for the co-ordinated extraction of excessive profits, is constantly shifting and is extremely difficult to pin down. While the public is entitled to protection against abuse, the card schemes and their participants are entitled to certainty so that they can get on with productive business, and in so doing expand the local and global reach of innovative and efficient alternatives to cash and paper-based payments.

The *Nabanco* decision in the United States in the mid-1980s seemed simply to give a green light to interchange – but, as we have seen, its analysis did not adequately distinguish and disentangle the necessity and legitimacy of interchange in principle from the reasonableness of the methodology and "business judgment" employed in setting it. In the latter respects the decision was merely case-specific. At that relatively early stage in the development of four-party schemes, the potential for systematic abuse was not identified.[614] Everything was supposedly for the best in the best of all possible worlds. In other jurisdictions authorities have not accepted interchange so readily.[615]

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[614] Even now it is not identified by some well-informed writers on competition in the United States. Cf e.g. Muris, T.J., "Payment Card Regulation and the (Mis)application of the Economics of Two-Sided Markets", 2005 *Columbia Business Law Review* 515-550. However, despite *Nabanco*, there are evidently a number of pending cases brought by merchants in the US against MasterCard and Visa challenging the legality of scheme interchange rules. See: http://www.mastercard.com/us/company/en/newsroom/interchange_lawsuit.html. Moreover, a Bill has recently been introduced in the US House of Representatives (HR 5546) which would seek to impose a regulatory regime on interchange setting in "covered electronic payment systems", being those electronic payment systems used for at least 20% of the combined dollar value of US credit, signature-based debit, and PIN-based debit card payments processed. The Bill is supported by the National Retail Federation, but opposed by card schemes and banks. See e.g. http://www.paymentsnews.com/2008/03/retailers-welco.html; http://www.electronicpaymentscoalition.org.

[615] "Australian regulators are not alone in expressing an interest in interchange. Regulators in Europe, in the US and in Hong Kong have also recently introduced interchange reforms or are currently considering their introduction." Visa, Second Submission, June 2007, document T (March 2005), p 7. "[A]uthorities in Austria, Portugal, Spain and Switzerland and Poland have also launched interchange focused investigations or have considered interchange in the context of broader payment system reforms." *Id.*, p 51. The *Financial Times* reports (19 December 2007): "Up to 12 EU

In Europe, for example, interchange has been a bone of contention since at least 1992. Back in 1977, the company which became known as Visa International had notified various rules and regulations governing the Visa association and its members to the European Commission, applying for negative clearance under Article 81(1) of the Treaty or, in the alternative, an exemption under Article 81(3).[616] In 1992 the Commission withdrew a comfort letter previously given, and "re-opened" its investigation. In 1997 the re-opened investigation also took into account a complaint filed by EuroCommerce, a European retailers' organisation, concerning various aspects of, *inter alia*, the Visa International payment card scheme, in particular interchange fees. On 24 July 2002, the Commission issued a decision relating to the intra-regional interchange fee scheme of Visa International for consumer cards, as applied to cross-border point of sale Visa card payment operations between EEA Member States.[617] The effect of this decision was to exempt Visa's intended multilateral interchange fee (MIF) from the prohibition under Article 81(1) until 31 December 2007, on the basis of certain proposals and undertakings from Visa. The undertakings included significant reductions in the prevailing levels of interchange for different types of cards – a reduction of more than 50 per cent in the case of average debit card transactions.[618] The proposals involved the use of a costing methodology, subject to independent audit, which was designed to serve as a "proxy" for benefits received by merchants from cross-border card payments by retail consumers, and which would set a cap to the permitted level of

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member states are believed to be looking at the legality of interchange fees although investigations are at differing stages. An Office of Fair Trading probe in the UK is the most public."

616 The Treaty of Rome established the European Community. Its articles were amended and renumbered in terms of the Treaty of Amsterdam. Article 81 (formerly Article 85) provides as follows:

1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:
   (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
   (b) limit or control production, markets, technical development, or investment;
   (c) share markets or sources of supply;
   (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
   (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.
2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.
3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:
   - any agreement or category of agreements between undertakings;
   - any decision or category of decisions by associations of undertakings;
   - any concerted practice or category of concerted practices,

   which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
   (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
   (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

617 See OJ L 318, p 17 ff, 22.11.2002 (Case No COMP/29.373 – Visa International – Multilateral Interchange Fee), (2002/914/EC). The European Economic Area (EEA) came into existence on 1 January 1994, comprising the countries of the European Union and the European Free Trade Association.

618 See *id.,* para (18).

interchange for each card type.

In reasoning its way to its decision the Commission concluded that, while Visa's MIF did not have the *object* of restricting competition, it did have the *effect* of appreciably restricting competition, and therefore required exemption from Article 81(1).[619] It found that adequate grounds for such an exemption existed. The Commission's analysis did not make a clear distinction between the necessity of interchange in principle, on the one hand, and a methodology of interchange setting which may unnecessarily restrict or distort competition (whether in object or effect), on the other. Indeed, the methodology which it approved for purposes of the exemption was essentially the same as the one used in South Africa, which we have found above to be inherently unsatisfactory.[620] Although mentioning the argument regarding the need in principle for a balancing mechanism in an open or four-party scheme, the Commission seemed to give it no weight. It concluded that interchange was not technically necessary since the Visa scheme could admittedly survive on a greatly reduced scale without it.[621] We are unable to follow this line of reasoning. By implication it acknowledges that interchange would have been necessary to enable the *additional* transactions to occur, but the point at which "technical" necessity would be established in a two-sided market remains unclear. At the same time, so the Commission's reasoning went, the necessity of interchange for optimising card usage was clear enough to warrant an exemption under Article 81(3) – subject to the provisos as to reduced levels and the "proxy" costing methodology.[622]

The logical consequence of this approach would seem to be:

- that multilateral or other uniform interchange setting is always prone to prohibition in Europe under Article 81 unless specifically declared exempt;
- that exemptions would have to be periodically reconsidered; and
- that in this way regulation of interchange would in fact occur indirectly under the supervision of the competition authorities.

On 19 December 2007, the European Commission announced its decision on MasterCard which has been referred to earlier in this chapter. Still maintaining that open card schemes

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619 See *id.,* paras (69) and (73).

620 The methodology approved in the EC's Visa exemption used (a) the issuer's costs of processing transactions, (b) the issuer's cost of providing the "payment guarantee", and (c) the cost to the issuer of the "free funding period" as an "acceptable proxy" for the average marginal utility of a Visa card to the merchant accepting it. (See *id.,* especially paras (83) – (90).) At best the Commission could only say that these costs reflected the cost of services which issuing banks provide "wholly or partly" to the benefit of merchants. (See *id.,* para (91).) In the case of the "free funding period", this was "a feature of international charge and credit cards that partly benefits the merchant for cross-border transactions." Why the *whole* of these costs should then simply be included in the approved interchange methodology (and no others), and why no attempt to assess and balance elasticities of demand on the two sides of the market was thought necessary to a rational outcome, remains a mystery. The likelihood is that the grant of the exemption relied less on systematic reasoning than on the promise that Visa's interchange levels would actually come down.

621 See *id.,* para (59).

622 See *id.,* paras (98) and (99).

"can operate without a MIF",[623] and that methods other than interchange can provide a balancing mechanism in a four-party scheme,[624] the Commission nevertheless stated that it did not consider interchange as such to be prohibited.[625] However, it found that MasterCard's multilateral intra-EEA default interchange fees for debit and consumer credit cards did violate Article 81 of the Treaty.[626] In its announcement, the Commission stated:

> MasterCard has six months to comply with the Commission's order to withdraw the fees. If MasterCard fails to comply, the Commission may impose daily penalty payments of 3.5 per cent of its daily global turnover in the preceding business year.[627] MIF are not illegal as such. However, a MIF in an open payment card scheme such as MasterCard's is only compatible with EU competition rules if it contributes to technical and economic progress and benefits consumers.[628]

The criteria mentioned are ones applicable to exemptions under Article 81(3), thus suggesting that multilateral interchange is indeed to be treated as prohibited unless exempted.[629] At the same time, the European Commission drew attention to the fact that the Visa's 2002 exemption was about to expire.

> [F]rom that moment on VISA will be responsible to ensure that its system is in full compliance with EU competition rules.[630]

From our perspective, the EU approach lacks the clarity and certainty that we would be looking for.

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623 European Commission MEMO/07/590, Brussels, 19th December 2007, p 5.

624 *Id.*, p 6. The alternatives are not specified and it is not clear why they would be less objectionable in principle or in fact if their object or effect would be to place a cost burden on merchants similar to that which interchange accomplishes. In the same explanatory memorandum in respect of its December 2007 decision on MasterCard, the European Commission also said that its Sector Inquiry of 2005/2006 into retail banking had found that in 22 of 25 EU member states credit card issuing remains profitable without interchange fees. See *id.*, p 5, citing IP/07/114 (Brussels, 31st January 2007). Reference to the underlying analysis reveals a rather more qualified position. (See Report on the retail banking sector inquiry, Commission Staff Working Document accompanying the Communication from the Commission – Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report) [COM(2007) 33 final] SEC(2007) 106, 31 January 2007, pp 121ff.) It appears that, in the case of 62 out of the 100 issuing institutions that reported positive profits from credit card issuing, they would have remained profitable without the component of their revenues provided by interchange. In other words 38 of the 100 would not have been profitable without interchange. As for the 62, the level of their residual profitability is not indicated, nor is there an examination of the extent of any likely exit on their part from credit card issuing in the event that interchange in respect of such cards were to be prohibited. (Mere profitability may not be enough to keep a firm in a market if the rate of profit is abnormally low.) The working document itself indicated a need for caution when it stated: "The aim of this analysis is not to argue in favour of a zero interchange fee for all networks. However, in the light of the results, it is legitimate to question the optimality of the current level of interchange fees in several countries. The inquiry's findings seem to confirm some recent theoretical predictions of the two-sided market literature, which suggest that privately optimal interchange fees may be too high, notably if merchant fees increase with interchange fees but issuers do not pass the additional interchange fee revenue back to cardholders." From the South African perspective, we have addressed all of these aspects in this chapter above.

625 *Id.*

626 IP/07/1959, Brussels 19th December 2007, p 1. On the same day, MasterCard Europe announced that it would appeal the decision to the European Court of First Instance. (MasterCard press release, 19 December 2007.)

627 According to a report in the *Financial Times*, 19 December 2007, this would amount to $316,000 per day.

628 *Id.*

629 "Far from providing clarity, today's decision leaves MasterCard Europe and the entire payments industry in doubt as to what interchange fees the Commission will allow," said the President of MasterCard Europe, promising to "continue to seek common ground with the Commission" while contesting the decision. (MasterCard press release, 19 December 2007.) To the extent that, in the Commission's reasoning, there is an implied approval of *bilateral* setting of interchange, we consider this both impractical and (at least in South Africa) highly undesirable for reasons discussed above.

630 Introductory remarks at press conference, Brussels, 19 December 2007, by the European Commissioner for Competition Policy, p 3.

Like the European Commission, the South African Competition Commission has no direct regulatory powers. *Unlike* the European Commission, our Competition Commission lacks wide powers of exemption. The powers in terms of section 10 of the Competition Act to exempt a practice from prohibition are very limited indeed.[631] Even if these powers were to be expanded – which may be warranted in any event – we do not consider that exemption under competition legislation provides a satisfactory framework for regulating interchange.

For the reasons explained above, an approach which assumes that multilateral or uniform interchange is prohibited unless exempted seems inherently flawed. At the same time, the constant resort to exemption in order to legitimise interchange would oblige the competition authorities to function in effect as price regulators. They are not cut out for such a role. Moreover, criteria for exemption under competition legislation – criteria which, by their nature need to be generally applicable across industries – could not be tailored adequately to the complex subject-matter of interchange and would thus not be sufficiently precise. The vagaries of official discretion would consequently reign at the expense of objectivity, clarity, business certainty and the rule of law.

In Australia, the Reserve Bank cut through these difficulties by imposing a regime of interchange regulation in respect of payment cards, standing independently of competition law. In an appendix to this report we have provided considerable detail of the Australian reforms for ease of future reference and comparison. While our recommended methodology differs from that adopted by the RBA for determining appropriate levels of interchange, we do recommend that South Africa follows their pioneering initiative in moving to the regulation of interchange on an independent, objective and transparent basis.[632]

6.9.2 An independent, objective and transparent process

After the conclusion of the Enquiry hearings, the Panel asked the Technical Team to engage in a consultative process with banks and other relevant stakeholders in order to explore further the feasibility and practical implications of certain changes which had been mooted in the hearings. One of these was

> the introduction of an independent, objective and transparent methodology and procedure for

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631 Section 10 (3) of our Competition Act limits permissible exemptions to those restrictive agreements or practices where the restriction concerned is required to attain (i) the maintenance or promotion of exports; (ii) the promotion of the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive; (iii) a change in productive capacity necessary to stop decline in an industry; or (iv) the economic stability of any industry designed by the Minister of Trade and Industry, after consulting the Minister responsible for that industry. Section 10 (4) further allows the possible exemption of agreements or practices relating to the exercise of intellectual property rights. The intended scope of this is not clearly indicated. It was under section 10 (4) that Visa sought and obtained – whether validly or otherwise is not a matter for us to address – an exemption until 2013 of its interchange arrangements in South Africa.

632 Obviously domestic regulation cannot affect cross-border interchange rates. There needs to be discussion between competition authorities internationally as to how to address this problem.

determining interchange in all payment streams in which interchange is necessary.[633]

A series of exploratory meetings was then arranged. It was emphasised that nothing said at those meetings would be considered as being on the record of the Enquiry, unless specifically advanced and recorded as an on-the-record statement at the instance of, or by agreement with, the participant concerned. Moreover, participation in the exploratory process would not be taken to imply support for or endorsement of any particular change or measure that the Panel might ultimately recommend.

Three such meetings on interchange were held – on 15 August, 4 September and 30 October 2007 – which were attended by representatives of banks, card schemes and the larger retailers. The consultative process envisaged by paragraph 6(c) of the Enquiry terms of reference continued also in other ways. Valuable contributions to our further understanding of the subject were made in this way, both in oral debate and by means (for example) of working documents for discussion, and we have drawn on them to varying degrees in coming to our own conclusions. They are not specifically identified and acknowledged in what follows because they have remained off the record.[634]

In our view, there is a need for the process of interchange-setting to be subject to regulation under specific statutory authority. This is necessary to ensure, *inter alia*, that the global four-party card schemes are effectively subordinated to the envisaged process in so far as their operations in South Africa are concerned, and that their participating institutions here adhere to that process despite any provisions to the contrary regarding interchange that may exist or be adopted in the schemes' own rules.

The regulator of the payment system – the South African Reserve Bank (SARB) – would appear to have the authority under section 10(1)(*c*) of its own enabling Act[635] to devise and implement the necessary rules and procedures. That Act, however, has to be read in conjunction with the NPS Act. It should be noted that in the chapter of this report dealing with Access to the Payment System, we have concluded that certain fundamental changes to the NPS Act are required. Other, less fundamental changes may also be necessary. Currently section 12 of the NPS Act, which allows the SARB to issue binding directives regarding a payment system, does not apply to a "designated settlement system". It will be important to ensure that a regulated process of interchange-setting which might be provided for by way of

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633 Letters of invitation to stakeholders, July 2007.

634 The exploratory process on appropriate regulation of interchange went considerably beyond the on-the-record submissions of the various participants, and similarly beyond the questions asked and the answers given by them at the hearings in that regard. No purpose would be served by recapitulating those earlier submissions, questions and answers here. The record stands as a direct source of reference should it be needed. Occasional references are made to the record in footnotes to this section below, where that helps to elucidate certain issues not elaborated in the main text.

635 South African Reserve Bank Act 90 of 1989. Section 10(1)(*c*)(i) 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 supervised payment, clearing or settlement systems". Section 10(1)(*c*)(iii) empowers it to "perform the functions assigned to the Bank by or under any law for the regulation of such payment, clearing or settlement systems".

a directive under section 12, is not able to be circumvented by the simple device of banks deciding to clear and settle their card transactions through designated off-shore systems of the card schemes.

The regulated process of interchange setting which we have in mind would not cast the SARB or its National Payment System Department (NPSD) in the role of having to establish the appropriate level of interchange itself. It would not become, in effect, a price-setter. Rather its role would be to confirm that the process provided for in the envisaged rules had been duly carried out by the participants and, on that basis, to declare the result binding. It would then have the role of ensuring compliance and dealing in the ordinary way with contraventions.[636]

The basic elements of the envisaged regulatory process are set out below. Payment streams that should be included in the process at the outset are the credit card, debit card, electronic funds transfer (EFT) and early debit order (EDO) streams.

In our view, the regulator should have the authority to invoke the process also in respect of any other existing or future payment stream, or any means of payment in any stream, whenever satisfied that interchange in that connection (however it may be set or proposed to be set) may give rise to significant competition or consumer welfare concerns. (Advice from the Competition Commissioner from time to time could assist the regulator in being satisfied or otherwise in regard to the first of those criteria, at least.)

The advantage of such a flexible approach would be that, at least initially, where innovations occur in methods of payment, including the introduction of new types of payment cards, interchange could (where it is necessary) be established for them by private arrangements without immediately facing regulatory control. There should, however, be a requirement of public disclosure of *all* interchange arrangements at least twice a year, combined with frequent reporting to the regulator of all volumes and revenues connected with interchange, whether regulated or not. This would both enable compliance with the regulatory arrangements to be monitored and put the regulator in an informed position from which to investigate further and invoke the process once concerns over unregulated interchange setting arise.

The possibility of such flexibility follows from the conclusion that multilateral or uniform interchange in a payment stream, where it is necessary to balance the two sides of the market, is not unlawful *per se* – but that it may nevertheless be abused.

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[636] This role appears to be in keeping with the responsibilities set out by the Bank for International Settlements (BIS) for overseers of Systemically Important Payment Systems, in its Core priniciples and Responsibilities of Central Banks. In particular Core Priniciple IX, which aims to address access and competitive aspects in payment systems, read together with the Responisibilitiy C, which is designed to include overseeing compliance of other systems with the core principles, would apply.

6.9.3 Participation in the process

The process which we envisage would involve the establishment of an "Interchange Forum", within which there would be a specific sub-forum for each payment stream where interchange is to be subject to regulation. The mandate of the combined forum would be to consider and reach a decision on the optimal (i.e., welfare maximising) level of interchange in respect of each of the relevant payment streams, having regard *inter alia* to the way in which different payment streams may compete with each other. The role of the sub-forums would be to consider and convey advice to the combined forum regarding the optimal level of interchange from the separate point of view of each particular payment stream and its stakeholders.

Decisions reached in the Interchange Forum need not set or modify the levels of interchange in all the relevant payment streams at the same time.

The SARB should appoint a chairperson and a deputy chairperson for the Interchange Forum. These persons would also be responsible for convening and chairing the sub-forums. A reasonable combination of independence and expertise or experience should be sought in these appointments.

Participation in the Interchange Forum and its sub-forums should be open to all relevant stakeholders, including, for example, merchants where relevant, representative consumer organisations, consumer protection authorities, payment schemes and scheme participants, and other relevant payment service providers. The NPSD of the SARB, as well as any payment system management body such as PASA, should be informed of all meetings of the Interchange Forum and its sub-forums, so as to be able to observe or participate in proceedings if it so wishes.

Working procedures for the Interchange Forum and its sub-forums would have to be drawn up, including provisions to ensure the submission of complete and accurate information together with the protection of business information that firms may legitimately need to keep confidential from their competitors. There should be no restriction, however, on the public airing of different views and motivations regarding appropriate criteria, methodologies and levels for interchange. A primary objective is to render the process of interchange setting as transparent as possible.

Since divergent interests would be represented in the Interchange Forum and its sub-forums, proceedings in each of the sub-forums could well give rise to conflicting advice to the combined forum, and consensus could well ultimately be lacking in the latter. In our view, the decisions in the Interchange Forum should be the decisions of the chairperson (or deputy in the absence of the chairperson), duly recorded with reasons.[637] Where a

[637] Given that there will in fact not be democratic decision making in the Interchange Forum, the setting out of reasons is

consensus exists and is recorded, that would be reason enough: the decision would simply express the consensus. Failing consensus, the decision would have to be supported by adequate written reasons.

Clear governance procedures should thus be established, so as to allow for an orderly and expeditious process in the forums in which facts, views and arguments are properly recorded, and so that these can be adequately reflected in any reasons for decision which may ultimately have to be given.

There should also be an expeditious appeal procedure, to a tribunal appointed by the SARB but including at least one external independent adjudicator. An appeal should be possible on grounds that the decision made is insufficiently supported by the reasons given for it. In the interests of efficiency, the appeal tribunal should also have power to review and set aside procedural decisions, and correct procedural omissions, where a fundamental failure of due process would otherwise result. The appeal tribunal should be able either to remit an unsatisfactory decision to the chairperson for reconsideration or substitute its own decision (with reasons) where it has adequate information enabling it to do so.

At the conclusion of the process, the SARB would bring the relevant interchange levels officially into operation by confirming the decisions reached. In so doing, the SARB would satisfy itself that the process has been duly carried out in compliance with the regulations or directives concerned.

6.9.4 The methodology

General criteria

First among the decisions to be reached in the Interchange Forum would be the formulation of general criteria for the setting of interchange in payment streams which are to be subject to the regulatory process. There would be no need for sub-forums to debate this aspect separately, unless particular criteria are thought to be stream-specific. Draft criteria could be published to allow for comments to be more widely received. After consideration by the Interchange Forum, a decision on the criteria would be arrived at – again supported by reasons, subject to appeal, and subject to confirmation by the SARB.

Apart from the decision on the general criteria and final decisions on the levels of interchange to be applied, it should not be necessary for the SARB to have to confirm each step or decision taken in the course of the interchange-setting process as it occurs. Its ability to observe and participate in the process, should it so wish, would enable it to indicate dissatisfaction at an early stage and advise remedial steps should the need for that arise.

essential. Moreover, it captures the spirit of the country's constitution.

Among the general criteria should be the promotion and maintenance of effective competition, both within and between payment streams. For reasons extensively set out in this chapter above, we consider that the objectives of competition are generally best secured by levels of interchange no higher than is reasonably necessary to balance disproportions of cost and demand on the different sides of a two-sided market. Whereas hitherto a "business judgment" – a profit-maximising judgment – has been exercised in order to collectively "optimise" output by means of interchange in particular payment streams, it should now be expected that the optimisation of the output of one payment stream vis-à-vis other payment streams by means of uniform interchange would involve a social value-judgment aimed at welfare-optimising effects. Thus, for example, the replacement of cash with electronic and other paperless means of payment might legitimately be given weight as a general objective in the interchange-setting process. Likewise the promotion of the use of debit cards by consumers and ending the privileged position of credit cards in payment transactions, for may also be an identified aim. "Business judgment" would now have to defend itself openly in a forum concerned also with potentially divergent interests and wider social aims.

At the same time, efficiency, reliability, profitability and the encouragement of modernisation and innovation within existing payment streams would surely constitute general criteria to be applied in evaluating appropriate levels of interchange.[638]

The general criteria for the setting of interchange should be open to reconsideration, if called for, whenever the process of interchange-setting is repeated in any payment stream.

Uniformity

We have shown above why bilateral setting of interchange is in fact anti-competitive;[639] and also why competition between card schemes would usually tend to raise or sustain high interchange levels rather than bring them down. Accordingly, in our view, there should be a uniform level (or levels) of interchange compulsorily applicable on the same basis to all participants within the payment stream concerned – save only that in the case of payment

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638 Visa, for example, has specifically put forward innovation as one of the strategic objectives involved in determining "the appropriate rate of interchange". (Visa, June 2007, Second Submission, document B (third part) p 19.) However, the legitimacy of this where interchange is privately set by profit-making firms, such as the schemes and their participants, is open to question. In a competitive market, the entrepreneur must finance ongoing innovation through re-investment of profit. An ability to make the customer pay now for future innovation smacks of the existence and the exercise of market power. However, once interchange setting is moved into a transparent and objective process, with full participation of all stakeholders and subject to regulatory oversight, then the objection would fall away. The public interest in innovation could then be brought effectively into the balance. Cf also FRB, October 2006, First Submission, p 67; Nedbank, March 2007, Second Submission, Access and Interoperability, p 42 and p 53; Transcript 19 April 2007, pp 51-55. This aspect (the financing of innovation through interchange) is distinct from the importance of interoperability in facilitating innovation, and the role of interchange in enabling interoperability to develop in conjunction with innovations. FNB stated that the development of payments by cellphone has been held back by the absence of interchange and of a four-party model. (Transcript 19 April 2007, p 115. Cf also *id.*, pp 178-180.) The development of the hybrid card, on the other hand, was facilitated by the existence of interoperability and interchange. (*Id.*, pp 183-184.)

639 See section 6.6.

streams involving the cards of "open" or four-party card schemes (such as Visa and MasterCard) a *lower* uniform level or levels of interchange may, if they so wish, be applied by those schemes *on a scheme-wide basis* to the type of transactions concerned.

This approach would serve (a) to set a cap on permissible interchange levels, (b) maintain a prohibition against bilateral setting between individual participants, and (c) at the same time allow scope for the schemes to compete interchange levels downward across the board in the instances when it might be in their respective interests to do so.[640]

Costing methodology

Following a competitive tender process, the Interchange Forum should instruct an independent third party with relevant experience and expertise to draw up and submit a precise costing methodology in order to enable the disproportions in costs between the issuing and acquiring (or paying and collecting/receiving) sides of the market in each of the relevant payment streams, and for each relevant means of payment or transaction type therein, to be assessed.[641]

This draft costing methodology would then be considered and debated in the Interchange Forum, and could be referred back to the third party for further attention if necessary, before becoming the subject of a decision in the Interchange Forum. If (as seems likely) the appropriate costing methodology would differ (for example in its relevant cost categories) between different payment streams and means of payment or transaction types, then the need to involve particular sub-forums in considering and debating it would naturally arise.

In the event that the chairperson (or deputy) has to make the decision on the costing methodology in the absence of consensus, and where reasons accordingly have to be given, the decision would be subject to appeal.

We have indicated above why we consider that a sub-set of issuing costs is not acceptable as a "proxy" for use in the process of interchange setting (as has hitherto been the case with credit cards). First, it is altogether inadequate as a means of determining the true disproportions of relevant costs on the two sides of the market. Second, it subsumes into *a partial costing exercise on the one side* of the market an alleged measure of *the elasticity of*

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640 To ensure a level playing field, our recommendation of a uniform "cap" on interchange in each card payment stream is subject to one potential qualification which is addressed below.

641 "Independence" here will obviously be relative. The crucial requirement is that the entity concerned should not be financially interested in the outcome of the process (Transcript 19 April 2007, p 58). It should be independent of the issuing and acquiring institutions involved so that it can be entrusted also with their confidential data in performing the costing exercise. Given the need for experience and expertise, it is probably inevitable that the entity concerned will have a history of providing services to one or other of the card schemes, and the expectation of continuing to do so, whether in South Africa or in other jurisdictions. In these circumstances transparency becomes all the more important, along with wide participation, proper reporting, open debate and informed decision-making in the Interchange Forum itself.

demand on the other side. Not only have we found the justification advanced for this to be unconvincing, and its true objective purpose to be objectionable; it also simply disregards the need to evaluate the relative elasticities of demand on *both* sides of the market, in order for the setting of *necessary* interchange to be properly carried out in any payment stream.

The costing methodology which is called for is one which assesses *all* relevant categories of costs incurred in supplying the payment service on both sides of the two-sided market in each stream. Which categories are relevant, and which are irrelevant, is a matter for recommendation by the independent third party and for debate in the Interchange Forum and sub-forums.

As we have explained above, we do not consider that the costs of credit extension – including the funding costs of the interest free (or "free funding") period afforded to credit card transactors – are legitimately included in payment card interchange. Processing costs and the net costs of the payment guarantee (to the extent that this is a benefit truly provided by issuers and truly passed through to merchants) are a qualitatively different matter.[642] In our view, it is the use of a card *as an effective means of payment* that gives rise to the necessity (and hence legitimacy) of interchange in principle where four-party schemes are concerned. While the relevant cost categories may differ in detail as between debit card and credit card interchange, the principles for determining relevance would seem to us to be essentially the same. *It is as a means of payment and not as a means of credit extension that the credit card qualifies for interchange.*

Issuers' costs of providing "loyalty" or frequent-user benefits to cardholders would also seem not to be a legitimate component of interchange, and indeed such costs are conventionally excluded from existing interchange calculations.[643]

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642 We recognise that the payment guarantee is essential to the acceptance of a card as a means of payment, and could legitimately be included among the costs relevant to interchange. It is at least arguable that the cost of the payment guarantee would include the cost of cardholder default. This arises potentially when, in using the card to make payment, the cardholder draws on a credit facility of some kind. That is invariably the case with credit card transactions, but may also occur where a debit cardholder draws on an overdraft facility. In this connection, the question arises as to the period within which default (and with it the cost of default) might reasonably be regarded as relevant to interchange. A suitable period would need to be identified, in order to prevent interchange being used to finance what is essentially the issuer's lending business. The cost of the payment guarantee in the case of credit cards is commonly taken to include the cost to the issuer of default by borrowers during whatever "free funding" period the issuer allows – but this period varies between countries and there is nothing logically sacrosanct about it. Clearly the longer the period, the less relevant the costs of the borrower's default becomes where payment card interchange is concerned. Nevertheless, the inclusion of some part of the cost of cardholder default in interchange calculations would seem unobjectionable, at least when (as we go on to recommend) the merchant is free to accept a scheme's debit cards or credit cards, or both, without being obliged either to accept its cards of all types or none at all. For reasons discussed above, however, qualitatively different policy considerations come into play when the inclusion of costs in interchange setting is extended to the funding costs incurred by the issuer-lender in providing to its customers a period of credit that is interest-free. We do not regard such lending costs as a legitimate component of interchange.

643 It is instructive, nevertheless, to find in a 2005 study by Datamonitor on the effects of the Australian interchange reforms that lower interchange rates have been found to result in a cut-back of loyalty benefits, or higher charges for providing them. (*Interchange in Australia – Global implications,* supplied by Visa, June 2007, Second Submission, document T.) "Card issuers have long used interchange revenues to fund loyalty schemes. It is therefore no surprise to see that the reforms have brought about a raft of loyalty scheme cut backs and fee increases." (*Id.*, p 34.) "Loyalty scheme access is now considerably more expensive." (*Id.*, p 43.) Datamonitor also says that one of the outcomes of the interchange reforms has been to expedite the trend towards low-rate cards which have limited or no loyalty schemes. "Consumers have lost out as a result of higher fees for loyalty but have gained from greater competition at the low rate end of the market." (*Id.*, pp 43-44.)

In drawing up an appropriate costing methodology for consideration, the independent third party should recommend the size and composition of the representative sample to be used for the cost study. In our view the advantage of establishing and utilising weighted average costs rather than the costs of the most efficient firm, on each side of the market, is that the competitive incentive for firms to reduce their costs would be more likely to be stifled if a firm could not retain the rewards of above-average efficiencies but instead were to lose those rewards automatically the next time interchange levels came to be evaluated.

We were informed that currently the costs incurred by card scheme participants, while they vary considerably as between the issuing and acquiring sides, do not vary significantly as between the two major card schemes. This is something the independent third party would have to confirm. If correct, it would mean that averaging of costing data as between participants in the two schemes would not give rise to major anomalies. If in fact there are significant differences – or if, for example, one scheme or both were to change appreciably the allocation of costs in terms of their rules as between the issuing and acquiring sides – then it might well be necessary to change or set different interchange caps for them in order to take proper account of this and level the playing field.

The consequent cost study

Once the appropriate costing methodology has been finally formulated and formally decided upon, the Interchange Forum, through its chairperson or deputy, would instruct the independent third party to carry out a cost study accordingly. Participants in the relevant payment streams would be required to submit cost data to the independent third party on a confidential basis. The latter would check and interrogate the data supplied by participants to ensure accuracy and consistency. Another independent entity should be engaged to audit the calculations that have been made with the collected data, as well as a random audit of data supplied.[644]

The independent third party which has conducted the cost study would then submit the results to the Interchange Forum. These would need to be accompanied by calculations showing the effect that different rates of interchange would be likely to have on ultimate average net costs on each side of the market, and advice as to whether interchange should be applied in each stream, or to each means of payment or transaction type, at a flat rate or on an *ad valorem* basis.

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644 Cf MasterCard, October 2006, First Submission, para 16.3: "One method adopted by MasterCard to verify the integrity of the data collected and utilised in the cost study, is to ensure that EDC maintain an audit trail of all documentation received. This audit trail makes it possible for participating members to trace the reported cost, revenue and statistical data back to their source. Detailed documentation of source data is developed by customer banks during the data collection process in order that reported cost, revenue and statistical data may be traced back to its source."

All recommendations and calculations by the independent third party, once formally submitted to the Interchange Forum, should also be made available to the general public in the interests of transparency and to encourage public awareness of and confidence in the process.

Assessment of demand elasticities and application of general criteria

Objective methods of assessing demand elasticities on both sides of the market in each relevant payment stream, or for each means of payment or transaction type, should be adopted, if they can feasibly be devised, in order to assist the eventual judgment process in the Interchange Forum and its sub-forums. That judgment process, as already indicated, would be aimed at achieving optimal levels of interchange in accordance with the general criteria previously established.

Recommendations should be made by the independent third party in this regard, to the extent that it is possible to do so. Consideration could also be given to whether different interchange rates should apply to different types of merchants or segments of the market within a payment stream.

To the extent that it proves impossible or unreasonably difficult to establish objectively the relative elasticities of demand, the judgment process itself will have to suffice in this regard, guided mainly by experience. The Interchange Forum, in exercising its own judgment, would have to take carefully into account the implications of any shift from existing levels of interchange in any payment stream, and would need to consider calculations, estimates and recommendations by the independent third party in this regard. The Interchange Forum would not be bound by any recommendation of the independent third party. Where appropriate, the implications of a particular proposal arising in the Interchange Forum or its sub-forums could be referred by the chairperson or deputy to the independent third party for an assessment of its implications, before a decision is adopted.

Decision on interchange levels

As outlined above, the decision of the Interchange Forum would be made by the chairperson (or deputy, as the case may be), either on the basis of consensus or, failing consensus, on the basis of reasons given. The decision would then be subject to possible appeal and to ultimate confirmation by the SARB. Upon confirmation and publication of the decision, the interchange levels so determined would apply in the payment streams concerned until duly altered by a subsequent interchange-setting process conducted in due course.

The consensus during the Enquiry has been that a review every two or three years would be sufficient. In Australia, the costing process for the setting of interchange is carried out every

three years. In our view this seems adequate and could be laid down as the norm. In a particular case, if the independent third party has so advised and the Interchange Forum so decided, a shorter period could be determined at the time when the level of interchange is set. In any event, however, there should be a provision allowing the regulator to invoke a review at an earlier time in respect of any payment stream or streams if it appears that a material change in circumstances has occurred.

Cost of the process

It may be anticipated that the process outlined above will (especially at the outset) be intensive, time-consuming and costly. Once the relevant procedures have been laid down, the necessary appointments made and the methodology established and tested, the process can be expected to become more efficient and streamlined over time.

Subject to what is said below, stakeholders participating in the Interchange Forum and its sub-forums should bear their own costs incurred in doing so, including their own costs incurred in any appeal. Participants in payment streams who are required to submit cost data to the independent third party should likewise have to bear their own expenses in doing so.

However, the costs of establishing and operating the Interchange Forum and its sub-forums, the costs connected with the appointment of the chairperson and deputy, and the costs of engaging the independent third party and auditor should, in our view, be seen as a public expense.[645] If these costs were to be borne directly by banks, card schemes, or other powerful participants, then the suspicion would inevitably arise in the public mind that "he who pays the piper calls the tune". Whether public funds duly expended for this purpose could and should be recovered by levies on participating entities which are involved in receiving or paying interchange revenue is a matter for consideration by the authorities concerned. Moreover, it may be necessary to fund the participation of appropriate and relevant consumer bodies.

6.9.5 Avoiding negative consequences of regulation

We appreciate – and this has been emphasised especially by MasterCard[646] – that the regulation of interchange can potentially have negative unintended consequences. Two categories of possible consequences require particular consideration: the effect of regulation on competition between three-party and four-party schemes, and the effect of regulation on

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[645] And for example, administered by the SARB or the National Treasury

[646] See e.g. Transcript 18 April 2007, pp 35-38; Exhibit MM, slide 18; Exhibit BBB, Slides 12 &13; and also MasterCard's published critique on the RBA's regulatory intervention in Australia: *Insights* (MasterCard Worldwide), First Quarter 2007. Although it would not be directly affected by the regulation of interchange, American Express likewise warned in its Submission, October 2006, p 9, against regulatory intervention.

innovation.

The effect on competition between three-party and four-party schemes

It is suggested that three-party schemes such as American Express and Diners Club, in respect of which there is no explicit interchange and which would thus be unaffected by the regulation of interchange, could gain an undue advantage over their four-party rivals. If, for example (so the argument goes), interchange levels affecting the four-party schemes were to be brought down as a result of the regulatory process, the three-party schemes could still maintain their "intrachange" or implicit subsidy from the acquiring side to the issuing side at existing levels, and so provide greater benefits to cardholders for comparable issuing fees than the issuing participants in the four-party schemes could afford. More banks would be inclined to become issuers of the three-party cards under licensing arrangements. The three-party schemes would therefore be able to grow their market share at the four-party schemes' expense – a "perverse" and anti-competitive consequence of regulation.

In order to address the problem rationally, it is necessary first to examine its assumptions and also strip away the elements of special pleading which overlay the manner in which it is expressed.

Just as the interchange in four-party schemes is financed ultimately by the merchant service charges levied by the institutions participating on the acquiring side, so the "intrachange" of the three-party schemes is financed by the merchant service charges which these schemes themselves levy. Our analysis earlier in this chapter has shown that the premium benefits provided to cardholders in the three-party schemes are financed (to the extent that there is reliance on "intrachange") by way of premium merchant service charges. Insofar as the three-party schemes have to compete with the four-party schemes for merchants willing to accept their cards, their merchant service charges must retain a relation to the rough "benchmark" of comparative merchant service charges generally applicable within the far larger four-party schemes. A higher merchant service charge than the norm would thus generally have to be justified by a higher value of benefits to the merchant from accepting the three-party scheme card.

If the process, which we have outlined, of arriving at appropriate levels of interchange to be applied to the four-party card schemes is carried out effectively – if the imbalances in issuing and acquiring costs as well as the differing elasticities of demand on the issuing and acquiring sides of the market are reliably assessed – then the new comparative "benchmark" of merchant service charges resulting in the four-party schemes should be a rational one producing few if any anomalies.

In time, competition between the schemes should then cause the merchant service charges of the three-party schemes to be brought again into a relationship with the four-party

merchant service charges, so that any three-party premium again has to be justified by additional benefits to merchants. It would be different if appreciable market power could be exercised and sustained by three-party schemes over merchants – but at present it is most unlikely that it could.

Assuming that interchange levels were to come down in, say, the credit card payment stream as a result of the regulatory process, it is likely that there would be a period in which the three-party schemes could take advantage of merchant inertia, by continuing to levy their merchant service charges at or relatively nearer to the existing level. (That appears to have happened initially in Australia.) But if – in accordance with the recognised purpose in adjusting interchange – the merchant service charges in the four-party schemes were to come down significantly in consequence of lower interchange rates, then pressure on the three-party schemes to reduce their merchant service charges (or increase their benefits to merchants for the same charges) should follow.

In the interim, the "perverse" consequence entailed in the advantage that could be taken by the three-party schemes as interchange levels come down would be the result of a more fundamental perversity – namely, that the pre-existing rates of interchange had been collectively applied within the four-party schemes at a level above the necessary one, implying the extraction of supra-competitive profits within those schemes. Correcting the more fundamental perversity (assuming there is one which falls to be corrected by the lowering of interchange) should not be held back by fears of resulting temporary anomalies.

The suggestion that the three-party schemes should also be subjected to regulation in this area is not one that we can accept. They do not have interchange. Their "intrachange" is a matter of applying revenue to different costs within a single firm and of that firm's own pricing to its cardholding and merchant customers respectively. To regulate "intrachange" in these firms at this stage would effectively require nothing less than the regulation of merchant service charges. That is not recommended. However, as the three-party schemes develop, the authorities (including the Competition Commission) should keep an eye on the situation. One may expect that their competitors will do the same. If their licensing arrangements were to evolve so that, whatever the form of things, there is in substance a transfer of revenue between different firms in order to use one firm's revenue from the acquiring side to subsidise another firm's issuing, then something akin to a four-party scheme will have been developed. In that event, the adaptation of the regulatory process to include them would have to be considered.

The effect of regulation on innovation

We have addressed this above, recommending that where innovations occur in the form of new methods of payment, including the introduction of new types of payment cards, interchange could (where interchange is necessary) be established for them initially by

private arrangements without immediately facing regulatory control.

The regulatory process would be invoked as and when the development of the new means of payment so takes hold that competition and/or consumer protection concerns arise in connection with the interchange arrangements. So far as existing means of payment are concerned, the flexibility of the interchange-setting methodology which we have proposed, the use of weighted-average costs as a criterion, and the possibility of invoking the process for reviewing interchange levels when new circumstances arise, should allow for and indeed encourage improvements.

The process provides a mechanism for the setting of interchange in all payment streams where interchange is deemed necessary, and provides a framework within which interchange for new payment mechanisms can be assessed and applied. It allows for the avoidance of a situation where innovators are disadvantaged by the pricing decisions of incumbents in a certain PCH and the setting of interchange below sustainable levels.[647]

The possibility which would be open to the four-party schemes of introducing new types of cards – including premium cards – initially outside of the regulated interchange process, should also assist in ensuring a level playing field in this regard between them and the three-party schemes. It is important to ensure, however, that this latitude does not open the way for evasion of interchange regulation. The critical requirements here must be: (a) that the new card is not introduced and issued simply as a replacement, however modified, for an existing card currently subject to interchange regulation, but has to be separately applied for by cardholders; and (b) that the merchant has complete freedom whether or not to sign up for the acceptance of the new card on a separate and distinct basis.

If any aspect of the "honour all cards rule" were to be applied by a scheme or any of its participants so as to constrain the merchant who accepts a card that is subject to the regulation of interchange also to accept the new card, then the new card should be included automatically under the regulatory regime. Should the new card, independently, come to be issued and accepted *en masse*, it would soon enough become a candidate for inclusion in the regulatory process in its own right.

6.10 Other rules of the schemes

6.10.1 The "honour all cards" rule

The "honour all cards" rule is often abbreviated in the submissions as the "HAC rule" or the "HACR".

647 Concerns related to current pricing practices affecting innovation are further discussed in the Chapter on Access to the Payment System.

MasterCard Worldwide explains that

> the HAC rule stated that if a merchant participates in the MasterCard system it must accept all MasterCard-branded cards. The rule ensured that consumers have the ability to choose their preferred method of payment at the point of sale. In fact, many networks that offer payment cards --- including MasterCard, Visa and American Express – have honour all cards rules.[648]

MasterCard International's *Merchant Rules Manual* (Revised 7 April 2006), which was submitted to the Enquiry, provides excerpts from MasterCard bylaws and rules published in April 2005.[649] These include that "each participating merchant must accept MasterCard cards universally",[650] and that the merchant "must honor all valid MasterCard cards without discrimination when properly presented for payment."[651] As to the comparable Maestro rules, see *Maestro Global Rules* (published July 2005).[652] MasterCard has confirmed that these rules allow merchants to accept either all MasterCard cards or all Maestro cards, or both, as they wish.[653] However, that would still oblige the merchant who accepts MasterCard credit cards also to accept all MasterCard-branded signature-based debit or "cheque" cards (hybrid cards).

Visa's general rule in this regard is as follows:

> If a Merchant decides to participate in the Visa International Network, the HACR obliges the merchant to accept all Visa Cards equally.[654]

Visa's International Operating Regulations lay down that a merchant "must accept all Cards properly presented for payment, as specified in *Table 4-1*."[655] The effect of the table is to include (*inter alia*) all Visa and Visa Electron cards in the HACR.

These provisions – to the extent that they are not subject to exceptions applicable in various jurisdictions – combine into one rule what we would rather separate for purposes of analysis into two rules, namely an "honour all products" rule and an "honour all cards" rule in the narrower sense of all scheme cards of the same product type.

Taking the HAC rule in its narrower sense, we consider it to be legitimate. The positive network effects of payment card systems have been discussed above. The schemes exist precisely to maintain and develop such networks. The benefits to cardholders of being able to carry and rely on using a card instead of cash are obviously fundamental to the viability of

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648 http://www.mastercard.com/us/company/en/newsroom/discover_lawsuit.html

649 MasterCard, October 2006, First Submission, Annex O.

650 *Id.* Chapter 2, Rule 6.5.1.

651 *Id.* Chapter 2, Rule 9.11.1.

652 *Id.* Chapter 6, Rule 5.5.1 and Rule 7.1.6.

653 MasterCard, March 2008, Further Documentation and Information Requested by the Banking Enquiry, p 4.

654 Visa, First Submission, October 2006, p 52.

655 *Id.,* Annexure F (on CD-ROM), Vol 1, Chapter 5, Rule 5.1.B.1.a.

the schemes. If merchants displaying the scheme logo applicable to a certain card type were able to refuse to accept that card when it suited them – to differentiate between cardholding customers individually, for example by place of origin (local or foreign), or according to the identity of the issuing bank – then the schemes themselves would be radically undermined.

MasterCard notes that "The HAC rule also leads to the obligation of the acquirer to the merchant to guarantee payment irrespective of the identity of the issuer."[656] The obligation of the merchant to honour all cards of the same product type is a perfectly reasonable counterpart of the obligation of every issuing bank to pay the particular acquirer, and not choose whether or not to enter into and honour transactions depending on the identity of the merchant or the acquiring bank, etc.

6.10.2 The "honour all products" rule

The matter is different, however, with the "honour all products" rule.

This rule, in our opinion, facilitates the accumulation of market power by schemes and their participants over merchants. In principle, we consider that it constitutes anti-competitive product bundling or "tying" for which no necessity exists. It obliges the merchant who wishes to accept a card of one type (under the particular scheme) to accept cards of other types also notwithstanding that the latter may cost the merchant more on account of a higher merchant service charge per transaction resulting from a higher interchange rate.[657]

In South Africa, interchange hitherto has varied only according to whether the card is a (PIN-based) debit card, a credit card or a hybrid card.[658] In future, however, there could be different interchange rates for premium credit cards, for example. The introduction of the EMV card may also bring with it different interchange rates.[659] In our view, where a different interchange rate is applicable to the type of card, the merchant should have a choice whether or not to sign up for the acceptance of that card (and so be obliged to honour all cards within the accepted card type).[660]

The "honour all products" rule has been removed in several jurisdictions including Australia,

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656 MasterCard, October 2006, First Submission, p 63.

657 It should be noted, moreover, that the existence of the "honour all products" rule in South Africa, by compelling merchants who only wish to accept debit cards to accept credit cards also, will have had the effect *inter alia* of forcing them to bear the burden – under the existing interchange arrangements – of certain of the costs of credit extension engaged in by by issuing banks in which they (the merchants) may wish to have no part. MasterCard does not oblige merchants to accept both MasterCard branded cards and Maestro branded cards (see above). Visa does however require merchants to accept both debit and credit cards under their brands (see Visa, October 2006, First Submission, Annexure F (on CD-ROM), Vol 1, Chapter 5, Rule 5.1.B.1.a.).

658 See above.

659 See footnote 180.

660 If interchange rates were to vary by merchant category, the distinguishing criterion for our purposes would still be whether the merchant is affected within that category by different interchange rates applicable to the different card types.

while leaving the "honour all cards" rule otherwise intact.[661] There is no evident damage to the viability of the card schemes as a result.

In the United States, the "honour all products" rule has effectively been eliminated by way of a settlement arising out of litigation initiated by Wal-Mart and others. This has applied to both the Visa and MasterCard schemes. Visa says:[662]

> In the United States, as part of the Wal-Mart settlement, Visa USA, Inc. and MasterCard agreed to bifurcate the "honour all products" dimension of the HACR (i.e. both payment card schemes no longer oblige merchants to accept debit cards and credit cards in the package of products covered under the acceptance contract).[663] In Australia, Visa International and MasterCard were compelled by regulation to bifurcate the "honour all products" dimension of the HACR.

"Bifurcate" seems to be a euphemism for "abandon".

The following more detailed account of the settlement in the US is given by MasterCard, naturally promoting its point of view:[664]

> In June 2003, MasterCard signed a settlement agreement on all claims in the class-action antitrust lawsuit brought against MasterCard and Visa in 1996 by merchants in the United States. … [U.S. District Court Judge John Gleeson approved the settlement on December 19, 2003.]
>
> The suit, which was initiated by Wal-Mart and several other merchants, challenged each card association's Honor All Cards rule. The merchants claimed that they did not want to accept consumers' MasterCard- or Visa-branded off-line, or signature-based debit cards, and that the associations violated the antitrust laws by tying acceptance of debit to acceptance of credit. As a remedy, the merchants sought billions of dollars in damages as well as the right to elect not to accept MasterCard-branded debit cards while accepting MasterCard credit or charge cards.
>
> The settlement agreed to by MasterCard and the merchants ensures that the payments system will continue to work for consumers, merchants and MasterCard member financial institutions. It preserves the important consumer benefits of MasterCard's Honor All Cards rule, while giving merchants flexibility to choose how broad a range of payment choices to offer their customers.
>
> MasterCard's key consumer protections prohibiting merchants from surcharging cardholders or discriminating against any MasterCard card or cardholder will be maintained for credit and charge cards and honored by merchants who continue to accept MasterCard debit cards. Merchants will have the right to choose not to accept U.S.-issued MasterCard debit cards, and under the terms of the agreement, MasterCard is free to establish an Honor All Cards rule for MasterCard debit cards. This will ensure that merchants who accept MasterCard debit will accept all MasterCard-branded debit cards.
>
> MasterCard also agreed to establish a new interchange rate for debit at least one-third lower than the existing interchange rate, and at a level which should incent [*sic*] both issuance and acceptance of MasterCard debit cards. MasterCard will also develop rules requiring issuers to

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661 Transcript 17 April 2007, p 27.

662 Visa, October 2006, First Submission, pp 57-58.

663 Visa added: "It should be noted that under the terms of the US Wal-Mart Settlement, bifurcation only applies to domestic cards issued in the US."

664 http://www.mastercard.com/us/company/en/newsroom/merch_law.html

> clearly and consistently identify MasterCard debit cards on their face and to make these debit cards identifiable through electronic terminals.
>
> Also as part of the agreement, MasterCard agreed to pay into a settlement fund for eligible merchants $100 million a year for ten years, except for the first year when the payment will be $125 million.
>
> One result of this lawsuit is that after January 1, 2004, the date by which merchants can choose to accept MasterCard-branded credit cards but not MasterCard-branded debit cards, some consumers may get to the front of the checkout line and find that the merchant rejects the payment option they have chosen. While this could impact a consumer's ability to choose their preferred method of payment, MasterCard is confident that because of the strength of the MasterCard brand and the value proposition it brings to merchants and consumers, the vast majority of merchants will continue to choose to accept MasterCard-branded debit cards.
>
> If a consumer finds that after January 2004, a merchant rejects his/her MasterCard-branded debit cards, the consumer has several options. First, the consumer can choose a store that welcomes the MasterCard debit card. Alternatively, the consumer can utilize a MasterCard credit card or other form of payment. Finally, the consumer can express his/her opinion that the merchant should offer their customers the broadest choice of payments by accepting MasterCard debit cards.

In South Africa, the elimination of the "honour all products" rule would seem most likely to facilitate the acceptance of debit cards, by completely freeing the acceptance of these cards from being tied to more expensive credit card acceptance by merchants.

If the complete withdrawal of the "honour all products" rule cannot be negotiated on a voluntary basis with the schemes concerned, then we would recommend a regulation or other appropriate statutory intervention to prohibit it. If this is not forthcoming within a reasonable time, we would recommend that the Commissioner give consideration to initiating and investigating a complaint or complaints of possible contraventions of the Competition Act through the application of the "honour all products" rule.

6.10.3 The rule against surcharging

MasterCard International's Bylaws and Rules (published April 2005) provide that a merchant must neither directly nor indirectly require any MasterCard cardholder to pay a surcharge or any part of any merchant discount – i.e. the merchant service charge levied on the merchant by the acquirer – or any contemporaneous finance charge in connection with a MasterCard card transaction. However, a merchant may provide a discount to its customers for cash payments. A merchant is also permitted to charge commission, postage, an expedited service fee, etc., provided that the fee is charged on all like transactions regardless of the form of payment. "A surcharge is any fee charged in connection with any MasterCard transaction that is not charged if another payment method is used."[665]

Visa's rules are similar in effect, save that the latitude allowed to merchants to provide

[665] MasterCard, October 2006, First Submission, Annex O, Chapter 2, Rule 9.12.2. Chapter 6, Rule 7.2.3 of the *Maestro Global Rules* (published July 2005) is to similar effect.

discounts or other incentives extends beyond payments in cash to include rival networks' payment cards.[666]

It is argued that the rule against surcharging is necessary to sustain the "honour all cards" rule.[667] There seems to be merit in this argument, at least so far as the legitimate ambit of the "honour all cards" rule (i.e. in its sense of cards of the same product type) is concerned.

At first sight this view may seem to lack foundation inasmuch as merchants who have signed up to accept scheme cards do not widely use surcharging where it is allowed.[668] For example, there has been only a small incidence of surcharging by merchants in Australia.[669] However, it stands to reason that consumers will tend to be deterred both from taking cards and from attempting to use them once issued, where surcharging is known to be a real possibility. As Visa puts it:[670]

> … even though surcharging, where it is permitted, may affect only a minority of transactions, it can still have profound effects on the reputation and reliability of the payment card system which can consequently lead to a reduction in the number of cardholders and/or card usage, in particular, as cardholders will tend to "blame" the system and not the merchant if they are surcharged. …
>
> One recent example of the impact of abolishing no surcharging rules is the experience in Denmark following changes to the Danish Payment Act, which permitted from 1 January 2005 charging only a capped MSC to merchants and to surcharge Dankort (the Danish national debit system) transactions. The total number of Dankort transactions fell from 42 million in January 2004 to 33 million transactions in January 2005 following the introduction of surcharging. Similarly, the average number of Dankort transactions per card fell from 175 in 2004 to 167 in 2005 due to customers' fears of being surcharged. Due to opposition from cardholders, pre-election debate created political pressure to change the legislation again with the result that surcharging has not been allowed on Dankort transactions since March 2005 and on any Danish issued card since June 2005. …
>
> Although the Danish Competition Authority estimated that only approximately 19 per cent of (mainly the very large) merchants initially surcharged in Denmark, the effect on cardholders across the board was substantial as it resulted in the loss of certainty for cardholders that a payment card could be used anywhere which accepted that particular payment card, without penalty or unpleasant surprises and consequently without damage to the payment card's reputation.

In Australia, however, where a far smaller percentage of merchants engaged in surcharging after the rule against surcharging was prohibited (see above), a negative effect on card issuing and usage has not so far been shown.

During our hearings, Absa indicated that it would not have a problem with abolition of no-

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666 Visa, October 2006, First Submission, p 48.

667 See e.g. Visa, October 2006, First Submission, p 52.

668 Nor do they discount for cash in order to discourage the use of cards: Transcript 17 April 2007, p 26.

669 Visa, June 2007, Second Submission, document A p 3, referring to the Datamonitor report 2005, p 46.

670 Visa, October 2006, First Submission, pp 53-54.

surcharging rules;[671] however, it would not want merchants to be able to surcharge in excess of the merchant's service charge when accepting payment by card.[672] In our view, it would not be practicable to have to track and enforce such limits. The rules against surcharging should either stay or go. Generally, we do not consider that there is sufficient reason in the public interest to prohibit such rules.

Because of "price coherence" and the cost to merchants of price differentiation, the freedom to surcharge would not provide adequate protection for merchants (and end consumers) against the abuse of interchange setting by the schemes and their participating banks. Thus the abolition of the "no surcharge" rule, in and of itself, would be of little use as a remedy. If, on the other hand, the "honour all products" rule is eliminated, and if the setting of interchange is subjected to an independent, objective and transparent process under regulatory supervision as we recommend, then the continued existence of the "no surcharge" rule can do little if any harm, at least in domestic transactions.

Indeed there are positive reasons for maintaining the rule. Surcharging, where permitted, has mostly been utilised by large merchants rather than smaller ones, or by merchants having market power over customers as a device for extracting additional revenue. We find the following submission by Visa persuasive:

> … [E]xperience has shown that customers are most likely to be surcharged where they are "captive" card-using customers. A captive card-using customer is one who, on a particular buying occasion, does not have ready access either to a non-surcharged means of payment, such as cash, or to a card-accepting merchant who is not levying a surcharge. The high cost to cardholders is particularly onerous where merchants, taking advantage of the fact that the customer may have no choice but to pay with a payment card, seek to make a profit from surcharging by imposing a surcharge with no reference to what it costs the merchant to accept the card. Foreign and out-of-town consumers are those likely to be most at risk.

With the increasing influx of tourists to South Africa, and as 2010 approaches, the argument for retaining the no-surcharge rule as a measure of consumer protection appears all the stronger. Although international interchange rates would not be subject to the regulated domestic process which we recommend, we would advise caution at this stage over any attempt to interfere with the schemes' "no surcharge" rules even in respect of international transactions.

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671 Transcript 17 April 2007, p 98.

672 *Id.*

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.

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[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.

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[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.

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[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

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[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

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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 Saambou[13] in 2001, its liquidity problems were apparent in the payment system long before they were apparent in any statutory Deposit-Taking Institution (DI) returns.

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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 instruments[16] 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.

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[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 though 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)

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[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 code[20] 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]

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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]

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[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]

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[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

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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")

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[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.

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[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 intervention[39] 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.

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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]

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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.

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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 Constitution[46] 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 Act [47] 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

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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.

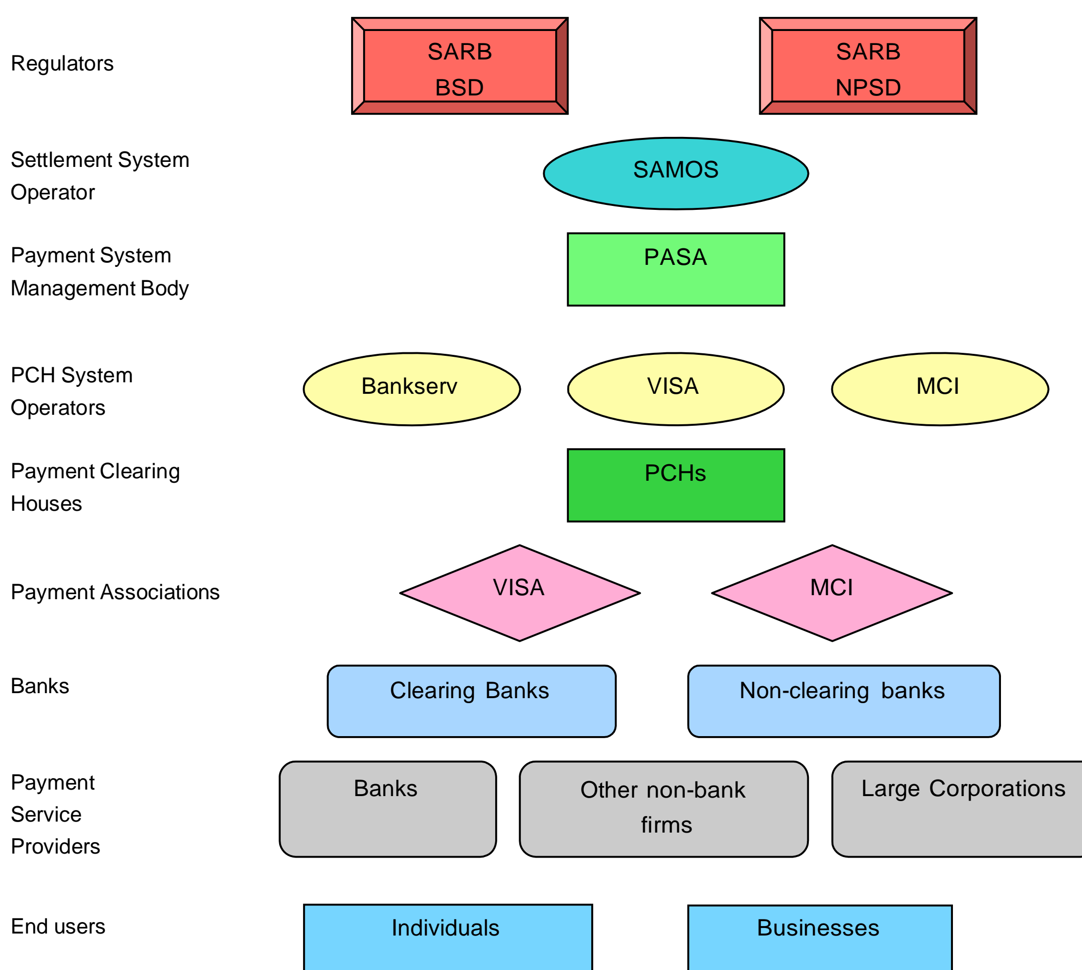
> play a central role in establishing and controlling Payment Stream Associations representing the banks participating in each particular payment stream. It was the view at the time that although the Bank would remain responsible for the overall safety and soundness of the NPS, the clearing environment 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 though 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

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[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.

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[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]

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[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 to do not form part of the deferred clearing and settlement process from Bankserv to SAMOS for the low-value streams.

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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 System[60]	6,130	0.10	5,917	0.16	28,721	0.79
Debit Card[61]	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 though 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

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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 though 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

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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 anomoly 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.

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[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.

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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

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[71] Transcript 19 June 2007, pp 116-119.

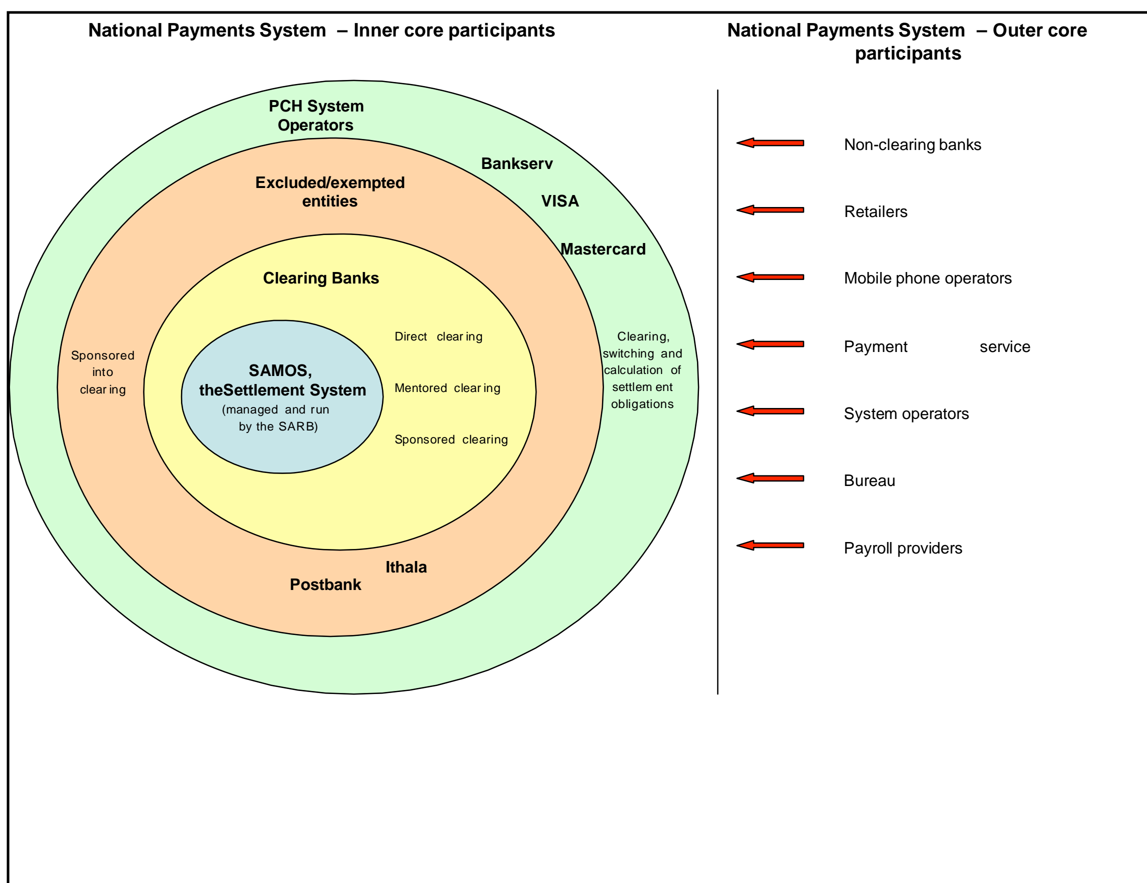
> deemed capable of affecting members directly or indirectly. I read that to mean, if national policy was to suggest … [w]hat is deemed to be against the interest of your members, in that specific situation you would be called upon to act as an advocacy group and you are no longer acting as a body mandated 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, bureaus 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.

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[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 banks[75] 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 though 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.

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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 participant[80] 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.

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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 form 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.

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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]

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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	Investec Bank	Debit card and ATM streams
FRB	Grindrod Bank [90]	ATM, EFT, debit and credit card
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]

FRB mentors Investec and Grindrod Bank. The debit card and ATM payment streams form part of the mentorship agreement by FRB with Investec. Grindrod Bank also has the abovementioned payment streams as well as EFT PCHs. FRB has not indicated that there are any underlying concerns regarding mentorship.[93]

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 Rennies 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 is 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.)

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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 machines[102] 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]

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[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 arise[110]
- Direct submission to NPS operators bypasses the banks even though the banks still carry the risks

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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 common-place.

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.

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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 providers [117] as well as system operators.[118]

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[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 though 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.

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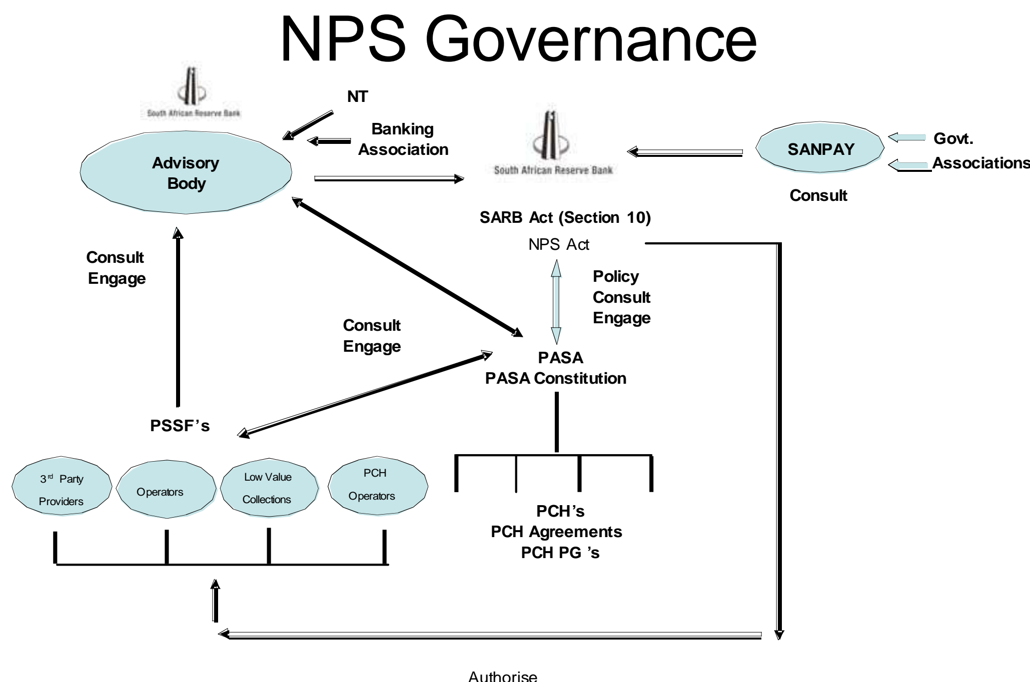
[119] Section 2.4 of the document.

Figure 3 Proposed NPS Governance Structures



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:

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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.

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[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]

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[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	Bidvest Bank	Correspondent banking function – settlement of international card transactions
Standard	SAPO/Postbank	ATM, EFT debit & credit, Mzansi money transfers and debit card

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 ABSA[134] 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.

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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]

SBSA indicates that its arrangement with Postbank (which they refer to as South Africa Post Office (SAPO)/Postbank) is not altogether satisfactory:

Confidential: SBSA

In terms of the Banking Models Position Paper 2000/02 issued by SARB, and the rules relating to the Banking Models Position Paper issued by PASA[141] if the sponsored bank's volumes and value in any PCH exceed 10% of the sponsoring bank's volumes and value, the sponsored bank must, within 12 months, find another sponsoring bank or change its status and become a mentored clearing bank in the applicable PCH. Currently SAPO/Postbank exceeds SBSA's volumes by more than 10%,[142] predominantly in relation to ATM transactions. This area of concern has been reported to PASA, the SARB and national treasury.

SAPO/Postbank participates in the NPS as an entity exempted from the Banks Act and the NPS Act and is unable to become a bank. Its primary regulator is the minister of post and telecommunications while the primary regulator of banks is the minister of finance. This presents a conflict as the two portfolios have different objectives. For this reason, SBSA finds itself in a difficult position as a commercial bank (rather than the SARB) attempting to govern and oversee a government entity in a highly regulated NPS with very little authority with which to compel compliance.

… The risk introduced into the payments system is systemic in nature, given that SAPO/Postbank's volumes are significant (in some payment streams they are more than 10% of SBSA volumes). If SAPO/Postbank experienced settlement failure the quantum of the failure could have extensive impacts on the industry as a whole.

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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 What is evidently meant here is that Postbank's volumes exceed 10 per cent of SBSA's volumes.

Confidential: SBSA

> A further concern is that SBSA, as a commercial bank, is responsible for the full extent of SAPO/Postbank's participation in the NPS. This includes clearing, switching, settlement, operational risk and risks associated with un-mandated and/or fraudulent transactions introduced by SAPO/Postbank into the NPS.[143]

Confidential: SBSA

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 below[144] 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

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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.

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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.

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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 Rennies 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 it 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.

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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:

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[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

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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 Dandyshelf, 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.

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[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

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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).

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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?

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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 position[169] – 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

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[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

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[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

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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.

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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 money[179] 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.

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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 majority[182] – 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

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[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,

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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.

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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 arrangements[190]. 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 by-passing 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

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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]

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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?

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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

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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.

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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.

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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.

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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.

Chapter 8

Conclusion and Recommendations

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8.1 Conclusion

In conclusion, it is appropriate to refer to the Competition Act to remind ourselves of what the Legislature anticipated in promulgating the Act. The Preamble to the Competition Act stipulates that:

> The people of South Africa recognise:
>
> That apartheid and other discriminatory laws and practices of the past resulted in excessive concentrations of ownership and control within the national economy, inadequate restraints against anti-competitive trade practices, and unjust restrictions on full and free participation in the economy by all South Africans.
>
> That the economy must be open to greater ownership by a greater number of South Africans.
>
> That credible competition law, and effective structures to administer that law, are necessary for an efficient functioning economy.
>
> That an efficient, competitive economic environment, balancing the interests of workers, owners and consumers and focussed on development, will benefit all South Africans.

In fitting with the Preamble, the main objectives of the Competition Act are set out as follows:

> The purpose of this Act is to *promote and maintain* competition in the Republic in order –
>
> (a) to promote the efficiency, adaptability and development of the economy;
>
> (b) to provide consumers with competitive prices and product choices;
>
> (c) to promote employment and advance the social and economic welfare of South Africans;
>
> (d) to expand opportunities for South African participation in world markets and recognise the role of foreign competition in the Republic;
>
> (e) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and
>
> (f) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons.[1]

The recommendations of the Enquiry contained in this report are an attempt to introduce or encourage changes in the South African banking sector, which will be in line with the objectives of the Competition Act.

The recent developments in overseas markets in respect of the banking sector which have been referred to in this report – such as the shift to a direct charging model for ATMs in Australia, the investigations into payment card interchange in a number of jurisdictions and the opening up of payment systems to non-bank payment service providers in Europe and Australia – cannot be ignored and they call for concerted intervention by the South African regulators.

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1 See Section 2 of the Act. (Own emphasis) Subsection (f) is unique to South African competition law (see *Anglo South Africa Capital (Pty) Ltd and others v Industrial Development Corporation of South Africa and another* 2004 (6) SA 196 at 206F (CAC).

Some of the contemplated changes have been canvassed with the banking sector and other stakeholders during the hearings and through consultations between the Enquiry Technical Team and relevant stakeholders. As can be expected, there was not a meeting of minds in respect some of the recommendations.

It is apparent from the objectives of the Act that promoting efficiency, developing the economy and providing consumers with competitive prices and product choices should be the goal of any government or regulator which seeks to protect consumers in a developing economy.

Section 21(1) of the Competition Act gives the Competition Commission the responsibility to implement measures to increase market transparency. Section 21(2)(*b*) empowers the Commission to enquire into and report to the Minister of Trade and Industry on any matter concerning the promotion and maintenance of competition in the Republic.

Our Constitution, the supreme law of the country, enjoins us to strive for a democratic and open society. Transparency and accountability are values enshrined in our constitution. Banking customers should benefit from these values as well. Traditionally banking has been a secretive industry, and this was manifest at times during the Enquiry. Nevertheless, and despite participation in the Enquiry being voluntary, a great deal of information was provided and examined in public.

Some of the issues addressed in this report were highlighted but not conclusively dealt with in two previous investigations into competition in the banking sector. We have had the benefit of considering some of the issues raised in the Task Group (Falkena III) and FEASibility reports.[2] The work in these two reports has been invaluable to us. We have had the further benefit of receiving submissions (both verbal and written) directly from the banks and other stakeholders. All interested persons and stakeholders, including the banks, were invited to respond to the FEASibility report and voluntarily to provide detailed information and answers on relevant questions to the Enquiry.

The Competition Commission has not initiated any specific complaint and has accordingly not invoked its formal powers to compel the production of information and answers to question in connection with this enquiry. We therefore appreciate the voluntary co-operation of the banks, regulators and the other stakeholders who took trouble to prepare and make submissions to the Enquiry. The conclusions and recommendations contained in this report are based in large part on those submissions.

[2] See Chapter 1 for a summary of these reports.

The Banking Enquiry Report is the beginning of a process which will assist the Commissioner in deciding whether to initiate a formal investigation into any of the current practices in the banking sector. Whilst this Enquiry (within the limits of its terms of reference) examined the banking sector generally and was a voluntary process, the Commissioner may follow a different process based specifically on the powers given to him by the Competition Act and our constitutional legal framework.[3] In our analysis of the submissions, and in making recommendations, we have always been guided by this fact. It is in this context that this report must be read.

We are aware of the fact that some of the banks have implemented some changes during the course of the Enquiry with the view to addressing some of the issues which were its subject matter. In considering these changes, the Commissioner will have to consider their sustainability and the context in which they were undertaken.

We are also aware of the proposed new developments in so far as the powers of the Competition Commissioner are concerned. The Department of Trade and Industry, we are advised, is contemplating an amendment to the Competition Act, which will enable the Commissioner to set up other enquiries similar to this one, with more powers than is currently the case.

In our view, there is no better way to end this Report than with the quote:

> It is not the strongest of the species that survives, nor the most intelligent, but rather the one most adaptable to change.[4]

The Competition Act seeks to introduce changes in the manner in which we as South Africans do business. Those businesses which don't want to change will encounter challenges in the South African market.

The *Business Report* of 15 November 2006 stated that:

> The Reserve Bank Governor, Mr Tito Mboweni, said yesterday that it was appropriate for the Competition Authorities to investigate high fees in the banking industry…

The necessity for the Enquiry has been confirmed by the public and stakeholders' support, for which we are grateful.

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[3] See Sections 46 to 51 of the Competition Act.

[4] Attributed to Clarence Darrow in *Improving the Quality of Life for the Black Elderly: Challenges and Opportunities*: Hearing before the Select Committee on Aging, House of Representatives, One Hundredth Congress, first session, 25 September 1987.

8.2 Recommendations

The recommendations of the Enquiry aim to address the concerns raised by various stakeholders. In particular, and of chief concern, has been the experience that consumers have brought to the attention of the Enquiry. Moreover, the concerns raised by merchants, non-bank service providers and small banks have also been examined by the Enquiry with a view to making appropriate recommendations.

The recommendations of the Enquiry set out below are summarised from the various chapters of the report. Those chapters should be referred to directly for more detail.

8.2.1 Recommendations on product and price comparison and switching

The report identified a clear need for measures aimed at improving the ability of bank customers to compare product offerings and prices and switch providers with a minimum of cost and difficulty.

In order to achieve these objectives the Enquiry recommends:

Standards and criteria for transparency and disclosure

The Banking Association should develop a set of minimum standards for the disclosure of product and price information to be included in the Banking Association Code of Banking Practice.[5]

This code should at least include criteria regarding:

- Standardisation of terminology and a “plain language” requirement
- Communication and provision of information to clients
- A requirement for at least certain minimum information to be included in bank statements
- A summary and breakdown of charges and interest (both debit and credit) on every account
- Advance notice of new charges and altered charges
- A regular rights reminder to customers.

The code on transparency and disclosure should be subject to a process of periodic review.

5 After consultation with the Ombudsman for Banking Services, consumer protection agencies and organisations, the regulatory authorities, the Competition Commission and other relevant bodies.

The provisions of the code should be incorporated by reference into banks' standard customer contracts, so that the protection which they afford to customers become part of the customer's contractual rights capable of being enforced with the assistance of the Ombudsman for Banking Services. Although membership of the Banking Association is not compulsory for banks, and its code is therefore not binding on every bank, all the major banks are members and would be bound by changes to its code. Should this position change, or should the provisions of the voluntary code prove inadequate for the purpose described, a legislative or regulatory intervention would be warranted to impose appropriate standards on all banks.

Measures to reduce search costs and improve the comparability of banks' product offerings and prices

While improvements in transparency and disclosure of product and price information should help reduce search costs, the Enquiry found that more direct and proactive measures are needed to simplify comparisons between the prices and product offerings of different banks.

Therefore the Enquiry recommends that:

- Generic customer profiles be drawn up and publicised to facilitate comparison shopping. In this regard, a "profile" is essentially a typical combination of customer needs.

  For this purpose, the Banking Association should initiate and support an independent process to establish a limited number of generic profiles that would apply to various typical customers of all banks in the middle market segments.[6]

  Once the profiles are established, and publicised by the Banking Association, the different banks can reveal in their own advertising and other information whether, how and to what extent they accommodate them, and their respective prices in that regard. Misleading advertising could then be combated via the Advertising Standards Authority, or with the assistance of the Ombudsman for Banking Services.

  A regular review would also be needed:

  - To account for changes in technology and consumer behaviour
  - To monitor the effectiveness of the process in facilitating comparability and stimulating price competition

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[6] This will not be a simple task, as banks themselves apply somewhat different criteria when deciding on the segmentation of their product market. Thus the profiles must be constructed from the point of view of various typical customers, and not from the point of view of particular banks. To the extent, say, that some customers may typically prefer a product bundle emphasising electronic payment channels, and others the facility of branch and paper-based transactions, that would have to be taken into account in deciding on the range of appropriate profiles.

  - o To determine whether any changes to profiles and/or the process is necessary in order to achieve the stated objectives.

- Establishment of a centralised banking fee calculator service. This should provide an accessible facility for consumers to input their own product requirements – with assistance if necessary – and obtain (without cost) an automatic, objective indication of where they could obtain those services and for what prices.[7]

- The Competition Commissioner should propose to the Minister of Trade and Industry that serious consideration be given to permitting comparative advertising that would allow banks to compare their own prices and product offerings directly and explicitly with those of their rivals.

- If, after two or three years, the recommendations put forward to improve comparison and switching have not been implemented or (once implemented) have not had the desired effect of increasing price competition and bringing prices down significantly, then the Competition Commissioner should revisit the idea of obliging the banks to provide one or more “basic banking products” with similar content, capable of being simply and directly compared. This would enable customers, whose needs would be satisfied by such a particular product, to compare price and choose their bank accordingly. That in turn would intensify price competition, and cut across the existing segmentation of the market at least to the extent that segmentation has been contrived by banks in order to maintain market power.

Measures to reduce switching costs and assist consumers switching

Easier product and price comparison will not help consumers much if it remains too expensive or troublesome to switch banks. Measures to reduce switching costs and assist bank customers in switching are therefore of crucial importance.

- Code of switching practice
  We recommend that the Banking Association develop a set of criteria for a switching code to be included in the Banking Association Code of Banking Practice. This code should include criteria regarding:

  - o The provision of sufficient information and documentation by banks to new and existing customers explaining the process of switching in their branches.

  - o A schedule in terms of which the old bank is to provide the new bank with information on standing orders and direct debits within a specified period of time of

[7] It would be up to the banks to make available reliable product and pricing data (open to public inspection and to audit and correction by the Banking Association in the event of dispute), if they wish their services to be included in the answers supplied by the calculator service.

receiving the request to do so.

- o A schedule in terms of which the balance on the account, standing orders and direct debits, net of any charges and interest but including any interest due, will be transferred from the old bank directly to the new bank, and the account with the old bank closed, within a specified period of time.
- o Provision to be made for customers to be exempt from paying, or be refunded, any fees and/or interest charges which are incurred within a specified period after the new account is opened as a result of a failure in the switching process.

The code on switching should also be subject to an independent process of periodic review.

- We recommend that the National Treasury encourage and pursue the notion of a central FICA information "hub" in consultation with the banking industry, to see whether it could be established as a central repository of customer information used to facilitate compliance with FICA and operated in a manner that is consistent with the anti-money laundering objectives of FICA.

Expand the mandate of the Ombudsman for Banking Services

We recommend that the role of the Ombudsman for Banking Services be expanded to include enforcement and monitoring of compliance with the proposed codes of conduct for information disclosure and switching.

8.2.2 Recommendations on costing and pricing

The pricing initiatives said to be aimed at reducing the fee-burden on customers – such as *ad valorem* pricing, banded fee options and appropriate bundled packages – which were highlighted by the banks during the course of the Enquiry, do not appear to be generally offered to lower-income customers. It is puzzling that the benefits of such initiatives do not accrue to those who most need them. Building on from our recommendations on product and pricing comparison and switching, we recommend that together with improving transparency, standardising terminology and educating customers, the Banking Association should encourage the appropriate application of these pricing initiatives to entry level accounts.

The Mzansi initiative, which is making considerable progress in extending banking services to the previously unbanked, also needs constant scrutiny to ensure that the structure of its bundling and pricing is truly pro-poor.

Consideration should also be given to ensuring that recipients of social grants are not disadvantaged by the cost of receiving and accessing their grants though bank accounts.

8.2.3 Recommendations on penalty fees

Both the level and the volume of the fees charged for rejected debit orders by the major banks provide grounds for grave disquiet. Payment by debit order is routinely required nowadays for all manner of regular services which have become an essential part of everyday life. Reliance on debit orders is widespread throughout the mass market served by banks, and it is notable that debit order facilities have recently been added to the basic Mzansi account offerings.

Analysis of the banks' data revealed that the average rate at which debit orders are rejected, and thus attract a penalty fee, is roughly twice as high for basic savings or transmission accounts as for all PTAs taken together. In other words, in accounts typically held by lower income customers, a relatively high proportion of debit orders presented for payment are dishonoured for insufficient funds. This means that the burden of penalty fees is falling disproportionately on those least able to afford them. Where detailed data has been provided, indications are that *as much or even more* revenue is earned by banks from rejected debit orders on these accounts than from the processing of successful debit orders.

Many ordinary bank customers are not in a position to pad their bank accounts with funds that are surplus to their immediate needs. They face the situation where, when credits such as salary payments are delayed, this causes the debit orders which they have signed in good faith to "bounce" for insufficient funds. It is not a matter of neglect, or irresponsibility, but of circumstances beyond their control. Yet the penalty fee is applied per debit order item, so that a customer may face multiple penalties to add to the primary misfortune of getting paid late. Customers on low incomes, with tight credit margins, can readily find themselves lacking sufficient funds without having had any intention of defaulting on their payments or of breaching their undertakings to the bank.

It seems to us quite unacceptable that a bank should recover more than the cost incurred in processing the rejections in such cases. It is no answer for banks to say that, on application, they might reverse the penalty fee in a deserving case. Very many consumers – even if they were assured of the possible indulgence – would suffer in silence rather than muster the confidence, or find the time, to challenge the debit when it appears on their account.

We recommend that a cap be imposed on the price of processing rejected debit orders at approximately R5 per dishonoured item. We have no reason to believe that, currently, banks

would be unable fully to recover their costs ordinarily incurred in respect of rejected debit orders within such a cap.

Such a cap should be imposed by regulation. It should apply both to savings and current accounts, and to ordinary as well as early debit orders. Banks, which incur additional expenses or losses in particular cases through their customers' default in respect of debit orders, can terminate those customers' accounts and/or sue for damages.

The regulatory remedy should also include a provision to ensure that the re-presentation of dishonoured items cannot itself amount to an abuse.

Whether such price regulation should be imposed using existing regulatory powers of the SARB, or by way of section 9(1) of the Sale and Service Matters Act 25 of 1964 (as amended), or by other existing or special legislation is a matter on which we are not best placed to express an opinion.

In our view, if the necessary regulatory intervention is not forthcoming within a reasonable time, the Competition Commissioner should recommend to the Minister of Trade and Industry that he consider directing the Consumer Affairs Committee established under the Consumer Affairs (Unfair Business Practices) Act 71 of 1988 (as amended) to conduct a full-scale investigation into dishonour fees in respect of debit orders charged by the four major banks.

Should the latter Act be replaced by the enactment of the Consumer Protection Bill, 2007, now before Parliament, then the necessary investigation could be initiated or continued as may be appropriate under the new Act.

We also recommend that systems should be put in place by the banks, which will enable customers to cancel any direct debit instruction at any time by phone, internet, or over the counter at a branch (subject to written confirmation by the customer where necessary). This would not alter the customer‘s contractual obligation to the creditor in respect of payment arrangements.

8.2.4 Recommendations on ATMs and direct charging

ATM cash withdrawals are a common activity for most bank customers. In 2006 around 1 billion ATM transactions were made through the network, generating gross revenues in excess of R4 billion for banks. We have come to the conclusion that pricing arrangements between banks have served to shelter the provision of ATM services from effective price competition, and that this situation needs to be changed.

In particular, we are concerned with the pricing arrangements that are currently in place when a customer of one bank uses the ATM of another bank. While only 15 per cent of ATM transactions are of this kind (i.e. off-us transactions), analysis shows that they have been unduly restricted and that the pricing arrangements in respect of them have had and continue to have repercussions for all cash withdrawal transactions made at an ATM.

The consumer is typically charged a substantially higher fee for off-us transactions, and for an average sized cash withdrawal a substantial part of this fee is retained by the issuing bank although it has not provided the cash dispensing service. The fee that is paid by the issuing bank to the service provider (that dispenses the cash) for an ATM transaction is generally referred to as carriage. Carriage is a fee agreed upon between banks – i.e. an inter-bank fee. Not only is carriage itself sheltered from competitive forces; the consumer is not free to shop around for ATM services but – also by inter-bank arrangement – treated as belonging to the issuing bank in all ATM transactions. Accordingly banks' own ATM services to their customers are also significantly sheltered from competition.

If the carriage fee is abolished and the cash provider instead charges the consumer *directly* for the cash dispensing service (i.e. if the direct charging model is adopted), price competition can become more effective.

We recommend that the current inter-bank pricing system of carriage be replaced with a model of direct charging in the ATM stream as soon as possible.

For the direct charging model, the carriage fee would be replaced by a direct charge, set by each ATM service provider. Instead of recovering costs from the issuing bank through a carriage fee, the ATM service provider would be recovering costs directly from the customer (who uses the payment card). The basic obligation to pay the ATM service provider would shift from the issuing bank to the customer, and so carriage would altogether fall away. In this instance – i.e. an off-us transaction – any existing basis for a "cash withdrawal fee" charged by the issuing bank would also fall away. **We recommend that the necessary compensation to the issuer in respect of its own processing and related service to its customer for an off-us ATM transaction, be obtained through the issuer levying its own charge directly on its customer, whether as a separate charge or in any other manner.**

Our recommendation is that the change to a direct charging model should be accompanied by a regulatory prohibition – whether by way of PCH clearing rules or otherwise – against any ATM service provider discriminating in price between customers using cards issued by other firms. It appears to be commonplace that where direct charging

(as opposed to surcharging) is adopted elsewhere in the world, such a rule of non-discrimination on the basis of issuer holds. This has been raised as a concern by smaller banks in the hearings.

If the recommendations which we make in this chapter regarding a change to a direct charging model for ATM transactions are not adopted by the banks within a reasonable time, then it would be appropriate in our view for the Competition Commissioner to begin a formal investigation into whether or not the continuing practices of the banks regarding inter-bank carriage fees contravene section 4 of the Competition Act.

The implications of having direct charging for mini-ATMs have not been fully considered by this study and there may be other issues which require further consideration. If carriage is to be retained in relation to mini-ATMs, then the appropriate carriage fee should be determined through an independent process, comparable with that which is proposed for the setting of interchange. (See recommendations below.)

Given the infancy of cash-back at point of sale (POS), and the dearth of information available to us in regard to this service, we are not in a position to draw conclusions as to whether carriage could effectively be replaced by a direct charging model in this context.

We therefore recommend that the Competition Commission revisit the question once adequate experience has been obtained of direct charging in ATM services and consider at that stage the case for and against extending the direct charging model to cash-back at POS and mini-ATMs.

8.2.5 Recommendations on payment cards and interchange

We recommend that an independent, objective and transparent regulatory process for determining interchange in the payment card and other relevant payment streams be effected and enforced as soon as practicable.

Such a process, under compulsory regulation, should:

- Be based on a transparent methodology
- Have objective criteria established for each relevant payment stream through a participatory process and justified in public
- Have the resulting appropriate levels of interchange, where applicable, independently assessed on the basis of audited data
- Have the integrity of the process verified under regulatory oversight

- Have the levels of interchange so determined, thereafter enforced.

Details on this process are set out in the chapter on Payment Cards and Interchange.

We recommend that certain rules restricting the participation of duly qualified institutions as acquirers in the payment card schemes be abolished. If the schemes do not voluntarily – both formally and in practice – abandon these restrictions forthwith, 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. The rules in question include:

- Visa's general international requirement that acquirers be authorised to take deposits is, in our view, too restrictive in the South African context (and indeed is likely increasingly to be challenged around the world).

  However, if a proper regulatory and supervisory framework for non-bank acquirers were established here, schemes could – in terms of their own rules requiring compliance with local laws – be brought into line where necessary. To ensure this, the regulatory and supervisory framework would have to oblige the relevant card schemes to accept as eligible, without discrimination, those banks and non-banks meeting the domestic requirements.[8]
- The rules or practice of restricting acquiring to institutions which issue scheme cards, and indeed which issue them on a significant scale, in our view are clearly restrictive of competition on the acquiring side. Such restrictions on acquiring have no legitimate basis. Acquiring should not be limited to issuers.

Regarding other rules of the payment card schemes, we do not recommend any interference with the card schemes' current rules against merchants "surcharging" customers who use payment cards.

We accept the legitimacy of the "honour all cards" rule (in the narrower sense), but not the "honour all products" rule commonly associated with it. In South Africa, the elimination of the "honour all products" rule would seem most likely to facilitate the acceptance of debit cards, by freeing merchants' acceptance of these cards from being tied to more expensive credit card acceptance. **If the withdrawal of the "honour all products" rule cannot be negotiated on a voluntary basis with the schemes concerned, then we would recommend a regulation or**

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[8] A provision comparable to section 6A(3) of the National Payment System Act, 78 of 1998 as amended, but tailored for the purpose, is what we have in mind. Non-bank acquiring is dealt with fully in the chapter of this report on Access to the Payment System.

other appropriate statutory intervention to prohibit it. If this is not forthcoming within a reasonable time, we would recommend that the Commissioner give consideration to initiating and investigating a complaint or complaints of possible contraventions of the Competition Act through the application of the "honour all products" rule.

We recommend that the card schemes should be requested by the Competition Commission formally and forthwith to withdraw their prohibitions on pure cash-back at POS, at least to the extent that such transactions are *permitted* under domestic law. Failing satisfactory responses in that regard, we would recommend regulatory measures to correct the situation decisively. If such measures are not forthcoming, then the Commissioner should consider initiating a complaint and investigating the relevant scheme rules for possible contravention of the Competition Act as prohibited restrictive practices.

We make the following recommendations regarding interchange in other payment streams.
In our view, even though EFT debit transactions meet the basic criterion of a two-sided market, the actual necessity of interchange in this payment stream has not been demonstrated. We are not in a position to say conclusively, on the basis of the information voluntarily submitted to us, that it has been proved *not* to be necessary. Consideration should therefore be given by the Competition Commissioner to initiating a complaint with reference to section 4(1)(*b*), and alternatively section 4(1)(*a*) of the Competition Act, in order formally to investigate a possible contravention or contraventions arising from the past and current inter-bank arrangements in respect of interchange in this stream.

As regards the future, if interchange is to be levied in relation to EFT debit transactions, then we recommend it ought to be included within the regulated process which we set out for interchange generally, and so be subject to the participatory procedures involved in arriving at and implementing an appropriate level of interchange. The first step would be to establish whether the interchange in this stream is necessary at all.

We recommend that the interchange fees applicable to EDO transactions also be brought within the transparent and objective regulatory scheme which we propose for payment cards and other payment streams. Once again establishing the necessity of interchange for the EDO stream would be fundamental to the process. That exercise will also help clarify the extent to which banks' pricing to users in these streams is in excess of costs, and whether a specific investigation into excessive pricing, either under the Competition Act or consumer protection legislation, is warranted.

8.2.6 Recommendations on access to the payment system

The existing regulatory regime for the National Payment System does not appear to meet 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.

We recommend an approach that requires an explicit access policy for banks and non-banks alike.

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.** There are international precedents – such as those from Australia and the European Union – that suggest that an access regime of this sort can be designed that does not threaten the systemic stability of the existing system.
- **The National Payment System Act should be revised**. 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. Once the NPS Act has been redrafted, the associated SARB and PASA 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.
- **The membership and governance of PASA should be revised so as to include qualified non-bank participants**. 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 participating non-banks.

  However, this does not necessarily require all members to be on an equal footing. A more nuanced membership of PASA – such as exists in the Australian payment system – would

lead the way to improved governance, as the current (and currently 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 diminish.

Moreover, a system whereby the executive officer of PASA, rather than the incumbent members of a PCH, takes the decision regarding the entry of new participants, having met the appropriate requirements for a PCH, is also recommended.

The self-regulatory approach of PASA gives it considerable authority in the NPS, which creates 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.

- **A Payment System Ombud should be established**. 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, processing of PCH applications, and so on.

  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.

8.3 Signatures of Panel

The work of the Banking Enquiry's has been concluded and we hereby submit our report.

Dated at Pretoria on this the 9th day of June 2008

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T.S.B. Jali (Chairperson)

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O. Bodibe

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T.H. Nyasulu

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R.O. Petersen SC

Appendices

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Appendix A Composition of the Enquiry and Terms of Reference

4 August 2006

Enquiry into Competition in Banking

Composition of the Enquiry and Terms of Reference

Introduction

1. The purpose of the Competition Act, set out in section 2, is to promote and maintain competition in the Republic in order —

   (*a*) to promote the efficiency, adaptability and development of the economy;

   (*b*) to provide consumers with competitive prices and product choices;

   (*c*) to promote employment and advance the social and economic welfare of South Africans;

   (*d*) to expand opportunities for South African participation in world markets and recognise the role of foreign competition in the Republic;

   (*e*) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and

   (*f*) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons.

2. Section 21 of the Competition Act gives the Competition Commission the responsibility and the function, among others, to implement measures to increase market transparency and to enquire into and report to the Minister of Trade and Industry on any matter concerning the purposes of the Act.

3. In 2004 the Task Group for the National Treasury & the South African Reserve Bank recommended that the Competition Commission should investigate the possibility of a complex monopoly in the governance and operation of the national payments system. The Commission is also aware of widespread public concern regarding the level of charges made by banks and other providers of payment services to consumers.

4. Following on the findings in the research report *The National Payment System and Competition in the Banking Sector*, the Commission announced earlier this year that it would hold an enquiry in terms of Section 21 into particular aspects of competition in banking.

Terms of Reference

5. 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.

6. The objects of this enquiry are, in connection with the subject matter stated above:

(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 payments 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

7. 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.

8. The panel will be assisted by a full-time administrative and technical staff, and by such expert consultants as may be necessary.

9. The panel will shortly issue guidelines and initial questionnaires for the assistance of those wishing or willing to submit relevant information to the enquiry.

Submissions

10. The enquiry depends entirely on the voluntary submission of information by all interested parties, and their willingness to have the significance and reliability of that information tested in co-operation with the panel and its supporting staff.

11. The enquiry will be on-the-record and its record will be made available to the public, subject only to restrictions on disclosure provided for in the Competition Act. Information submitted to the enquiry will be regarded as information submitted to the Commission for purposes of the Act.

12. It is envisaged that, in the course of the enquiry, public hearings will be held to

supplement and examine submissions made in writing or in interviews.

Report

13. The report of the Chairperson (endorsed by other panel members or together with any differing or supplementary reports by other panel members, as the case may be) will be provided to the Commissioner within a year.

14. The panel may make interim recommendations to the Commissioner, including, if necessary, recommendations concerning any alteration in these terms of reference.

Enquiry secretariat and contact details

The enquiry manager is Mr Charles Frank.

The personal assistant to Mr Frank is Ms Kamogelo Seleka.

Communications with the enquiry should be directed to Mr Frank, who, in consultation with the Chairperson, will also be responsible for liaison with the media.

Contact details:

Tel: 012-394 3250 Fax: 012-394 3493

e-mail: bankingenquiry@compcom.co.za

A banking enquiry website to facilitate public access to information has been set up, and is in the process of development:

www.compcom.co.za/banking

Appendix B November 2006 hearing schedule

1st November 2006: Red Room, Ground Floor, Commission Offices, Pretoria

No	Presentation by
1	Welcome and Introduction by Chairperson, Mr T Jali
2	Report by the Enquiry on Submissions received by the 27th October 2006 and the Hearings Schedule
3	Presentation by Dr P Hawkins on the background and landscape of the banking sector in South Africa
4	Dr Hawkins continues with her presentation
5	Ombudsman for Banking Services, Adv N Melville

2nd November 2006: Red Room, Ground Floor, Commission Offices, Pretoria

No	Presentation by
1	Consumer Representative : Financial Sector Campaign Coalition, Mr J Mahlangu – COSATU
2	Nedbank
3	Mercantile Bank
4	Benchmark Foundation, Mr A Ramadie

3rd November 2006: Red Room, Ground Floor, Commission Offices, Pretoria

No	Presentation by
1	National Credit Regulator, Mr G Davel
2	Micro Finance South Africa (MFSA), Mr H Ferreira, and Mr M Seymour
3	Financial Sector Campaign Coalition - Consumer Representatives, Ms C Caine, Mr N Kholisile (SACP) and Mr E. Paulus

9th November 2006: Red Room, Ground Floor, Commission Offices, Pretoria

No	Presentation by
1	First National Bank
2	Commercial Independent Bureaux Association (CIBA), Mr J de Wet and Mr W Pienaar
3	Bank Pensioners Society, Mr P Mc Queen and Mr W Hartung
4	Wizzit Payments (Pty) Ltd
5	Consumer , Mr N Iliev

13th November 2006: The Centre for the Book, 62 Queen Victoria Street, Cape Town

No	Presentation by
1	Pick ‘n Pay
2	South African Retailers’ Payment Issues Forum (SARPIF)
3	Shoprite Checkers
4	Consumer Groups : FSCC, Mr E Paulus; The Black Sash, Mrs M Naidoo, Ms N Mbambo and Ms M Madyosi; Savings and Credit Co-operatives League, Mr V Botha (Sibanya SACCO)
5	Standard Bank

29th November 2006: The Royal Hotel, 267 Smith Street, Durban

No	Presentation by
1	Ithala Limited
2	Consumer Groups: Ethekwini Civic Forum, Mr S Naidoo; Ms S Rai, Mr B Meintjies, Ms N Srikissoon; 1860 Pioneers Foundation, Mr R Choonilall
3	Intecon, Mr R de Swardt

30th November 2006: Red Room, Ground Floor, Commission Offices, Pretoria

No	Presentation by
1	ABSA Bank
2	NET 1
3	Payment Association of South Africa (PASA)
4	The Banking Association of South Africa

Appendix C April-July 2007 hearing schedule

3rd April 2007: ATMs and direct charging

No	Presentation by
1	Overview of ATMs by Dr P Hawkins - Enquiry Technical Team
2	Dr Hawkins continued
3	First National Bank

4th April 2007: ATMs and direct charging

No	Presentation by
1	Capitec Bank
2	Nedbank
3	Nedbank

11th April 2007: ATMs and direct charging

No	Presentation by
1	ATM Solutions
2	Standard Bank
3	ABSA Bank

17th April 2007: Payment cards and interchange fees

No	Presentation by
1	Presentation by Ms J Louw : Enquiry Technical Team
2	ABSA Bank
3	ABSA Bank

18th April 2007: Payment cards and interchange fees

No	Presentation by
1	MasterCard
2	MasterCard
3	MasterCard

19th April 2007: Payment cards and interchange fees

No	Presentation by
1	Nedbank
2	Standard Bank
3	First National Bank

25th May 2007: The National Payment System- Access and regulation

No	Presentation by
1	Presentation by Dr P Hawkins – Enquiry Technical Team
2	ABSA Bank
3	ABSA Bank

28th May 2007: The National Payment System- Access and regulation

No	Presentation by
1	First National Bank
2	Bankserv
3	Mercantile Bank

29th May 2007: The National Payment System- Access and regulation

No	Presentation by
1	PASA
2	Standard Bank
3	Nedbank

5th June 2007: Payment cards and interchange fees

No	Presentation by
1	Standard Bank
2	Standard Bank

18th June 2007: Market power & level and structure of charges
Payment cards & interchange fees

No	Presentation by
1	Presentation by Mr K Weeks – Enquiry Technical Team
2	Standard Bank
3	Visa International

19 June 2007: Payment cards & interchange fees
The National Payment System- Access and regulation

No	Presentation by
1	MasterCard
2	MasterCard
3	PASA

9th July 2007: Market power and the level & structure of charges

No	Presentation by
1	Nedbank
2	Nedbank
3	First National Bank
4	First National Bank

17th July 2007: Market power and the level & structure of charges

No	Presentation by
1	ABSA Bank
2	ABSA Bank
3	KLA

Appendix D Technical Team engagements

Date	Description	Venue
2006		
13-Jun-06 (Prior to constitution of Enquiry)	Briefing to Economic Policy Advisors on the progression from the 2004 Competition in Banking report to the 2006 FEASibility report prepared for the Competition Commission on the National Payment System	The Office of the Presidency
26-Jul-06 (Prior to constitution of Enquiry)	Interview at the request of EuroCommerce and SARPIF	Competition Commission, Pretoria
23-Aug-06	Absa	Absa, Johannesburg CBD
24-Aug-06	Nedbank	Nedbank, Sandton
24-Aug-06	FirstRand Bank	FRB, Sandton
24-Aug-06	Standard Bank	Standard Bank, Johannesburg CBD
29-Aug-06	Nedbank	Nedbank, Sandton
29-Aug-06	FRB	FRB, Johannesburg CBD Bank City
31-Aug-06	Absa	Absa, Johannesburg CBD
31-Aug-06	Standard Bank	Standard Bank, Johannesburg CBD
11-Sep-06	Master Card	Competition Commission, Pretoria
13-Sep-06	Banking Association	Parktown
12-Sep-06	Banking Ombudsman	JCI Building , Johannesburg
18-Sep-06	Banking Association	Competition Commission, Pretoria
20-Sep-06	Ithala	Ithala, Durban
20-Sep-06	Bank of Beroda	Bank of Beroda, Durban
03-Oct-06	Capitec	Cape Town
03-Oct-06	SARPIF, Pick n Pay, Shoprite Checkers and Clicks	Cape Town
04-Oct-06	Standard Chartered Bank	Sandton
04-Oct-06	HSBC	Sandton
10-Oct-06	Micro Finance South Africa	Competition Commission, Pretoria
12-Oct-06	Mercantile Bank	142 West Street, Sandown
12-Oct-06	Banking Association	Parktown
13-Oct-06	Financial Sector Campaign Coalition (FSCC) and Benchmark Foundation	Competition Commission, Pretoria
13-Oct-06	Commercial Independent Bureaux Association	Competition Commission, Pretoria
16-Oct-06	Registrar of Banks, SARB	Pretoria
17-Oct-06	National Treasury	Pretoria
17-Oct-06	VISA	Competition Commission, Pretoria
18-Oct-06	First Rand Bank	Competition Commission, Pretoria
19-Oct-06	Micro Finance South Africa	Competition Commission, Pretoria
23-Oct-06	MasterCard	Teleconference
25-Oct-06	National Treasury	Pretoria

Date	Description	Venue
26-Oct-06	Nedlac	Rosebank
30-Oct-06	FSCC, Cosatu, SACP	Parktown
20-Nov-06	Standard Bank	SBSA, Johannesburg
01-Dec-06	ATM Solutions	Competition Commission, Pretoria
01-Dec-06	CIBA	Competition Commission, Pretoria
2007		
23-Jan-07	Bankserv	Johannesburg
24-Jan-07	MasterCard	Competition Commission, Pretoria
25-Jan-07	National Payments System Department, SARB	Pretoria
29-Jan-07	National Treasury	Pretoria
07-Feb-07	FRB	Competition Commission, Pretoria
13-Feb-07	Nedbank	Competition Commission, Pretoria
13-Feb-07	American Express	Competition Commission, Pretoria
13-Feb-07	ABSA	Competition Commission, Pretoria
14-Feb-07	FRB	Sandton
15-Feb-07	MasterCard and .econ	WWB Offices, Illovo
26-Feb-07	Standard Chartered Bank	Sandton
26-Feb-07	FRB	Bank City, Sandton
06-Mar-07	First Data	Parktown
06-Mar-07	MasterCard and Edgar, Dunn & Co	WWB Offices, Illovo
14-Mar-07	Visa	Competition Commission, Pretoria
28-Mar-07	Pretorium Trust	Pretoria
29-Mar-07	Net-1	Rosebank
06-Apr-07	Standard Bank	Standard Bank, Johannesburg, CBD
10-Apr-07	ATM Solutions	Sandton
10-Apr-07	FSCC	Parktown
20-Apr-07	ABSA	Johannesburg
07-May-07	Nedbank	Competition Commission, Pretoria
07-May-07	NPSD	Pretoria
07-May-07	PASA	Competition Commission, Pretoria
08-May-07	FRB	Sandton
10-May-07	Banking Association	Competition Commission, Pretoria
17-May-07	UK Office of Fair Trading - Telecon	CT, Jhb and Pta
11-Jun-07	APACS and LINK (UK)	London, UK
15-Jun-07	KLA	KLA, Rosebank
27-Jun-07	FRB	Bank City, Johannesburg
28-Jun-07	Nedbank	Nedbank, Sandton
02-Jul-07	ABSA	Main Street Johannesburg
05-Jul-07	KLA	KLA, Rosebank
03-Jul-07	Smart ATM	Parktown
10-Jul-07	National Treasury	Pretoria
23-Jul-07	Nedbank	Competition Commission, Pretoria
24-Jul-07	Direct Transact	Competition Commission, Pretoria

Date	Description	Venue
01-Aug-07	KLA	Rosebank
02-Aug-07	National Credit Regulator	Competition Commission, Pretoria
14-Aug-07	Standard Bank	Competition Commission, Pretoria
15-Aug-07	Exploratory process First meeting	Competition Commission, Pretoria
17-Aug-07	PASA	Parktown
17-Aug-07	Eskom	Megawatt Park, Sandton
24-Aug-07	Prof Harvey Wainer	Parktown
28-Aug-07	PASA	Competition Commission, Pretoria
03-Sep-07	Exploratory process - continued	Competition Commission, Pretoria
04-Sep-07	Exploratory process - continued	Competition Commission, Pretoria
06-Sep-07	National Treasury	National Treasury Office, Pretoria
19-Sep-07	Department of Trade and Industry	Pretoria
20-Sep-07	ATM Solutions	Parktown
29-Oct-07	American Express	Competition Commission, Pretoria
30-Oct-07	MasterCard	Deloitte Offices, Pretoria
06-Nov-07	MFSA	Parktown
08-Nov-07	Net 1	Parktown
28-Nov-07	ATM Solutions	Johannesburg
06-Dec-07	ATM Solutions	Teleconference
10-Dec-07	ATM Solutions	Teleconference
12-Dec-07	Bankserv	Teleconference
2008		
17-Jan-08	PASA	Parktown
17-Jan-08	ATM Solutions	Johannesburg
12-Feb-08	National Credit Regulator	Midrand
14-Feb-08	Reserve Bank of Australia	Teleconference
20-Feb-08	PASA	Johannesburg
27-Feb-08	MFSA	Teleconference

Appendix E Updated statistics in Task Group (Falkena III) report

The appendix updates some of the data in the 2004 Task Group (Falkena III) Report on *Competition in South African banking* – commissioned by the National Treasury and the SA Reserve Bank – with a view to assessing possible continuations of, or changes in, the trends highlighted in the 2004 report.

This update completes the picture up to the end of 2006 (the latest year for which we have comparable data), whereas the Task Group report reflected data up to 2002.

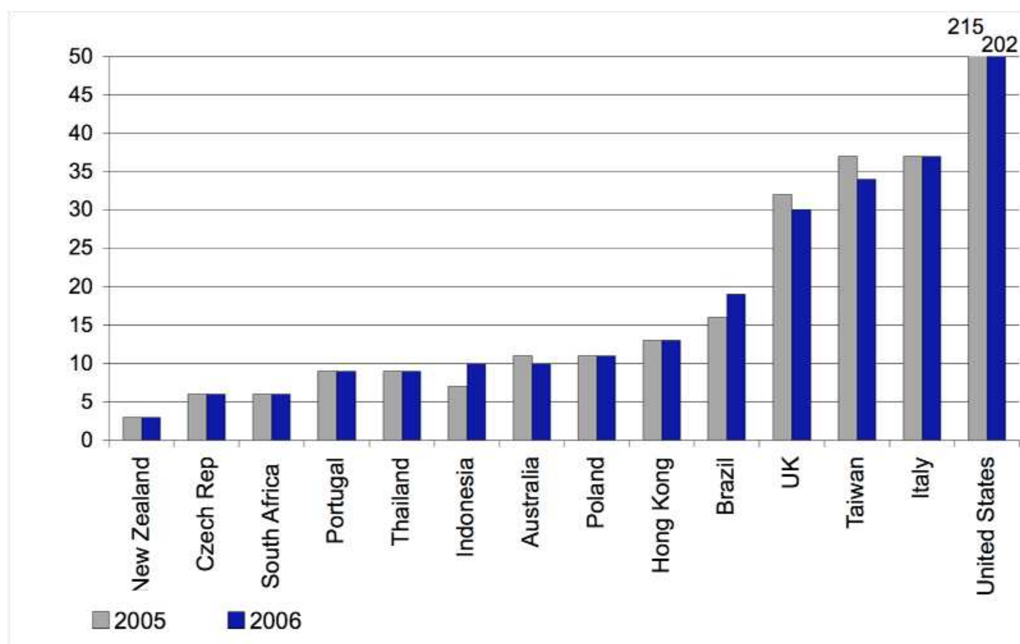
The update shows that:

- The number of South African banks in the World's Top 1000 banks increased from 5 in 2002 to 6 in 2004 – with the entry of African Bank (a micro-credit bank) as one of the world's most profitable banks.
- The top five South African banks have become more efficient, with the cost-to-income ratio falling from 67% in 2002 to 58.9% in 2006. This ratio improved significantly in 2006 from its level of 66.4% in 2005.
- Non-performing loans decreased from 3.2% in 2002 to 1.44% in 2006, which has been more in line with developed than developing countries.
- Loans and advances as a percentage of GDP topped 80% in 2006, from around 69% in 2002.
- The before-tax return-on-assets of the sector increased substantially from 0.8% in 2002 to 1.8% in 2006. After-tax returns increased from 0.43% to 1.4% over this period.
- The return on equity of the top five big banks increased from 22.46% in 2002 to 38.16% in 2006.
- The market share of the top five banks[1] (measured in terms of assets) increased from 80% in 2002 to 90% in 2006.
- The interest rate margin as a per cent of interest income decreased in 2002 and 2003, after which it increased. By 2006, it was at its highest level since 1994.
- The Herfindahl-Hirschman Index (HHI), which provides a measure of concentration, increased steadily between 2002 and 2005, indicating that the sector became more concentrated.

In summary, the trends identified in the 2004 report appear to have continued and indeed have strengthened in most cases. This is depicted in the figures and tables below.

[1] Standard Bank, Absa, FNB, Nedbank and Investec.

Figure 1 Number of banks in the global top 1000

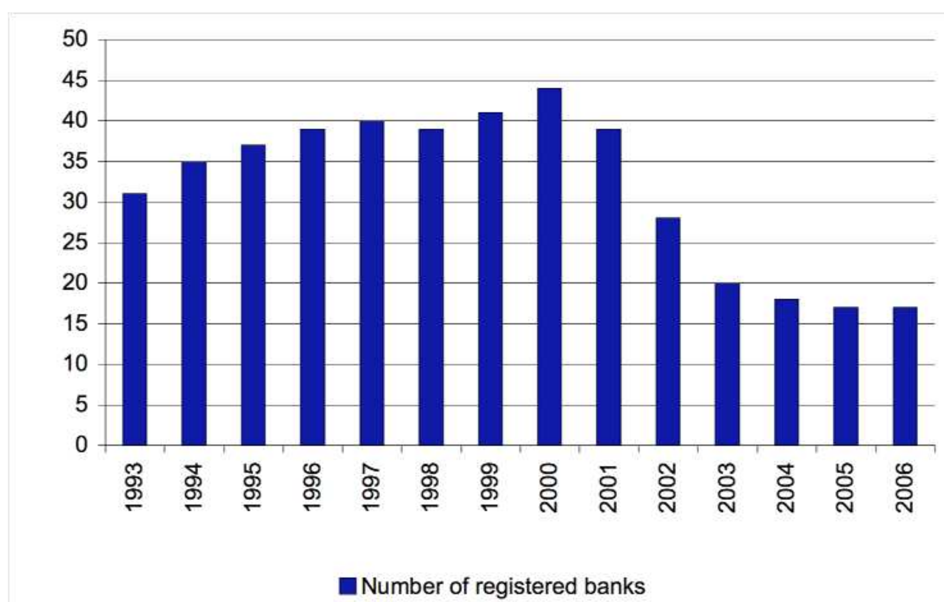


Source: The Banker[2]

The number of South African banks in the Top 1000 increased from 5 in 2002 (Standard Bank, Absa, FNB, Nedbank, Investec) to 6 in 2006 (African Bank was included for the first time in 2003/04). The combined tier 1 capital for these six South African banks increased from $8,406 million in 2003 (equivalent to the 59th ranked bank in the world) to $20,176 million in 2006 (equivalent to the 34th ranked bank in the world).

2 The data used from The Banker throughout this document are calculated using the top 5 banks in each country.

Figure 2 Number of registered banks in South Africa



Source: Bank Supervision Department

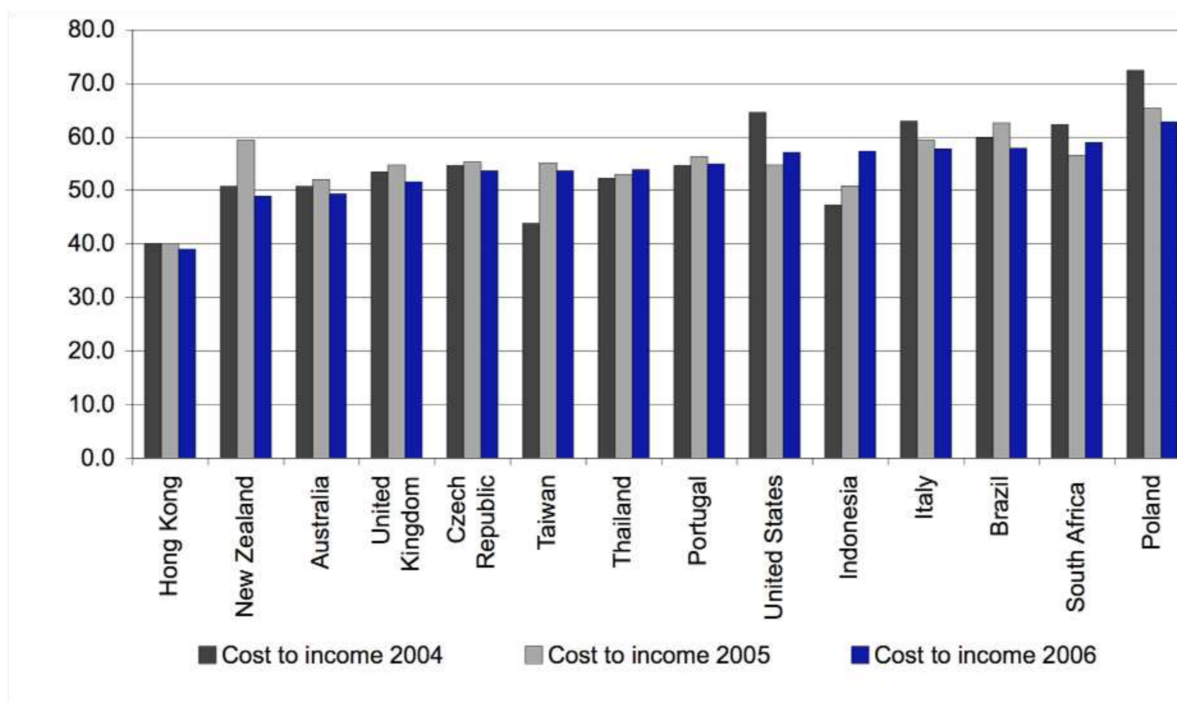
Table 1 Number of registered banks and the value of assets

	Number of registered banks	Value of banking sector assets R billions (month end balance for year)	Value of loans and advances R billions (month end balance for year)	Nominal GDP (SARB code 6006j) R billions	Growth in bank assets	Growth in Nominal GDP	Value of Assets as a % or GDP	Loans and advances as a % of GDP
2000	44	R 819.24	R 616.48	R 922.15	12.53%	13.33%	88.84%	66.85%
2001	39	R 1,049.99	R 773.52	R 1,020.01	28.17%	10.61%	102.94%	75.83%
2002	28	R 1,099.98	R 863.55	R 1,168.78	4.76%	14.59%	94.11%	73.88%
2003	20	R 1,379.82	R 940.51	R 1,257.03	25.44%	7.55%	109.77%	74.82%
2004	18	R 1,498.11	R 1,077.11	R 1,386.66	8.57%	10.31%	108.04%	77.68%
2005	17	R 1,677.54	R 1,303.43	R 1,523.26	11.98%	9.85%	110.13%	85.57%
2006	17	R 2,075.15	R 1,659.66	R 1,741.06	23.70%	14.30%	119.19%	95.32%

Source: Bank Supervision Department

Number of registered banks decreased to 17 in 2005 (Peoples Bank Limited was deregistered) and did not change in 2006. On average, the loans and advances of the banking sector make up around 80% of its assets in 2006. The growth in bank assets outperformed growth in nominal GDP, with the growth rate in assets increasing substantially from 11.98% in 2005 to 23.7% in 2006.

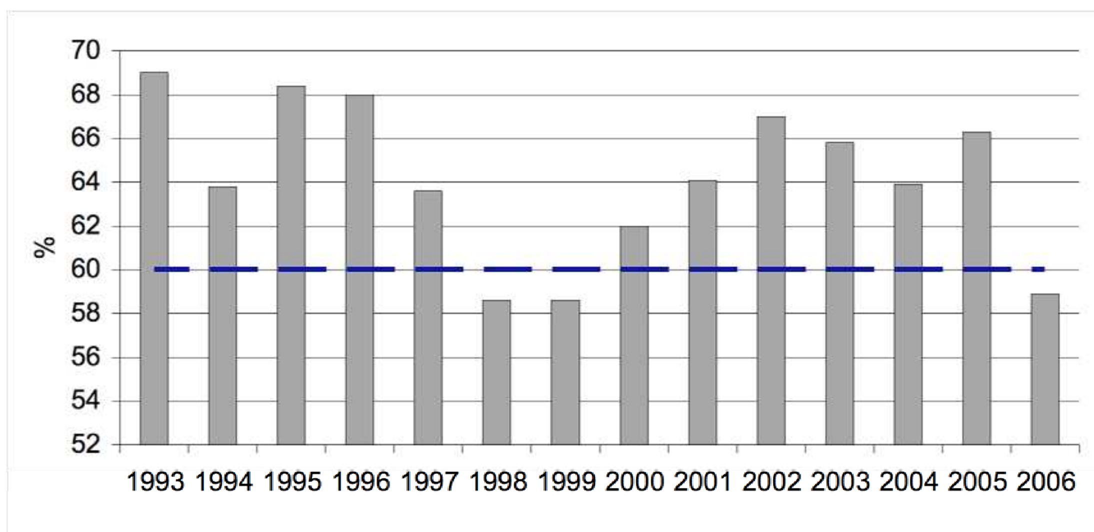
Figure 3 Cost-to-income ratios



Source: The Banker

The cost-to-income ratio increased from 60.3 in 2002 to 65.6 in 2003 after which it decreased again to 59 in 2006, improving the overall efficiency of South African banks over this period. However, most countries' banks improved their efficiency between 2004 and 2006, leaving South African banks outperforming only Polish banks on this measure.

Figure 4 Cost-to-income ratios of the South African banking sector

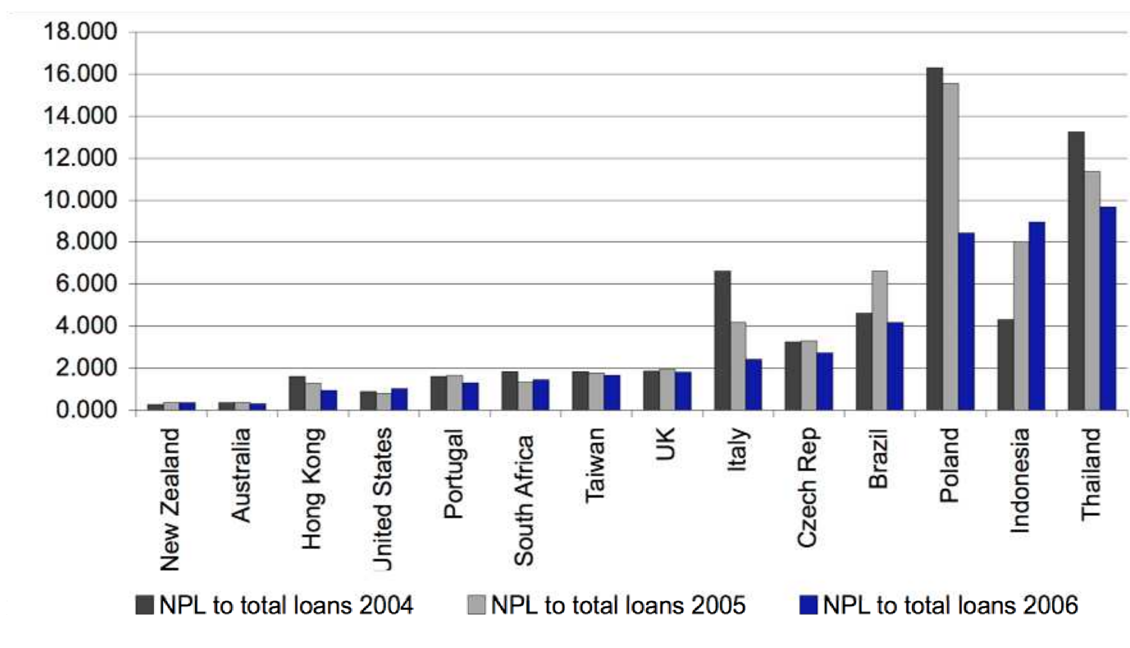


Source: Bank Supervision Department

Cost-to-income ratios for the South African banking sector as a whole decreased after 2002, except in 2005. However, this ratio improved significantly in 2006 to 58.9%. This was mostly attributable to the increase in total income whilst operating expenses remained fairly stable.[3] Sixty per cent is the international benchmark of efficiency – with higher values considered to be inefficient.

[3] Banks Supervision Department, Annual Report, 2006, p 49.

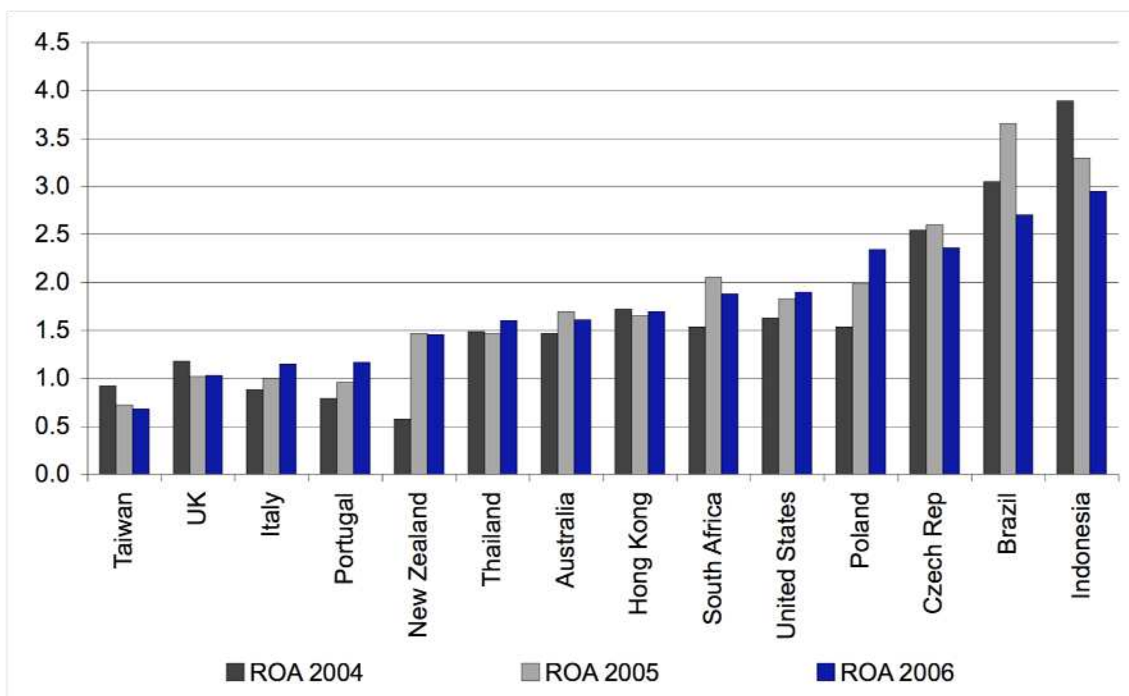
Figure 5 Non-performing loans as a percentage of total loans



Source: The Banker

Efficiency in the banking sector was also improved through a decrease in the non-performing loans as a percentage of total loans. This indicator decreased from 3.2% in 2002 to 1.44% in 2006. South African banks' performance is still in line with that of more mature banking industries.

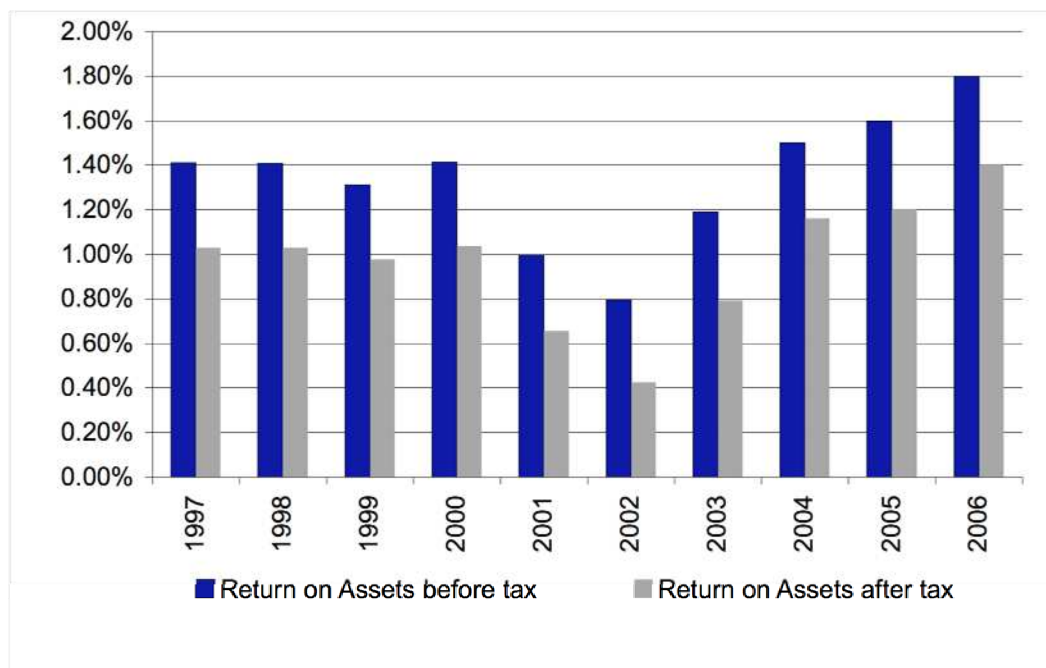
Figure 6 Return on assets



Source: The Banker

The return on assets for South Africa's top banks increased from 1.1% in 2003 to 1.9% in 2006. This is well above developed countries such as the UK, New Zealand and Australia.

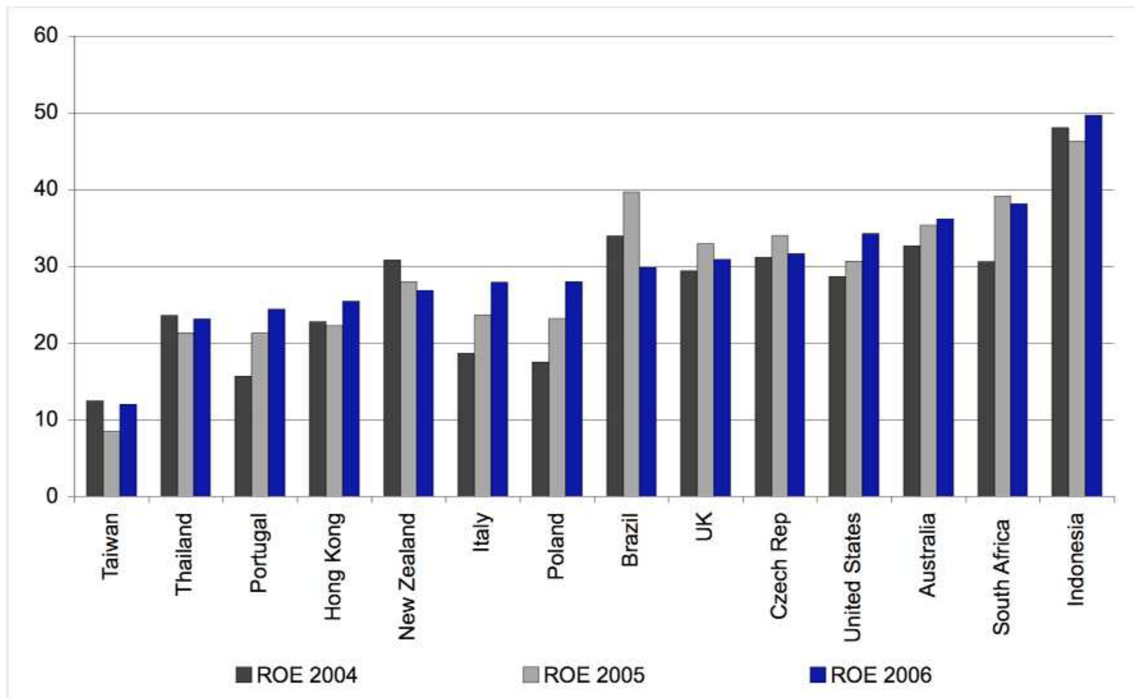
Figure 7 Return on assets of the South African banking sector



Source: Bank Supervision Department

The return on assets before tax for the South African banking sector as a whole increased substantially from 0.8% in 2002, to 1.8% in 2006. After tax return increased from 0.43% in 2002 to 1.4% in 2006.

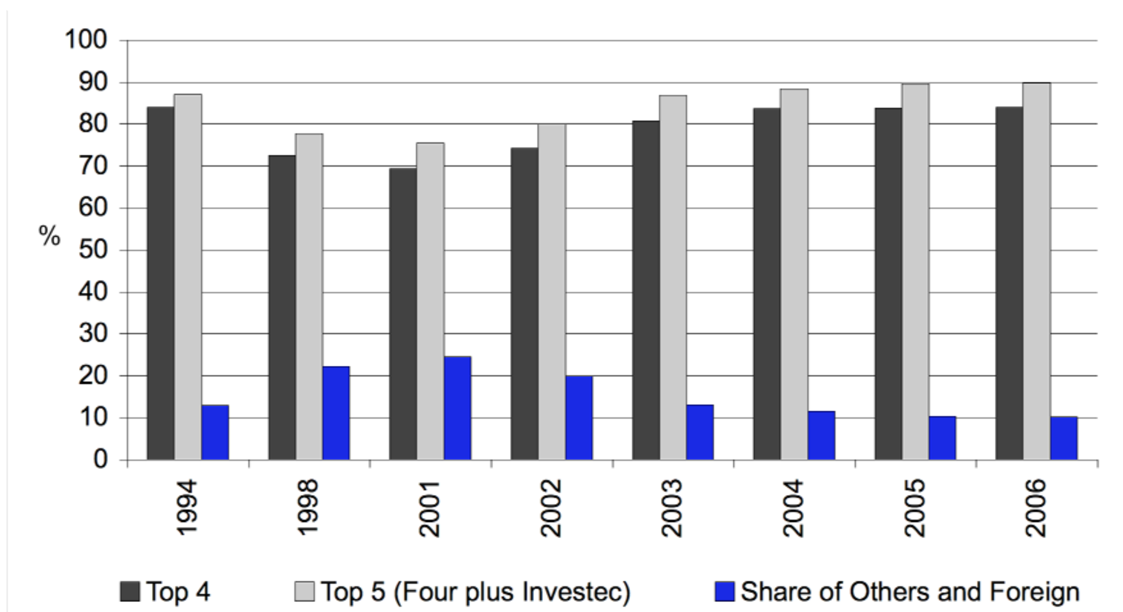
Figure 8 Return on equity



Source: The Banker

Return on equity for the South African banks increased from 22.46% in 2002 to 38.16% in 2006. Only one country (Indonesia) in this selection of comparators outperformed South Africa.

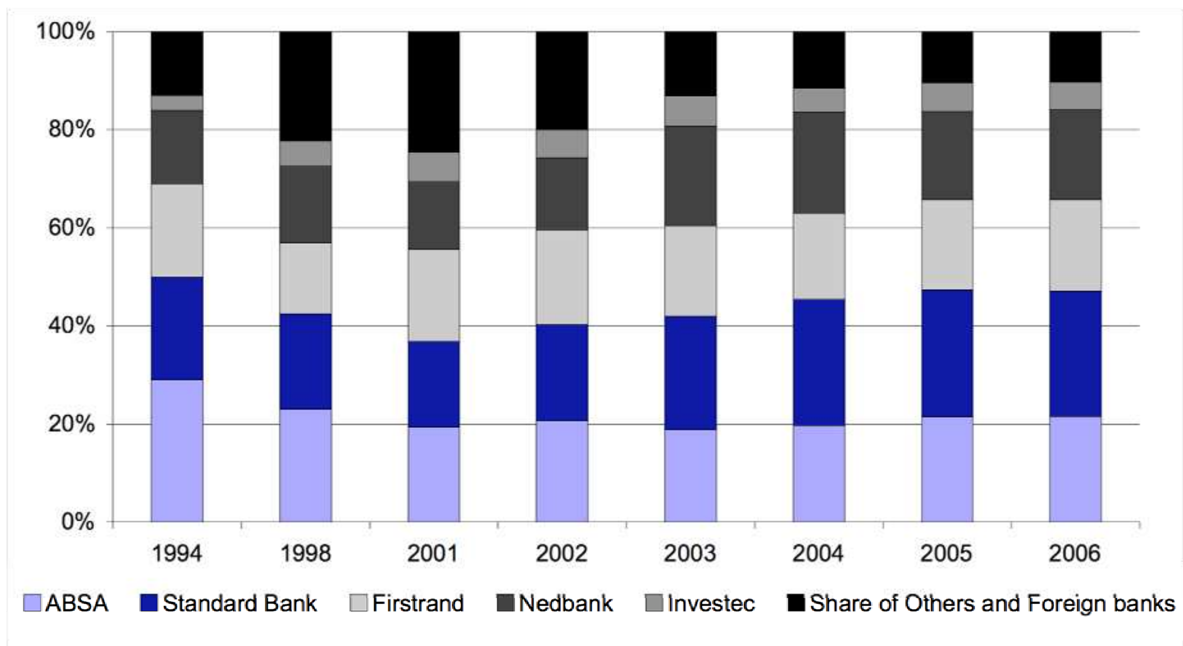
Figure 9 Market share of assets for South African banking industry



Source: Bank Supervision Department

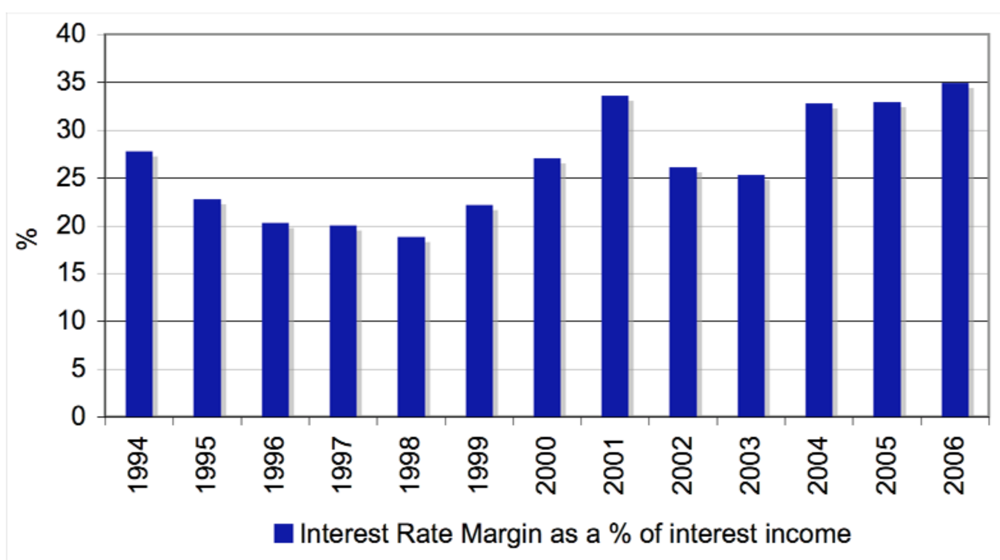
The market share of assets of the big four (and the big five when we include Investec), increased steadily from 2002 to 2005, reversing the trend we saw from 1994 to 2002. The market share of the top 4 (top 5) banks increased from 74.28% (80.09%) in 2002 to 84.06% (89.74%) in 2006.

Figure 10 Market share of assets of top South African banks



Source: Bank Supervision Department

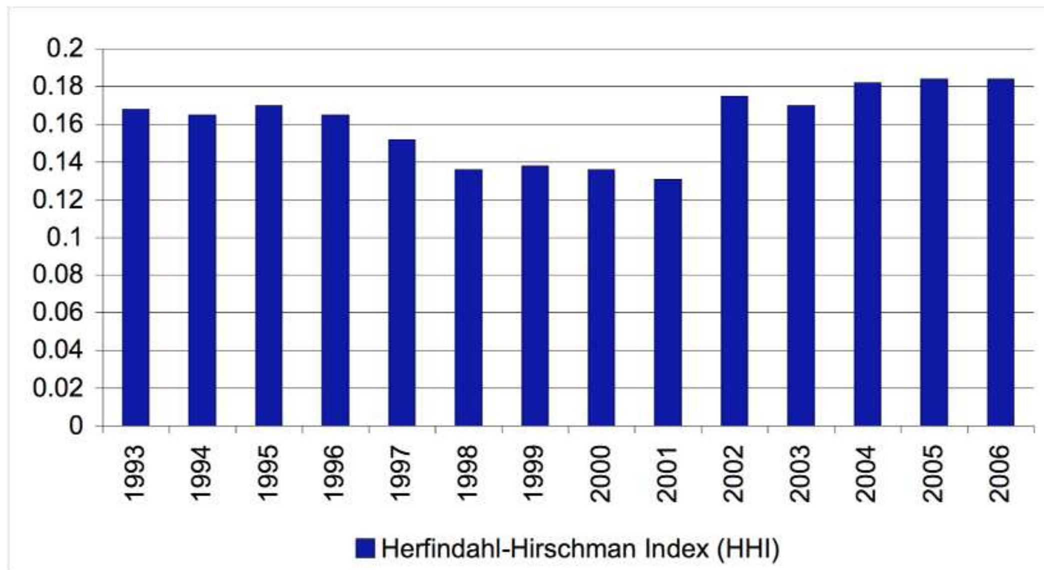
Figure 11 Interest rate margins as a percentage of interest income



Source: Bank Supervision Department

The interest margin as a percentage of interest income decreased in 2002 and 2003, whereafter it increased each year, to 35% cent in 2006; its highest level since 1994. The SARB repo rate increased eleven times between 2004 and 2006.

Figure 12 HHI Index



Source: Bank Supervision Department

From 2002 to 2005 the Herfindahl-Hirschman Index (HHI) index deteriorated further from 0.175 to 0.184. This index stayed unchanged at 0.184 in 2006.

Appendix F "Complex monopoly", "collective dominance" and "tacit collusion"

The purpose of this Appendix is to address briefly three matters of a legal nature which arise in connection with an analysis of market power and with the behaviour of firms in an oligopolistic market. The are: (a) "complex monopoly"; (b) "collective dominance"; and (c) "tacit collusion".

(a) "Complex monopoly"

In 2004 the Task Group (Falkena III) report recommended that the Competition Commission should investigate the possibility of a "complex monopoly" in the governance and operation of the national payment system. It also advised:

> The concept of a *complex monopoly* should become part of the vocabulary of the Competition Commission. A *complex monopoly* occurs when firms, whether voluntarily or not and with or without agreement between them, so conduct their business that it prevents, restricts or distorts competition. This would give the Competition Commission scope to investigate anti-competitive behaviour even where it does not involve proven collusion.[4]

The concept of a "complex monopoly" does not have any foundation in South African competition law. The concept was – but is no longer – used in UK competition legislation. The UK Fair Trading Act of 1973 (since repealed) provided for "monopoly situations" to be referred by the Office of Fair Trading (OFT) to the Competition Commission in that country for investigation. Following investigation, various remedies (including, if appropriate, a structural remedy) were available to the Secretary of State.[5]

Monopoly situations could be of a "structural" or "behavioural" type. An example of a *structural* monopoly was a "scale monopoly" – where at least one quarter of the goods or services of a particular description supplied in the UK were supplied by or to one and the same person. A "complex monopoly", on the other hand, was an example of a *behavioural* monopoly – where at least one quarter of the relevant goods or services were supplied by two or more persons who, whether by agreement or otherwise, so conducted their respective affairs as to prevent, restrict or distort competition.[6]

"Complex monopoly" was thus a term of UK legislative art. It enabled parallel conduct by firms, not prohibited by the Competition Act, to be scrutinised by the Competition Commission under the Fair Trading Act. Firms could be considered part of a complex monopoly in terms of the Fair Trading Act without necessarily being found to be collectively dominant in terms of the Competition Act or Article 82 of the European Treaty (see below).

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4 Exhibit H, p iv, p 155.

5 Richard Whish, *Competition Law*, 4th edition, p 363.

6 *Id.*, pp 364-5; *Encyclopedia of Competition Law* (Sweet & Maxwell, Library CD edition), 1–052, 1–351.

By the time the Task Group (Falkena III) report appeared, the Fair Trading Act had in fact been repealed and replaced by the UK Enterprise Act 2002. "Complex monopoly" disappeared with the Fair Trading Act. Under the new provisions of the Enterprise Act, the OFT has power to make a reference to the Competition Commission, for purposes of a market investigation, where it has reasonable grounds for suspecting that any "feature or combination of features" of a market prevent, restrict or distort competition. A wide array of powers is available to the Commission following its investigation, including where appropriate the power to impose a structural remedy.[7]

It does not appear that any advantage was lost – but, on the contrary, it seems that greater flexibility was gained – by giving up the concept of "complex monopoly" in the UK law. We see no reason to import the concept into our legislative framework.

The present enquiry has been conducted on the basis of the general powers of the Competition Commission contemplated by section 21 of the Competition Act 89 of 1998. The Department of Trade and Industry is reported to be considering possible amendments to the Competition Act, including expanded powers on the part of the Competition Commission to conduct market investigations. Our views, based on the experience of the present Enquiry, have not been sought, and it is not part of our mandate under our terms of reference to consider and make recommendations in that regard.

(b) "Collective dominance"

Article 82 (formerly Article 86) of the European Treaty prohibits any abuse "by one or more undertakings of a dominant position". This wording raises the question of "collective dominance" by firms, although that expression is not actually used. In our Competition Act, by contrast, it is simply prohibited for "a dominant firm" to abuse its dominance in any of the ways specified.[8] No concept of "collective dominance" appears to be invoked in our competition law; each firm's position must be evaluated on its own terms. At first sight this may seem a flaw, but on closer study, in our opinion, it turns out not to be the case.

In examining whether a particular firm has "market power" – the ultimate test for "dominance" in terms of section 7 of our Competition Act – one must consider whether the firm has the power *inter alia* "to behave to an appreciable extent independently of its … customers".[9] In an oligopolistic market, a firm's independence of its customers – its ability, for example, to raise prices significantly and sustain them without significantly losing sales – will depend on the reliance it can place on the behaviour that will be forthcoming from its rivals in response

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[7] Richard Whish, *Competition Law*, 5th edition, p 416.

[8] See Chapter 2, Part B, of the Competition Act (sections 6-9).

[9] See the definition of "market power" in section 1.

to its pricing decisions. Where the individual firm can rely on the response of the other firms not being a vigorously competitive one, that is a factor which is properly to be taken into account when assessing whether the firm concerned has appreciable market power.

In an oligopolistic market, whether or not each firm actually derives market power from the behaviour of the other firms – whether and to what extent it is able to rely on a non-competitive response from them – is always a question of fact. The likely behaviour of the other major firms in such a market is thus a factor contributing to the market power which each of them may have individually. The market power of each thus depends upon the others – their market power would be *interdependent* in that sense – but each would have it, or not, as the case may be. A special concept of "collective dominance" seems unnecessary to the analysis, and it is unclear what (if anything) it adds in the jurisdictions where it is employed.[10]

Section 79(1) of the Canadian Competition Act applies a test of dominance by requiring a finding that *one or more persons* "substantially or completely control … a class or species of business." The Competition Bureau (counterpart of our Competition Commission) "considers control to be synonymous with market power, where market power is the ability to profitably set prices above competitive levels for a considerable period of time."[11]

The Canadian Competition Act provides for a prohibition order to be made by the Competition Tribunal in cases where persons who are collectively dominant engage in a practice of anti-competitive acts likely to prevent or lessen competition substantially in a market.[12]

> The wording of the Act clearly contemplates cases where a group of unaffiliated firms may possess market power even if no single member of the group is dominant by itself. In joint dominance cases, there are three sources of competition that can defeat the profitability of a price increase. These are competition from existing rivals outside the allegedly jointly dominant group; competition from potential rivals (i.e. entrants) outside the allegedly jointly dominant group; and competition from within the allegedly jointly dominant group. Given this, an additional element of proof is necessary to establish joint control, or market power, by more than one firm, as compared to the case of a single dominant firm.
>
> The jurisprudence provides only limited insights into the additional evidence necessary to establish control by a group of firms. To date, there have been only two cases involving joint dominance under the Act.[13] In both instances, the fact that joint dominance existed was taken

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10 See Sutherland and Kemp, *Competition Law of South Africa*, 7–14; cf Irvine, "Does the South African Competition Act Accommodate the Concept of Collective Dominance?", 2004 *SA Mercantile Law Journal*, 448.

11 Strikeman Elliott LLP, *Competition Act and Commentary* (2007), p 380, citing *Canada (Director of Investigation and Research) v. NutraSweet Co.* [1990], 32 C.P.R. (3d) 1 (Comp. Trib.), *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* [1992], 40 C.P.R. (3d) 289 (Comp. Trib.) and *Canada (Director of Investigation and Research) v. The D&B Companies of Canada Ltd.* [1995], 64 C.P.R. (3d) 216 (Comp. Trib.). The objective in analysing factors relevant to the presence or absence of dominance "is to determine the extent to which a firm or group of firms is constrained from pricing above competitive levels because of the presence of effective competition or the likelihood of competitive entry." (*Op. cit.*, p 366.)

12 Section 79(1).

13 The author cites *Canada (Director of Investigation and Research) v. Bank of Montreal* [1996], 68 C.P.R. (3d) 527 (Comp. Trib.) and *Canada (Director of Investigation and Research) v. AGT Director Ltd. et al.* [1994], 32 C.C.T.D. No.

> as a given and was supported by an explicit agreement.
>
> A group of firms that collectively possesses market power may be able to coordinate its actions in a manner that allows the market price to be profitably increased above the non-coordinated price levels without the firms entering into an explicit agreement. Firms within an oligopoly normally base their decisions on how their rivals have behaved in the past. In addition, firms recognize that their current decisions may affect their rivals' future reactions. The fact that firms recognize these interactions over a longer time period results in competitive response strategies becoming more complex. It is possible for firms to act in a "consciously parallel" fashion, thereby achieving higher profits than would be the case in a competitive environment.
>
> The jurisprudence in respect of the criminal conspiracy provisions is clear in not condemning "conscious parallelism".[14] The Bureau has adopted a similar position with respect to the abuse provisions, recognizing that something more than mere conscious parallelism must exist before the Bureau can reach a conclusion that firms are participating in some form of coordinated activities,
>
> The ability of a group of firms to coordinate actions without entering into an explicit agreement can be addressed under the abuse provisions. To infer control by a group of firms, the Bureau will consider the following:
>
> (a) whether the group of firms collectively accounts for a large share of the relevant market;
>
> (b) any evidence that the alleged coordinated behaviour is intended to increase price or is for the purpose of engaging in some form of anti-competitive act;
>
> (c) any evidence of barriers to entry into the group, or barriers to entrants into the relevant market;
>
> (d) any evidence based on the particular facts of the case that members of the group have acted to inhibit intra-group rivalry; and
>
> (e) any evidence that a significant number of customers cannot exercise countervailing power to offset the attempted abuse. [15]

It does not seem to us that any of these factors would be left out of account in an investigation under our Competition Act as to whether a particular firm – or each firm on a list of firms – in an oligopolistic market actually possesses market power as defined. In our view, all relevant structural and behavioural facts and circumstances must be taken into account in evaluating whether a firm has such power.

Where oligopolists are able to act in parallel so as to avoid competitive outcomes in the market concerned – although they may remain within the law in doing so – the evidence of this ability will serve as evidence of the degree of independence of its customers that is enjoyed by each of the firms concerned. It is therefore difficult to see that the test for "collective dominance" outlined above would really enlarge the number of firms in respect of which an individual finding of dominance could be made. The concept of "collective dominance" does not seem to add anything definite or material to the exercise.

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24 Trib. Dec. No CT9402/19.

[14] The author cites *R. v. Canadian General Electric* [1974] 17 C.C.C. (2d) 433 and *R. v. Armco* [1974] 21 C.C.C. (2d) 129.

[15] Strikeman Elliott LLP, *Competition Act and Commentary* (2007), pages 383-384.

European jurisprudence points towards the same conclusion. Richard Whish writes:[16]

> One of the most complex and controversial issues in Community competition law has been the application – or non-application – of Article 82 EC and the ECMR [merger regulations] to so-called "collective dominance". Discussion of this question in relation to Article 82 can be traced back at least to the early 1970s; an enormous body of literature has developed. The law and decisional practice on collective dominance, under both legal instruments, developed considerably in 1998 to 2002; of particular importance are the ECJ's [European Court of Justice] judgments in *France v Commission* (the so-called *Kali und Salz* case)[17] and *Compagnie Maritime Belge Transports SA v Commission* [18] and the CFI's [Court of First Instance] judgments in *Gencor v Commission* [19] *and Airtours v Commission.*[20]

In the 1970s, in *Hoffmann-La Roche v Commission,*[21] the ECJ had held:

> A dominant position must also be distinguished from parallel courses of conduct which are peculiar to oligopolies in that in an oligopoly the courses of conduct interact, whilst in the case of an undertaking occupying a dominant position the conduct of the undertaking which derives profits from that position is to a great extent determined unilaterally.

However, subsequent European cases have amply confirmed that undertakings (firms) can derive their dominance or market power – their ability to behave to an appreciable extent independently of (say) their customers – from the adoption of common conduct in a market, even where they are not united by structural links or by actual agreements or understandings.[22] Thus in *Compagnie Maritime Belge Transports SA v Commission* the ECJ held:

> … the existence of an agreement or of other links in law is not indispensable to a finding of a collective dominant position; such a finding may be based on other connecting factors and would depend on an economic assessment and, in particular, on an assessment of the structure of the market in question.[23]

In *Gencor v Commission* the CFI had to deal with a proposed merger of platinum and rhodium producers which, in the view of the Commission, was incompatible with the common market in that it would create or strengthen a dominant position that would hinder competition. The Court held that the merger regulations, although referring only to "a dominant position", should be interpreted so as to apply also where the creation or strengthening of a collective dominant position would result, "that is to say a dominant position held by the parties to the concentration together with one or more undertakings not

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16 *Op cit.*, 5th edition, pp 518-519.

17 Cases C-68/94 and 30/95 [1998] ECR I-1375, [1998] 4 CMLR 829.

18 Cases C-395/96 and 396/96 P [2000] ECR I-1365, [2000] 4 CMLR 1076.

19 Case T-102/96 [1999] ECR II-753, [1999] 4 CMLR 971.

20 Case T-342/99 [2002] ECR II-2585, [2002] 5 CMLR 317.

21 Case 85/76 [1979] ECR 461, [1979] 3 CMLR 211.

22 See the analysis of the cases by Whish, *op cit.*, 5th edition, pp 520-526.

23 Para 45.

party thereto."[24] In assessing whether there is a collective dominant position, the Commission is obliged to establish, using a prospective analysis of the relevant market, whether the merger in question would lead to a situation in which effective competition would be significantly impeded by the undertakings involved in the merger and one or more other undertakings which together, in particular because of the factors giving rise to a connection between them, are able to adopt a common policy on the market and act to a considerable extent independently of their competitors, their customers and, ultimately, of consumers.

The Court held that

> there is no reason whatsoever in legal or economic terms to exclude from the notion of economic links the relationship of interdependence existing between the parties to a tight oligopoly within which, in a market with the appropriate characteristics, in particular in terms of market concentration, transparency and product homogeneity, those parties are in a position to anticipate one another's behaviour and are therefore strongly encouraged to align their conduct in the market, in particular in such a way as to maximise their joint profits by restricting production with a view to increasing prices. In such a context, each trader is aware that highly competitive action on its part designed to increase its market share (for example a price cut) would provoke identical action by the others, so that it would derive no benefit from its initiative. All the traders would thus be affected by the reduction in price levels.[25]

Thus market conditions may be such that

> each undertaking may become aware of common interests and, in particular, cause prices to increase without having to enter into an agreement or resort to concerted practice.[26]

In our view, this approach can serve just as well as a basis for the evaluation of the degree of market power enjoyed by each firm in such a market. No need would seem to arise for a special concept of "collective dominance" in order to arrive at findings of dominance based on market power in terms of Chapter 2, Part B, of our Competition Act.

Section 12A of our Competition Act, dealing with consideration of mergers, similarly requires consideration to be given *inter alia* to the probability that firms in the market after the merger "will behave competitively or co-operatively". By watching, anticipating and shadowing each other, oligopolists may behave "co-operatively" without crossing the line to prohibited agreements and concerted practices which are the hallmarks of actual collusion and cartels.

(c) "Tacit collusion"

While parallel behaviour by oligopolists may provide evidence of market power on their part – and thus place them under the legal duty not to abuse their dominance – it does not follow that their behaviour would necessarily contravene the provisions of the Competition Act

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[24] Para 125.

[25] Para 276.

[26] Para 277. Cf also *Airtours v Commission*, *supra*.

prohibiting competitors from engaging in restrictive horizontal practices.[27]

John Campbell notes that

> Section 4(1) of the [South African Competition] Act prohibits an "agreement between, or a concerted practice by, firms, or a decision by an association of firms" between parties in a horizontal relationship that brings about or constitutes a restrictive horizontal practice. The prohibition in article 81(1) of the Treaty of Rome governing European community competition law is in virtually identical terms, as is s 2(1) of the English Competition Act of 1998. The formulation in the United States is directed at "(e)very contract, combination in the form of a trust or otherwise, or conspiracy" that is anti-competitive, and in Australia anti-competitive conduct in the form of a contract, an arrangement or an understanding is the target. The different formulations are directed at precisely the same conduct.[28]

Section 1 of our Competition Act provides that an "agreement", when used in relation to a prohibited practice, includes a contract, arrangement or understanding, whether or not legally enforceable; and "concerted practice" means co-operative or co-ordinated conduct between firms, achieved through direct or indirect contact, that replaces their independent action, but which does not amount to an agreement as defined.

These definitions are as clear and precise in their distinctions as language will allow. The difficulty lies in determining when parallel conduct by firms is the result of contact (whether direct or indirect) between them which has replaced their independent action. This is a problem of evidence – and of the proper characterisation of any conduct proved to have taken place. It is not made easier by the widespread use of loose terminology that obliterates the distinctions which the legislature has taken care to make. "Tacit collusion" is an example of terminology that has come to be used in a way that confuses rather than clarifies the issues.

Writers on competition economics are in the habit of using the expression "tacit collusion" to refer without distinction to conduct which crosses and conduct which does not cross the line of legal prohibition referred to above. This is because it may make no difference to the *economic* result whether the conduct crosses that line or not.[29]

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27 See section 4 of the Competition Act. Parties are in a "horizontal" relationship if they are actual or potential competitors.

28 Brassey (ed), *Competition Law*, Chapter 5, "Restrictive Horizontal Practices", pp 129-130.

29 Whish writes (*op cit.,* 5th edition, p 508): "There is little doubt that there are markets in which it is possible for economic operators to coordinate their behaviour without entering into an agreement or being party to a concerted practice in the sense of Article 81(1) or the Chapter I prohibition; such behaviour will be to their own self-advantage and to the disadvantage of customers and ultimately consumers. This situation is often described by economists as "tacit collusion": enjoying the benefits of a particular market structure without actually entering into an agreement to do so. If the firms in question had achieved the same end through explicit collusion, economists would have the same objection – that prices would be higher than they would be without coordination. Economists have no particular interest in whether collusion is 'tacit' or 'explicit': it is the effects of the collusion that matter. Lawyers however are considerably less comfortable with the expression tacit collusion. 'Collusion' is the evil at which Article 81 and the Chapter I prohibition are directed ('any agreement ... or concerted practice ... which has as its object or effect the prevention, restriction or distortion of competition'); in the same way section 1 of the US Sherman Act forbids 'every contract ... in restraint of trade', where the notion of collusiveness is inherent in the idea of contract." In fact, section 1 of the Sherman Act also prohibits every "combination" and "conspiracy" in restraint of trade – words which likewise import the notion of collusion.

Michael D. Whinston writes:[30]

> For example, imagine a scenario in which two firms sit down at a table with each declaring in sequence, “I am mortally opposed to price fixing, but tomorrow I will set my price equal to 100.” Should such unilateral speech be treated differently than if they instead each said “I’ll set my price equal to 100 if you do”? And does that differ from the situation in which firm 1 says “Let’s set our prices equal to 100 tomorrow,” and firm 2 replies “I agree”?

The problem with this set of examples is that it characterises the first scenario somewhat naively as involving only “unilateral” conduct. In fact the act of the two firms in deliberately conveying their pricing intentions to each other in this way, while avoiding actual or apparent agreement, could well be characterised as procuring co-ordinated conduct through direct or indirect contact that replaces their independent action. That would fall within the definition of “concerted practice” in our Competition Act.

Campbell illustrates aptly the legal boundary-line between unilateral and collusive conduct:[31]

> Assume that apple farmers in the Western Cape number about fifty. Some are bigger than others and one or two are very big indeed. One of these raises the price of apples and soon the others follow. Is this a concerted practice, *prima facie* evidence of one or just the normal workings of the market. Clearly costs rise, and sooner or later producers will have to adjust their prices to preserve their viability; someone has to be the first to do so and the news will always leak out, generally sooner rather than later.
>
> The competition laws are not designed to hit parallel conduct of this description. More is required: there must be evidence of contact (direct or indirect) and of some form of co-operation. Direct contact is relatively straightforward. If two or more farmers, following the above example, set a price for apples by means of direct notification between them of the prices they intend to charge and with the understanding that neither will undercut the other, a court will have little difficulty in finding a concerted practice. But such communications can also take place without any such notification through indirect contact, for example where the farmers hold press conferences in order to state their views on issues such as output, prices, demand, costs, industry margins of profit, etc. The more farmers that speak publicly in this manner, the greater the level of communication, and in this way behaviour can be both instigated and modified.
>
> In *ICI v The Commission*[32] the European Court was fully aware of these possibilities:
>
> > ‘Although every producer is to change his prices, taking into account in so doing the present or foreseeable conduct of his competitors, nevertheless it is contrary to the rules on competition contained in the Treaty for a producer to co-operate with his competitors, in any way whatsoever, in order to determine a co-ordinated course of action relating to a price increase and to ensure its success by prior elimination of all uncertainty as to each other’s conduct regarding the essential elements of that action, such as the amount, subject-matter, date and place of the increases.’
>
> …
>
> Something more than mere indirect contact must … be required if innocent price leadership is not to be caught in the net; it is undesirable (and probably impossible) to provide a *numerus clausus* of the additional ingredients, but they must be such as to remove the risk of, for example, increasing prices or, at a more general level, involve some organization or plan that replaces genuinely independent responses to changing market conditions.

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[30] *Lectures on Antitrust Economics*, The MIT Press, Cambridge, Massachusetts, 2008, “Price Fixing”, p 20.

[31] *Op cit.*, pp 133-134; p 137.

[32] [1976] 1 CMLR 295 at paras 172-6.

> In this regard the Australian approach is instructive. There, and again because of the difficulties in proving an actual consensus, the courts hold that this may be inferred from surrounding circumstances such as actual parallel conduct, joint action between the parties on some or other issue, similar pricing structures, opportunities for the parties to reach consensus or any other evidence tending to show that two or more parties are acting in concert. In particular, if there is coincidence in time, character or the direction of the actions taken by parties, an inference of concert may be drawn.

Trebilcock, Winter, Collins and Iacobucci write:[33]

> A cartel can be associated with an explicit agreement [whether overt or covert], in which a written or oral contract is established among cartel members, or an implicit [tacit] agreement, which simply establishes a common understanding among suppliers as to the benefits of cooperative pricing or output decisions and the consequences of deviations from cooperation.
>
> …
>
> The concept of tacit agreement or tacit collusion covers a wide range of behaviour. At one end of this range, the distinction between a tacit agreement and an explicit agreement can be as tenuous as the difference between a wink and a handshake. At the other end of the range of tacit collusion, the border between agreement and rational, independent behaviour by competing suppliers becomes murky. In many oligopolies, each firm in the market sets a price close to the monopoly level purely as a matter of individual interest, with no communication whatsoever with other firms. The recognition by each firm of responses by other firms to potential price cuts leads to non-aggressive pricing. … (Do firms in any oligopoly *not* consider their rivals' reactions to potential price changes?)

Despite these clear passages, the authors go on to suggest that tacit collusion between competitors is "outside the scope of the law".[34] That cannot be correct. "Tacit" merely means unspoken, silent or wordless. The fact that *collusion* is tacit rather than express in no way suffices to remove it from the prohibition.

This can readily be illustrated by examining the use of the word "tacit" in conjunction with "agreement". Is an unspoken, silent or wordless *agreement* between firms in a horizontal relationship *outside the scope* of the prohibitions against price- and other forms of market fixing? It would be startling if the law could be so easily circumvented.

In the law of contract, the concept of a "tacit term" is well recognised. It is used to denote an unexpressed term read into an otherwise express agreement on the basis of the unarticulated but nevertheless inferred or imputed intention of the parties to treat the term as binding between them. The inference or imputation is usually derived from the express terms of the agreement and the surrounding circumstances.[35] And just as there can be a tacit term

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33 *The Law and Economics of Canadian Competition Policy* (2002), pp 87-89.

34 *Id.,* p 89.

35 See *Alfred McAlpine & Sons (Pty) Ltd v Transvaal Provincial Administration* 1974 (3) SA 506 (A) at 531H-532G per Corbett AJA; *Anglo Operations Ltd v Sandhurst Estates (Pty) Ltd* 2007 (2) SA 363 (SCA) at 367H. See also Du Bois (ed), *Wille's Principles of South African Law* (9th edition), p 799. Van der Merwe, Van Huyssteen, Reinecke and Lubbe, *Contract: General Principles* (2nd edition), p 257 note: "There is no difference between express and tacit terms as far as their nature and effect are concerned. However, there is a difference in the way in which these terms are to be proved: an express term is proved by direct evidence and a tacit term by circumstantial evidence." Cf *Williston on Contracts* (4th ed) vol 1, §3:2: "A binding mutual understanding or so called 'meeting of the minds' (consensus ad idem) sufficient to establish a contract requires no express language regarding every detail of the proposed agreement; it may be implied from the parties' conduct and the surrounding circumstances." Also *Corbin on Contracts*, vol 3, §561, §562.

in an otherwise express agreement, so there can be an *agreement* — that is to say, a legally binding contract — that is itself *entirely tacit*.

Discussing contractual "offer and acceptance", Christie says:[36]

> The communication of an offer normally takes place by means of words, spoken or written, but this is not always so. The offeror may choose to make his intention clear by conduct unaccompanied by words, in which case his offer would properly be described as tacit or partly tacit. Such an offer could also be described as an offer by conduct, or by actions, or an implied offer. Countless offers of this sort are made daily in shops, buses and railway stations. …
>
> Just as an offer can be made tacitly, so can an acceptance. The Appellate Division on a number of occasions directed its mind to the question of acceptance by conduct – when the offeree, instead of signifying his acceptance of the offer by written or spoken words, does so by his conduct. In *Timoney and King v King* 1920 AD 133 141 Innes CJ said: "An acceptance may be inferred from conduct."
>
> In *Reid Bros (SA) Ltd v Fisher Bearings Co Ltd* 1943 AD 232 241 Watermeyer ACJ said:
>
> "Now a binding contract is as a rule constituted by the acceptance of an offer, and an offer can be accepted by conduct indicating acceptance, as well as by words expressing acceptance. Generally, it can be stated that what is required in order to create a binding contract is that acceptance of an offer should be made manifest by some unequivocal act from which the inference of acceptance can logically be drawn." …
>
> It being possible to make an offer tacitly, and to accept tacitly, it follows that a tacit offer may be tacitly accepted, giving rise to what is usually described as a tacit contract but may also be described as an implied contract or a contract by conduct (it being remembered that conduct may be negative as well as positive and there may be acceptance by silence).

The law in the United States and other (English) common law jurisdictions is, in this regard, essentially the same as ours.[37]

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[36] *The Law of Contract in South Africa* (5th ed), pp 81-82. Cf also De Wet en Van Wyk, *Die Suid-Afrikaanse Kontraktereg en Handelsreg* (5th ed), pages 31-32: "Onderhandelinge tussen mense geskied gewoonlik deur die middel van die gesproke of geskrewe woord, maar spraak of skrif is vir die maak van 'n afspraak nie noodsaaklik nie. Mens kan jou bedoeling aan 'n ander ook by wyse van gebare meedeel, bv. deur te knik met die kop of jou hand op te steek. Veral instemming kan geredelik deur niegeartikuleerde gedrag betuig word, maar dit is nie ondenkbaar dat mens ook 'n aanbod op die wyse kan maak nie, bv. deur op 'n veiling jou hand op te steek, waarmee jy te kenne gee dat jy die voorafgaande bieder met 'n rand of tien rand, na gelang van die geval, oorbie. Waar die verklaring in woorde gemaak word, praat ons van 'n uitdruklike wilsverkiaring, en waar dit by wyse van nie-geartikuleerde gedrag geskied, van 'n stilswyende wilsverklaring. In kwaliteit verskil die stilswyende wilsverklaring nie van die uitdruklike nie, en die stilswyende wilsverklaring het juridies dieselfde waarde as die uitdruklike, behalwe waar spesifiek voorgeskryf word dat die verklaring 'n bepaalde vorm moet aanneem om regsgeldig te wees. Of bepaalde gedrag 'n (stilswyende) wilsverklaring is, is natuurlik 'n feitlike vraag, wat onder omstandighede moeilik kan wees om te beslis, maar dit beteken nie dat die stilswyende wilsverklaring daarom regtens onbestaanbaar is nie."

[37] See e.g.:

Chitty on Contracts (29th ed), vol 1, par 1–066: "Contracts may be express or implied. The difference is not one of legal effect but simply of the way in which the consent of the parties is manifested. Contracts are express when their terms are stated in words by the parties. They are often said to be implied when their terms are not so stated, as, for example, when a passenger is permitted to board a bus: from the conduct of the parties the law implies a promise by the passenger to pay the fare, and a promise by the operator of the bus to carry him safely to his destination."

Story on Contracts (1884), vol 1, §11: "Both species of contract [i.e., express and implied] are, however, equally founded upon the actual agreement of the parties, and the only distinction between them is in regard to the mode of proof, which belongs to the law of evidence."

Farnsworth on Contracts (3rd ed), vol 1, §3.10: "No formalities are generally required for an offer. It may be made by spoken or written words or by other conduct. Sometimes a contract that results from words is described as 'express,' while one that results from conduct is described as 'implied in fact,' but the distinction as such has no legal consequences. Conduct that would lead a reasonable person in the other party's position to infer a promise in return for performance may amount to an offer [and thus be capable of contractual acceptance]. One who holds out goods may be taken to be offering them for sale. One who begins to perform services for another in apparent expectation of

Just as an agreement may be tacit rather than express, so obviously may a concerted practice – co-operative or co-ordinated conduct between firms, achieved through direct or indirect contact, that replaces their independent action – be brought about by means that are tacit rather than express. These are clearly both forms of *tacit collusion*, and it seems inappropriate to use the latter expression to refer to unilateral parallel conduct which involves no replacement of independent action through contact (direct or indirect) between the firms concerned.

In *Theatre Enterprises, Inc. v Paramount Film Distributing Corp.,*[38] the United States Supreme Court concluded:

> The crucial question is whether respondents' conduct towards petitioner stemmed from independent decision or from an agreement, tacit or express. To be sure, business behavior is admissible circumstantial evidence from which the fact finder may infer agreement. … But this court has never held that proof of parallel business behavior conclusively establishes agreement or, phrased differently, that such behavior itself constitutes a Sherman Act offense. Circumstantial evidence of consciously parallel behavior may have made heavy inroads into the traditional judicial attitude toward conspiracy; but 'conscious parallelism' has not yet read conspiracy out of the Sherman Act entirely.[39]

American antitrust author and Federal Appeals judge Richard A. Posner has argued for a new legal boundary-line which would prohibit unilateral parallel conduct by a firm in cases where it is *intentionally* rather than *unconsciously* parallel in character.[40]

> Tacit collusion is not an unconscious state. If the firm's sales manager recommends that the firm offer a wider variety of products in order to exploit consumer demand more effectively, and the financial vice president recommends against that course on the ground that it will make it more difficult for the industry to maintain "healthy" prices, the president of the firm can be in no doubt of the significance of his action if he adopts the financial vice president's recommendation. Or if a salesman has correctly calculated that a proposed sale would yield a handsome profit, and his boss turns it down on the ground that it might provoke a competitor to retaliate because the sale price would be considered price cutting, again there would be no ambiguity that the firm's action was designed to preserve a collusive arrangement. Or take the common case in which each seller in a market has "sleepers," that is, customers who do not shop around for the best deal but are content with their current supplier. If each seller declines to try to wake the other sellers' sleepers, on the ground that if he does so the others will try to wake his sleepers and everyone will then be worse off, the seller will know that he is acting to preserve a collusive arrangement.

In our view this argument begs the question which it is supposed to address. None of the conduct described is necessarily indicative of the existence of "a collusive arrangement" or, conversely, necessarily inconsistent with purely unilateral calculations by the firm concerned

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payment may be taken to be offering to furnish them for reasonable compensation. The question of fact in each case is whether a reasonable person in the position of the other party would understand that payment was expected for the services and that they were not gratuitous." In §3.13 the author adds that an acceptance likewise may be inferred from conduct other than words. "The language or other conduct that will suffice as acceptance [of the offer] … depends on the circumstances, and cases tend to turn on their special facts." See also §3.14.

38 346 U.S. 537, 74 S.Ct. 257 (1954).

39 346 U.S. 537, 540-541.

40 *Antitrust Law* (2nd edition), ""Price Fixing and the Oligopoly Problem", p 97.

about the likely conduct of its competitors in the event that it were to adopt a particular output or pricing choice.

The difference between express collusion and tacit collusion is that, in the latter instance, the firms *conspire* – i.e., *arrange to act together* – *without needing to use words*. Collusion, whether express or tacit, requires more than that the firms separately arrive at the same conscious calculation of self-interest, taking each other's likely behaviour into account. It is essential not to confuse the common rational behaviour of oligopolists – who necessarily, and indeed by definition, take into account the likely behaviour of their competitors – with "tacit collusion" between the firms concerned.

The approach advocated by Posner would demand of firms behaviour that is not rational market conduct in their circumstances. In the examples which he puts forward, he would in each case require of the firm a *short-term* profit maximising decision which, while understandably recommended by the sales staff, is understood by the senior executives to be *likely to reduce profit in the longer term*. Expecting oligopolists not to behave as oligopolists – i.e., not to take each other's likely conduct into account – is to repudiate the rationality of individual conduct which is the central claim of the market system as a means of regulating social production and distribution. It is to expect of market participants that they should – while facing competition – abandon the calculation of self-interest in their business decisions.

Such an approach is too hazy to recommend itself as a solution to the serious competition issues that are posed by oligopoly behaviour. Behavioural prohibitions require clear delineation, or else the rule of law is undermined. If, for structural reasons, rational market decisions must produce an anti-social result, and behavioural prohibitions are unsuitable, the remedy must be sought in a regulatory or other intervention of public power.

It is with these considerations in mind that we have addressed the issues, and assessed the available evidence, discussed in this report.

Appendix G "Concurrent jurisdiction" as a defence – the effect of the ATM PCH agreement and rules

At the hearing of the Enquiry on 25 May 2007, Absa drew attention to the issue of "concurrent jurisdiction" in regard to banking practices which comply with current regulatory stipulations although they may be thought to fall foul of the Competition Act.[41] The discussion concerned access to the national payment system, and non-bank acquiring, but the principles would be applicable equally, for example, to the question of interbank arrangements in respect of off-us ATM transactions.

Banking is an industry under the regulatory authority of the Minister of Finance and of the South African Reserve Bank (the SARB). The same applies to the national payments system.

Section 4 of the Competition Act, prohibiting restrictive practices by parties in a horizontal relationship (i.e. by actual or potential competitors), is part of Chapter 2 of the Competition Act. Section 3(1A) of the Act provides:

> (a) In so far as this Act applies to an industry, or sector of an industry, that is subject to the jurisdiction of another regulatory authority, which authority has jurisdiction in respect of conduct regulated in terms of Chapter 2 or 3 of this Act, this Act must be construed as establishing concurrent jurisdiction in respect of that conduct.
>
> (b) The manner in which the concurrent jurisdiction is exercised in terms of this Act and any other public regulation, must be managed, to the extent possible, in accordance with any applicable agreement concluded in terms of section 21(1)(*h*) and 82(1) and (2).

Section 21(1)(*h*) gives the Competition Commission the responsibility to negotiate agreements with any regulatory authority to co-ordinate and harmonise the exercise of jurisdiction over competition matters within the relevant industry or sector, and to ensure the consistent application of the principles of the Competition Act. Section 82 deals further with the negotiation of such agreements.

Such agreements as are in existence currently between the Competition Commission and these authorities do not operate to reconcile the regulatory arrangements applicable to ATM service provision with the principles of the Competition Act. That is a matter which, in our view, needs attention.

In the absence of a relevant agreement, the issue raised by Absa must be addressed on general principles.

The clear implication of sections 21(1)(*h*) and 82 of the Competition Act is that the legislation empowering other regulatory authorities should, as far as possible, be interpreted

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41 Transcript, pp 101-103.

consistently with the principles of the Competition Act. Such other legislation should never lightly be read as having been intended to permit anti-competitive conduct. It would be contrary to legal principle and public policy to construe such other legislation as suggesting or encouraging the disregard of the basic competition law enacted by Parliament.

In our view, furthermore, where the law in terms of which the other relevant authority exercises its (concurrent) jurisdiction may *permit but does not actually require* the conduct allegedly contravening the Competition Act, the existence of concurrent jurisdiction would not provide a defence.[42]

The question also arises as to what the legal outcome would be where the applicable regulatory provisions cater only for a particular mode of agreement or arrangement, devised by the parties in the horizontal relationship themselves, that would allegedly contravene the Competition Act. In our view, if the parties could have devised and obtained approval for an agreement or arrangement that would not contravene the Act, but failed to do so, they ought not to have such a defence.

The provisions of the current PCH agreement between banks that is applicable to off-us ATM transactions, together with the accompanying clearing rules applied by the payment system management body, PASA, do not explicitly require any particular pricing arrangement. Nevertheless, they are obviously predicated on the current charging model. So far as we can see, there is nothing to prevent banks entering into an ATM PCH agreement, and obtaining through PASA appropriate clearing rules, predicated on a direct charging model.

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[42] In the United States, the so-called "state action" doctrine provides a defence to alleged contraventions of federal antitrust law. This doctrine applies under certain circumstances where states have created their own regulatory regime that displaces competition in certain markets. (See Hovenkamp, *Antitrust,* 4th edition, pp 332-337.) However, historically the state action doctrine applied only to conduct *mandated* by the state. (See e.g. *Goldfarb v. Virginia State Bar,* 421 U.S. 773, 95 S. Ct. 2004 (1975).) Where the state merely *authorises* the conduct under its regulatory regime, the conduct is not generally shielded from antitrust enforcement. It may be different, however, where the regulatory scheme itself depends on the conduct which would otherwise be condemned – for example, where the scheme of regulation necessarily involves the participants setting price or engaging in other anti-competitive conduct. (Cf e.g. *Southern Motors Carriers Rate Conference v U.S.,*471 U.S.48, 105 S.Ct. 1721 (1985).) Also, where the state itself does not conduct (cf *Hoover v. Ronwin,* 446 U.S. 558, 104 S.Ct.1989 (1984)) or at least actively supervise (cf *California Retail Liquor Dealers Ass'n v Midcal Aluminum Co.,* 445 U.S. 97, 100 S.Ct. 937 (1980); *Patrick v Burget,* 486 U.S. 94, 108 S.Ct. 1658 (1988)) the arrangement under which, say, prices are set, the defence will not apply. Furthermore, the restraint on competition must be one that is clearly articulated and affirmatively expressed as state policy. (Hovenkamp, p 333 citing *Midcal;* cf also *Lafayette v Louisiana Power and Light Co.,* 435 U.S. 389, 98 S.Ct. 1123 (1978).)

In European competition law, the defence of "state compulsion" is very similar. According to Whish, *Competition Law,* 5th edition, p 128, this defence has been raised on numerous occasions, but has always failed. "For a successful defence, it would seem that three requirements must be satisfied. First, the state must have made certain conduct *compulsory*: mere persuasion is insufficient; secondly, the defence is available only where there is a legal basis for this compulsion…; and thirdly, there must be no latitude at all for individual choice as to the implementation of the governmental policy."

Broadly speaking, similar criteria would not seem to jar with the approach to "concurrent jurisdiction" as contemplated by our Competition Act.

Appendix H FICA and Direct Charging

This appendix sets out reasons for the view that, in the absence of a suitable exemption, FICA might present an impediment to the implementation of the direct charging model for off-us ATM transactions.

In terms of section 21 of FICA, an "accountable institution" – an expression which includes banks[43] – may not establish a business relationship *or conclude a single transaction*[44] with a client[45] unless the accountable institution has taken the prescribed steps to establish and verify *inter alia* the identity of the client.

This presents, of course, no unusual difficulty in the case of on-us ATM transactions, because in that case the ATM service provider transacting with the client and the institution which has issued the card to the client are one and the same. The issuer would ordinarily have complied with FICA when entering into its business relationship with the client,[46] or would have been required to do so subsequently in terms of that Act.[47] However, the matter is different where off-us ATM transactions occur. Here the user ordinarily has no pre-existing relationship with the ATM provider. The "prescribed steps"[48] in terms of FICA for establishing and verifying *inter alia* the identity of the client are such that they could not practically be taken by the ATM provider itself in that situation. The customer approaches the terminal, the card goes in, buttons are pressed, electronic signals fly, and the cash comes out or a payment is effected: the relationship between ATM provider and customer in off-us situations is impersonal, momentary and mechanical. Accordingly, the ATM provider would not have complied and would not be able to comply with FICA – *if FICA were to be applicable to that*

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43 "Accountable institution" is defined in section 1 of FICA as meaning "a person referred to in Schedule 1". That Schedule contains 19 items. Item 6 refers to: "A person who carries on the 'business of a bank' as defined in the Banks Act, 1990 (Act 94 of 1990)". Item 7 refers to mutual banks, item 14 to the Postbank (which is excluded from the Banks Act) and item 16 to Ithala (which has an exemption under the Banks Act).

44 A "single transaction" is defined in section 1 of FICA as meaning "a transaction other than a transaction concluded in the course of a business relationship" (see below). "Transaction" is defined in section 1 of FICA as meaning "a transaction concluded between a client and an accountable institution in accordance with the type of business carried on by that institution." In terms of section 4(c) of FICA, the Financial Intelligence Centre is empowered and directed to "give guidance to accountable institutions" and others "regarding the performance by them of their duties and their compliance with the provisions of this Act". The Centre issued Guidance Note 2 (Government Notice 735, in *Government Gazette* 26469 of 18 June 2004) which seeks to interpret the Act, and which suggests that a transaction between an accountable institution and a client is "an instance of commercial activity between" them taking place in accordance with the nature of the business carried on by the institution in question. That is probably correct. Cf *Norwich Union Fire Insurance Society Ltd v SA Toilet Requisite Co Ltd* 1924 AD 212 at 216: business transactions are "dealings in the way of business with third parties". Also *id.*, at 224-225.

45 "Client" is not defined in FICA. One of the ordinary meanings of "client" is simply a customer (*Webster's Third New International Dictionary*); and a shop's "clientele" are its customers (*The Shorter Oxford English Dictionary*). Although the word "client" may usually imply a professional relationship, here, in its actual context – which must include the full range of business entities identified as "accountable institutions" in Schedule 1 of FICA – it could be held to bear the broader meaning.

46 "Business relationship" is defined in section 1 of FICA as meaning "an arrangement between a client and an accountable institution for the purpose of concluding transactions on a regular basis".

47 Read with Government Notice R749 (*Government Gazette* 26487) of 21 June 2004.

48 See Government Notice R1595 (*Government Gazette* 24176) of 20 December 2002, Chapter 1.

service provider in respect of the transaction.

Under current arrangements between banks the problem is avoided because the off-us ATM provider *does not conclude a transaction with the cardholder.* Instead, the ATM provider undertakes the cash dispensing or other ATM service *on behalf of the issuer.* The latter, by means of this outsourcing arrangement,[49] itself provides the cash-dispensing or other ATM service to, and enters into the relevant transaction with, the client. Thus, currently, the off-us ATM service provider is *not* required to take the steps prescribed under FICA for establishing and verifying *inter alia* the identity of the cardholder in respect of the transaction.

A change to direct charging for ATM services would mean that, in off-us situations as well, a *transaction would be concluded directly between the ATM service provider and the cardholder* to whom the cash is dispensed or other ATM service is supplied. Would it necessarily follow that, in off-us situations, the ATM service provider would be in breach of FICA for failing – being unable in fact – to establish and verify *inter alia* the identity of the client?

Where the ATM service provider is not a bank, it would ordinarily *not* be an "accountable institution" within the meaning of FICA,[50] and so would *not* be required to take the prescribed steps to establish and verify *inter alia* the identities of those with whom it enters into transactions. The fact that it would be unable in any case to take the steps prescribed by FICA is thus irrelevant: FICA simply would not apply. We are confronted therefore by the anomaly that banks,[51] which *are* accountable institutions, could – having the same inability to take the prescribed steps where they directly provide the service in off-us ATM transactions – be held to be in contravention of FICA, whereas non-bank ATM providers would ordinarily be in the clear.

It is arguable that an off-us ATM transaction with a stranger would not be a "transaction" as defined in FICA – i.e., one concluded between a client and an accountable institution in accordance with the type of business carried on by that institution – when the institution concerned is a bank. It is similarly arguable that the bank's customer in such a case is not its "client" as contemplated by FICA, because no account-holding by the customer with that bank is involved. However, this is an area where clarity and certainty rather than points of argument are needed for institutions to rely on.

Current exemptions from the provisions of FICA and the regulations do not seem to cover

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[49] It is unnecessary to consider whether "agency", or rather simply mandate, would describe the legal relationship involved here.

[50] Likewise, merchants providing cash-back at the point of sale would ordinarily not be accountable institutions as contemplated by FICA. Note, however, that a non-bank ATM service provider – or indeed an entity providing cash-back at the point of sale – might also be engaged in some other kind of business (dealing in foreign exchange, for example) which is referred to in the list in Schedule 1. In that case it would be an accountable institution.

[51] Also mutual banks, the Postbank and Ithala.

the matter.[52] Paragraph 4 of the Exemptions promulgated in Government Notice R1596 (*Government Gazette* 24176) of 20 December 2002, as amended by Government Notice R1353 (*Government Gazette* 27011) of 19 November 2004 does not seem to cover the situation of direct charging, where the off-us ATM service provider concludes a transaction directly with the customer and not simply with the issuing bank acting on the customer's behalf. Paragraph 17, does serve to limit the scope of the particulars required, and the records to be kept, where withdrawals, transfers and payments not exceeding R5 000 per day or R25 000 per month are involved, and where accounts with balances not exceeding R25 000 are maintained. However, the *remaining* particulars and records which *are* required would themselves be beyond what is practical for the service provider to obtain directly where off-us ATM withdrawals are concerned.[53]

It is for these reasons that a specific exemption such as the one suggested in the chapter on ATMs and Direct Charging should be considered.

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52 Currently "there are no exemptions whereby one bank can rely on the FICA identification and verification of a client by another bank (or accountable institution), nor whereby a bank can rely on the fact that it is a (small value) single transaction between itself and a non-client." Memorandum by Stuart Grobler, *supra,* para 2.

53 Absa's view is that only cash deposits remain a problem for non-banks. We believe an agency relationship with the issuing bank in respect of deposits could address this. See Absa, September 2007, Direct charging models for ATM's, p 19-21.

Appendix I The payment card reforms in Australia

1. Introduction

> Leading the drive to regulate the interchange fee has been the Reserve Bank of Australia (RBA).[54]

It has been concluded earlier in this chapter that an interchange-setting methodology which merely quantifies certain costs and does not assess demand elasticities cannot be adequate for achieving the legitimate purpose of interchange as a mechanism balancing the two sides of a two-sided market. It has been concluded further that, in calculating relevant costs on the issuing side as a necessary ingredient in interchange setting, the costs of credit extension should not be included. Having regard to these fundamental considerations, the Banking Enquiry panel cannot recommend for South Africa the methodology adopted in Australia for regulating interchange. Nevertheless, the Australian experience remains highly instructive.

2. Background to the reforms

In Australia the Prices Surveillance Authorities (PSA) raised the first questions about interchange fees and *ad valorem* merchant service fees in a report on credit card interest rates in 1992.[55] These issues were again raised in 1995, with the PSA concluding that the interchange fees on credit and debit cards were unlikely to be priced efficiently.[56] In its 1995/96 annual report the Australian Payments System Council questioned the mechanisms of the card schemes and rationales for their pricing structures.[57]

The Financial System Inquiry (the "Wallis Committee") was established in 1996 to look into the efficiency and governance of the payments system.[58] Its report in 1997 recommended that the Australian Competition and Consumer Commission (ACCC), and a new Payments System Board (PSB) within the RBA, review the credit and debit card interchange fee arrangements as well as limitations on access to the MasterCard and Visa card schemes.

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54 MasterCard Worldwide, *Insights,* First Quarter 2007, "Interchange Regulation: Lessons learned from the RBA Intervention in Australia", p 1.

55 "In a wide-ranging inquiry that looked at, amongst other things, the profitability of credit card operations, the PSA noted that interchange fees for credit cards had not changed despite technological improvements and the increasing scale of credit card operations. It also questioned why fees to merchants were charged on an ad valorem rather than flat rate, since the costs incurred by their financial institutions varied more directly with the number of transactions than their value." (Reserve Bank of Australia (RBA) and Australian Competition and Consumer Commission (ACCC), October 2000, *Debit and Credit Card Schemes in Australia. A Study of Interchange Fees and Access*, p 2.)

56 "The PSA noted that, despite a number of indications that unit costs for debit card transactions should have fallen over the 1990s, interchange fees in debit card payment schemes had not changed since they were first negotiated in the late 1980s." (*Id.*)

57 *Id.*

58 "The Inquiry strongly advocated the substitution of electronic forms of payment for paper-based transactions as a means of achieving substantial gains in efficiency." (*Id.*, p 3.)

In September 1999 the ACCC and the PSB jointly launched an investigation into interchange fees for debit and credit cards, and membership criteria for credit card schemes.[59] Their report suggested, *inter alia*, that interchange fee arrangements for credit cards might be encouraging the use of credit cards relative to more efficient payment instruments (such as debit cards).[60] Among the recommendations was that the RBA regulate credit card schemes. In 2001, the RBA designated the Bankcard, MasterCard and Visa credit card schemes as payment systems under the Payment Systems (Regulation) Act 1998.

In August 2002 the RBA formulated a Standard for the setting of credit card interchange in all these schemes.[61] As a result, interchange fees were reduced in November 2003 from an average rate of 0.95 per cent to an average of 0.55 per cent of credit card[62] transaction values.[63] The Standard required a recalculation of the benchmarks every three years using updated cost estimates. The first recalculation occurred in the third quarter of 2006, resulting in a new benchmark of 0.50 per cent effective from 1 November 2006.[64]

Rules against surcharging by merchants were abolished from January 2003. Rules regarding the membership criteria of Visa and MasterCard were amended to ease the "restricted access" to these schemes.[65] The "honour all products" rule was abolished with effect from January 2007, leaving merchants free to choose to accept either debit cards or credit cards or both.[66]

Reforms to be implemented in the debit card market were only finalised in the first half of 2006.[67] These included the improvement of access and transparency in the EFTPOS system, abolition of the "honour all products" rule and lowering of the interchange fees.[68]

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59 *Id.*, p 4.

60 *Id.*, p 5.

61 See RBA, November 2005, *Common Benchmark for the Setting of Credit Card Interchange Fees*, p 1.

62 Interchange fees have historically been the same for both debit cards and credit cards. Prior to the reforms in 2003, interchange fees on debit cards also averaged around 0.95 per cent of the transaction value, declining to around 0.55 per cent when the credit card reforms were introduced (RBA PSB. *Annual Report* 2007, p 26).

63 RBA estimates indicate that prior to the 2003 interchange reforms more than 35% of a card issuer's revenue came from interchange, with almost all of the remainder (61%) coming from cardholders who used their card as a borrowing tool ("revolvers"). A mere 3.5% came from "transactors". (Visa, Second Submission, June 2007, document T, pp 13-14.)

64 RBA PSB. *Annual Report* 2007, p 23.

65 We do not deal with the Australian access regime in this Appendix. It is discussed in the chapter on access and regulation.

66 "On 1 January 2007, the honour-all-cards Standard covering the Visa system came into force; MasterCard provided a voluntary undertaking that had the same effect for the MasterCard system. The effect of this Standard and undertaking is that the schemes are no longer allowed to require that merchants accept debit cards as a condition of accepting credit cards and *vice versa*. There are also requirements that scheme debit cards must be visually and electronically distinguishable from scheme credit cards." RBA PSB *Annual Report* 2007, p 24.

67 The Bank introduced an interchange Standard for the EFTPOS and Visa Debit systems in April 2006, which came into effect on 1 November 2006 (RBA PSB. Annual Report 2007, p 26).

68 RBA PSB. *Annual Report* 2006, pp 11-18.

3. Regulation of the credit card system

As indicated above, the Standard enforced from November 2003 reduced credit card interchange fees by an average of 40 basis points (i.e., by 0.40 per cent). It appears that the reduction in interchange was fully passed through by acquirers to merchants by way of reduced merchant service charges. The merchant service charge has declined by 0.6 per cent since the implementation of the reforms.[69]

Following the MasterCard, Visa and Bankcard reductions, the merchant service charges of American Express also decreased, but only by approximately 29 basis points since September 2003 – i.e. from around 2.46 per cent to 2.17 per cent. Diners Club merchant service charges decreased by about 18 basis points over the same period, from around 2.37 per cent to 2.19 per cent[70].

Even though the merchant service charges of the three-party schemes remained significantly higher than for the four-party schemes it is estimated that, since the inception of the reforms, merchants have saved a net total of at least AUS$2.5 billion.[71] The table below summarises the changes.

Table 2 Interchange fee reductions in Australia

	Prior to 2003	2006/2007	Decrease	% Change
Avg. interchange fee[72]	0.95	0.50	0.45	-47%
Weighted MSC[73]	1.4	0.80	0.60	-43%
American Express[74]	2.46	2.17	0.29	-12%
Diners Club	2.37	2.19	0.18	-7.6%

Source: RBA PSB, Annual Reports, 2006, 2007.

Although the merchant service charges in the four-party schemes fell substantially, research data showed that 70 per cent of merchants were not aware of it and that merchants maintained that no changes had been applied to their applicable fees.[75] There was no

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69 RBA PSB. *Annual Report* 2007, p 30.

70 *Id.*

71 *Id.* "These savings are offset slightly by the small increase in the combined market share of American Express and Diners Club since the reforms…"

72 This is an average interchange fee for the four-party systems.

73 This relates to four party schemes.

74 This is the MSC.

75 Morgan, R. 2005 *Tracking study on credit card surcharging and the interchange fee*; MasterCard Worldwide, *Insights,*

evidence that consumer prices had actually fallen as a result of the interchange reductions.[76]

On the issuing side, although interchange revenue contracted, marginal prices charged to cardholders did not adjust as such.[77] However, actual prices facing cardholders did adjust in three ways: benefits and reward programs became less generous; annual and other fees increased; and surcharging by merchants was permitted. According to the RBA and the four major banks in Australia, the average amount that had to be spent by a cardholder in order to receive loyalty benefits increased by about 31 per cent[78] and the average annual fee revenue per credit card account increased by about 43 per cent from $40 to $70.[79] Other effects included changes in the product offerings, and adjustments of interest rate charges on credit in order to attract customers discouraged by higher cardholder fees. Competition on interest rates charged on credit cards led to a proliferation in the number of low-rate cards that emerged. According to the 2006 annual report of the PSB, the newly applied interest rates could be as low as 8.99 per cent compared to interest rates in the order of 16 per cent to 18 per cent before the reforms.[80]

Surveys also indicated that only about 12 per cent of large companies and about 2 per cent of smaller companies had started to surcharge within a few years after the reforms.[81] Where merchants did introduce surcharging, it tended to be arbitrary and non-systematic. Furthermore, it has evidently occurred mainly in markets with low levels of competition. Most retail segments show very little or no surcharging.[82] In 2006, the RBA commissioned East & Partners to include questions regarding surcharging in their survey of merchant acquiring business. The results showed that surcharging is becoming more common amongst large merchants, and in June 2007, 17 per cent of large merchants imposed a surcharge. Most merchants apply the same surcharge to both debit and credit cards, with some merchants applying higher rates to more expensive cards such as American Express and Diners Club. The average surcharge for MasterCard and Visa cards is around $1, compared to a $2 surcharge on American Express and Diners Club cards.[83]

The combined market share of American Express and Diners Club increased from an average of 14.9 per cent of the value of purchases in 2002/2003 to 16.5 per cent in

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First Quarter 2007, "Interchange Regulation: Lessons learned from the RBA Intervention in Australia", p 3.

[76] *Id.*

[77] See Evans and Schmalensee, 2005, *Economic Rationale for Interchange fees*.

[78] In order to receive a $100 shopping voucher, the average amount spent increased from around $12,400 to around $16,300 (RBA PSB. Annual Report, 2007, p 31)

[79] RBA PSB. *Annual Report* 2006, p 13.

[80] *Id.*

[81] *Id.*

[82] MasterCard Worldwide, *op. cit.*, p 4.

[83] RBA PSB. *Annual Report* 2007, p 29.

2005/2006.[84] This fuelled arguments that merchants have been harmed because of the relative increase in the usage of the more expensive three-party model cards. However, the bulk of this increase occurred in 2004 when two of Australia's major banks commenced the issuing of American Express and Diners Club cards.[85]

Even though the rate of growth in credit card transactions in Australia decreased substantially from about 34 per cent during 2000/2001,[86] it still increased by around 7 per cent during 2005/2006 and 5.4 per cent during 2006/2007[87] – thus answering MasterCard's warning that the reduction of interchange might lead to a "death spiral" of its network.[88]

Under the 2002 Standard determined by the RBA for the setting of credit card interchange fees, each participating scheme appointed its own specialist to collect, verify and calculate the eligible costs in order to arrive at a benchmark for interchange. To ensure that the cost calculations were representative, the data of issuing banks making up at least 90 per cent of the volume of card transactions for the scheme had to be included. The eligible costs were set out comprehensively by the RBA and include issuer's costs associated with authorisation, processing, fraud-related expenditures and the free-funding period.[89]

Once each scheme had calculated its benchmark, it was required to set its weighted-average interchange fees[90] no higher than that.[91] Under the Standard set in 2002, the RBA required a recalculation of the interchange fee in September 2006.

During 2005/2006, however, the RBA made changes to the regulations affecting credit card systems. Under the amended Standard the procedures would stay the same, but after the individual schemes' cost calculations had been completed, the RBA would use the information to calculate a single weighted-average interchange fee which will then be set as

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84 RBA PSB. *Annual Report* 2006, p 14.

85 *Id.* Their combined share in the volume (i.e. number) of transaction however was 12.4% for 2005/2006, lower than their share in the value of transactions. This is indicative of their differentiated business model and concentration of customers in the higher net-worth population resulting in higher per transaction values.

86 RBA PSB. *Annual Report* 2006, p 13.

87 RBA PSB. *Annual Report* 2006, p 13; RBA PSB. *Annual Report* 2007, p 11.

88 See Frankel and Shampine, 2006, "The Economic Effects of Interchange Fees", *73 Antitrust Law Journal (3/2006),* 627-673, p 656.

89 This is fully explained in the Guidance note attached to RBA, November 2005, *Common Benchmark for the Setting of Credit Card Interchange Fees*. Initially, the RBA argued that the interest-free period, being a benefit provided to cardholders, ought not be recovered through fees charged to merchants. The interchange fee should consequently comprise only costs attributable to the merchants' benefits net of any costs associated with the line of credit provided to cardholders. Subsequently, however, the RBA accepted that the costs associated with the interest-free period be included it in their list of eligible costs for the purpose of the interchange calculations.

90 The weighted average fee is calculated using weights for each scheme that reflect the sturcture of its own business over the previous financial year. This is also one of the aspects of the Standard that is proposed to be reconsidered in the RBA's next review of the reforms (RBA PSB. *Annual Report* 2007, p 25).

91 In other words, its particular interchange levels for different categories of cards and card usage could vary above or below the benchmark, provided that the weighted average did not exceed the benchmark.

a common benchmark for all the scheme participants to adhere to.[92] (Each scheme would then have to ensure that the weighted average of its own interchange fees did not exceed the common benchmark.) The nominated issuing banks chosen to participate in the cost calculations had to include a minimum number. Also, Bankcard was now exempted from the RBA regulations.[93] The amendments resulted in a common benchmark interchange fee of 0.50 per cent, implemented since 1 November 2006. Both Visa and MasterCard also introduced an array of different interchange fees applicable to different cards, transactions and merchants.[94]

The reason for the change to a common benchmark was to overcome the problem that, under the original standard, a scheme with higher costs would be entitled to set a higher weighted average interchange than a scheme with lower costs, and thus gain an undue competitive advantage in attracting issuers.[95]

The RBA stated that the new Standard was not aimed at further reducing the interchange fee. It was intended rather to promote more sound competition between the schemes and increase the incentives towards cost saving.

4. Regulation of the debit card system

There are two distinct debit card systems in Australia: the EFTPOS system and the "scheme" debit card systems.

The local EFTPOS system has accounted for 85 per cent of debit card transactions.[96] It is a purely domestic system and its cards cannot be used overseas. The system involves bilateral negotiations between the participating parties and the interchange fee is a flat fee, paid from the issuer to the acquirer ranging between 18 to 25 cents per transaction.[97] This was obviously designed to subsidise merchant acceptance. The EFTPOS system wanted to change its interchange fees to zero in 2003. At first this was rejected due to access considerations, but accepted in December 2003 conditional on adequate investigations into the access issues by the industry and the RBA.[98] Despite legal challenges by merchants wishing to retain the benefit of the previous interchange arrangements, the EFTPOS system is now subject to a regulated interchange Standard.

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92 *Id.*

93 It was decided that Bankcard's costs were reflective of a small, domestic scheme and were not representative of the industry as a whole and credit card issuing in general. *Id.*, p 3. The Bankcard scheme closed down in the first half of 2007.

94 *Id.* p 24.

95 This aspect has been dealt with earlier in this chapter.

96 RBA PSB. *Annual Report* 2006, p 15.

97 *Id.*

98 *Id.* p 17.

In the scheme debit cards system, the cards are signature-based and can allow for transactions over the internet and telephone, as well as overseas transactions. In contrast to the EFTPOS system, an interchange fee of 0.55 per cent of the transaction value was being paid from the acquirer to the issuer in 2006.[99]

In the most recent report of the PSB, the current regulatory regime applicable to debits cards is described as follows:[100]

> As part of the package of reforms to Australia's debit card systems announced in April 2006, the Bank introduced interchange standards for the EFTPOS and Visa Debit systems. These standards came into effect on 1 November 2006, the same date as the new credit card benchmark came into effect.
>
> In the scheme debit systems, interchange fees have historically been the same as in the credit card systems. Prior to November 2003, these fees averaged around 0.95 per cent of the transaction value (excluding GST). They then fell to around 0.55 per cent when the credit card reforms were introduced. In contrast, interchange fees in the EFTPOS system are flat fees – historically averaging around 20 cents per transaction – and flow in the opposite direction to those in the credit card and scheme debit systems (that is from issuers to acquirers).
>
> These differences in interchange fees in the two types of debit card systems meant that on a $100 debit card transaction, an issuer was around 75 cents better off in terms of interchange revenue if its customer used a scheme debit card rather than an EFTPOS card. The Board was concerned that, if this situation persisted, the EFTPOS system would have difficulty competing simply because of the structure of interchange fees, which themselves were not subject to the normal forces of competition.
>
> The EFTPOS interchange Standard requires that interchange fees in the EFTPOS system (which are bilaterally negotiated) be between 4 and 5 cents (excluding GST) if the transaction does not involve a 'cash out' component. Interchange fees for transactions that do include cash out are not covered by the Standard; the Bank's liaison suggests that in some cases the interchange fees on these transactions remain at around 20 cents or higher while, in other cases, the fees have fallen in line with the new rates for purchase transactions.
>
> The Visa Debit interchange Standard operates in a similar fashion to that of the credit card interchange Standard, in that the weighted-average interchange fee must be no more than a cost-based benchmark. Based on information supplied by industry, the Bank announced on 29 September 2006 that the benchmark was 12 cents (excluding GST).
>
> In announcing the Visa Debit interchange Standard the Bank indicated that the same arrangements would apply to the debit card schemes operated by both MasterCard and Visa. It also indicated that the schemes could provide undertakings that they would comply with the Standard rather than having it formally gazetted. In particular, in April 2006 the Board announced that 'the Visa Debit Standard on interchange fees will only be gazetted, if, by 1 July 2006, Visa has not provided the Bank with an enforceable undertaking that would deliver the same outcomes as the Standard. Similarly, the Bank will consider designating the MasterCard debit system, and then imposing a standard, if by 1 July 2006, MasterCard has not provided the Bank with an enforceable undertaking to the same effect. MasterCard voluntarily agreed to set interchange fees for its debit card in accordance with this benchmark. In contrast, Visa did not and, consequently, on 7 July 2006, the Bank gazetted the Visa Debit interchange Standard.

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99 *Id.* p 15.

100 RBA PSB. *Annual Report* 2007, pp 22-23.

As for credit cards, both schemes have a number of different interchange categories for different types of merchants and types of payments (Table 7). MasterCard has also introduced a chip rate for its debit cards, applicable when a card with a chip is used in a terminal that is not chip enabled. MasterCard initially had a relatively simple structure with only electronic and standard rates. At the end of June 2007, it released a table of rates very similar to those of Visa. MasterCard also introduced a 'tiered merchants' rate for large merchants that is substantially below other interchange rates. This rate requires merchants to meet volume thresholds but, unlike MasterCard's tiered merchants rate for credit cards, does not require merchants to accept all MasterCard products.

5. Regulatory issues concerning the three-party schemes

In Australia, both American Express and Diners Club agreed in negotiations to remove their no-surcharge rules.[101] A media release by the RBA dated 24 February 2005 stated:

American Express and Diners Club

Over recent months the Bank has examined whether it would be in the public interest to regulate the American Express and Diners Club card payment systems. This follows the issuing of American Express cards by two banks and the establishment of a partnership between another bank and Diners Club.

The Bank considered, in particular, whether there was a case to regulate the payments between American Express and Diners Club and their bank partners. It concluded that, at this stage, such regulation would not improve the overall efficiency of the payments system. In its view, regulation of these payments would have relatively little effect on merchant charges. Further, the existing incentives facing issuers of these cards could only be addressed through considerably more extensive regulation than that currently existing in the credit card schemes.

In the Bankcard, MasterCard and Visa schemes, the interchange fee paid by the merchant's bank to the cardholder's bank has an important influence on the charge levied on the merchant by its bank. In contrast, in the American Express and Diners Club arrangements, the causation runs the other way. Merchant charges are determined largely independently of the payment to the partner banks: instead, the fees that merchants pay influence the size of the payments to the banks. Given this, regulating the payments that flow between American Express and Diners Club and their partners would be likely to have little effect on merchants' costs of accepting the cards. This is in contrast to the credit card schemes, where merchant service fees fell quickly following the reforms to interchange fees.

On the issuing side, regulation of specific payments to the partner banks would be likely to lead to other forms of payment, leaving the incentive of banks to participate in the arrangements largely unchanged. One possible response might have been to regulate the totality of payments, including marketing payments, between American Express and Diners Club and their bank partners. Such regulation would then also be required in the Bankcard, MasterCard and Visa schemes. The Bank's view is that, at the current time, this form of extensive regulation is not in the public interest.

While the Bank is not intending to regulate the payments between American Express and Diners Club and their bank partners, it has had concerns about a number of clauses in these schemes' agreements with merchants. The relevant clauses have had the effect of reducing competition between the schemes by limiting merchants' ability to steer customers to lower-cost means of payment. Given this, the Bank has sought the agreement of American Express and Diners Club to either delete or change these clauses. It has also sought greater transparency in the average fee charged by the schemes. In response, both American

[101] Visa, June 2007, Second Submission, document U, p 5.

Express and Diners Club have agreed to:

i. reword clauses in their merchant agreements that currently prohibit merchants from encouraging cardholders to use another card; and

ii. publish their average merchant service fee in Australia on a quarterly basis. Diners Club has already done so.

American Express has also agreed that, should it seek to introduce a debit or prepaid card in Australia , it will not require merchants to accept such cards as a condition of accepting its existing cards, provided schemes issuing similar cards are subject to the same requirements.

As a result of these changes merchants will now have at least three options if they are not satisfied with the cost of accepting American Express or Diners Club cards: they can decline acceptance of any cards issued by the schemes; they can accept the schemes' cards but charge customers for using the cards; or they can accept the schemes' cards but indicate to customers that they would prefer another payment method be used. In addition, merchants will be better informed about how their particular merchant service fee compares with the average fee.

Finally, to provide all interested parties with a sounder basis for analysis, the Bank has written to the Bankcard, MasterCard, Visa, American Express and Diners Club schemes asking for their agreement to the publication of market share data. The data would be published regularly in the Reserve Bank Bulletin.[102]

6. Australian costing methodology and EDC (2002) methodology in SA

The following table sets out, for purposes of comparison, the elements in the cost calculation used in the regulation of interchange in Australia and the elements used by EDC in 2002 to arrive at their interchange recommendations to the ABCI and the South African banks in 2003.

Table 3 Comparison of cost calculations used in Australia and South Africa

Cost calculation elements used in Australia	EDC's 2002 cost calculation elements for SA
Issuers' transaction processing and authorisation (i) Receiving, posting to cardholder accounts and other processing of data for domestic credit card transactions; (ii) Receiving and processing authorisation requests for domestic credit card transactions; (iii) Receiving and processing retrieval requests; (iv) Receiving and responding to referral enquiries; (v) Investigating and processing exception transactions; (vi) Maintaining and updating card authorisation files; (vii) Clearing and settlement of domestic credit card transactions; (viii) Receiving and processing chargebacks and re-presentments; (ix) Net chargeback write-offs; (x) Scheme fees for processing and authorisation,	**Issuers' processing costs** (i) Incoming interchange processing costs (transaction receipt processing) – per transaction of receiving transmissions from acquirers, balancing, verifying, processing, merging files etc; (ii) Transaction settlement management costs – per unit cost per transaction of processing settlements; (iii) Chargebacks, replacement and document retrieval costs – unit costs of domestic chargebacks and re-presentments from SA acquirers and the unit costs of domestic document retrievals requested as an issuer; and (iv) Chargebacks and disputed transaction losses – value of losses issuers incur by writing off small value domestic chargebacks and writing off cardholder disputes.

[102] http://www.rba.gov.au/MediaReleases/2005/mr_05_02.html

clearing and settlement, retrievals and chargebacks; and

(xi) Compliance with scheme requirements related to processing and authorisation, clearing and settlement.

Issuers' costs of fraud and fraud prevention

(i) Investigation of suspect credit card transactions;

(ii) Processing fraud files;

(iii) Developing and maintaining fraud management systems, including detection and prevention systems;

(iv) Developing and implementing measures to monitor cardholder usage for potential fraud;

(v) Developing and operating fraud detection measures in cardholder application processing and the opening of new accounts;

(vi) Development and production of card security features where such features are implemented principally for the purposes of fraud prevention;

(vii) Compliance with scheme fraud mitigation measures, such as fraud reporting, blocking accounts, logging lost/stolen cards, paying card capture rewards and maintaining hot card files and card recovery bulletins;

(viii) Assisting and liaising with other members, schemes, law enforcement and other relevant parties for fraud investigations and prosecution;

(ix) Secure delivery of cards where such delivery is employed principally to prevent fraud;

(x) Scheme fees related to fraud prevention and investigation, such as for recovered cards, bulletin and file updates and payments to other members for captured or recovered cards under scheme rules; and

(xi) Total domestic fraud losses net of recoveries.

Issuers' payment guarantee costs

(i) Credit write offs and losses – collect the total value of bad debt written off during the year net of recoveries;

(ii) Fraud losses – data is collected for the total value of fraud losses on POS transactions written off during the year net of amounts that were charged back to acquirers to recover;

(iii) Authorisation and referrals – for authorization, the unit costs of processing domestic authorisation requests are collected split between on-us and off-us transactions. Thus the unit cost of authorisation requests, deciding on approve, decline or refer and then notification. Referrals occur when the merchant needs to contact the issuer to verify the cardholder identity before authorisation. Included in the data collected are:

- CPU usage charges for authorisation, processors and mainframes;
- Software licenses and maintenance fees;
- Charges from third parties for processing, switching and authorisation;
- Other issuer costs related to authorisation;
- Purchase confirmation call costs (costs associated with verification activities);

(iv) Collections – these are the costs involved in collecting on accounts in arrears. This includes the annual operating costs of the collection department; and

(v) Other risk control costs – this includes the costs associated with specific risk prevention measures and are composed of six distinct data elements:

- Fraud investigation costs;
- Incremental secure card delivery costs;
- Unit cost of issuer creation and processing of the Negative File Management and Electronic Hot Card File (EHCF). This is a centrally held list of cards for which transactions will not be authorised. This includes:
    - o Receiving calls from cardholders and statusing accounts;
    - o Prioritising the negative file and generating entries;
    - o Computer recourse charges;
    - o Software development;
    - o Preparation and transmission of the hot files;

(vi) Issuer payments to Retail Decisions (RED) for the EHCF processing;

(vii) Fraud prevention systems updates;

(viii) Total costs of collecting cards at POS;

Cost to issuers of interest-free period

Cost to issuers of free funding period

(i) The value of any advances outstanding on credit card accounts that did not accrue interest is determined for each day in the prior financial year. The value of cash advances, international transactions, fees and any other transactions other than domestic credit card purchase transactions that may be reflected in those advances are subtracted from these advances; (ii) The average daily value of advances not accruing interest is determined by summing the daily value of these advances calculated in (i) and dividing by the applicable number of days in the year; (iii) The average daily cash rate for the prior three financial years is determined using the rate for the inter-bank cash market for each business day published monthly in the Reserve Bank of Australia *Bulletin.* As at November 2005, this rate was published in *Bulletin* Table F1. For example, for the initial cost-based measure that must be calculated by 15 September 2006, the daily cash rate would be averaged for the three years between 1 July 2003 and 30 June 2006; and (iv) The average daily value of advances calculated in (ii) is multiplied by the average daily cash rate to obtain the total cost of funding the interest-free period. If agreed to by the Reserve Bank, an alternative method of calculating the cost of the interest free period which is equivalent to the above method may be used.	(i) Covers non-reimbursed expenses associated with the funding of interest bearing funds.

Sources: Association of Bank Card Issuers and Merchant Acquirers (ABCI): Edgar, Dunn & Company, "2002 South Africa Domestic Interchange Study"; and
Reserve Bank of Australia, "Common benchmark for the setting of credit card interchange fees", 2006

Appendix J Steps taken by Grindrod Bank to become a member of PASA

Step	Name	Duration[103]	Start	Finish
1	PASA membership	153.d	2007/02/01	2007/09/03
2	Bank Council Membership	1.d	2007/02/01	2007/02/01
3	Initial approach to PASA	1.d	2007/02/05	2007/02/05
4	Receive application form	1.d	2007/02/05	2007/02/05
5	Information Gathering	87.d	2007/02/06	2007/06/06
6	Prepare application	40.d	2007/02/06	2007/04/02
7	Prepare transaction volumes	10.d	2007/02/06	2007/02/19
8	Prepare technical information for PCHs	40.d	2007/02/06	2007/04/02
9	Prepare general information	14.d	2007/02/06	2007/02/23
10	Confirm PCHs needed with PASA	1.d	2007/02/06	2007/02/06
11	Meeting with Bankserv	1.d	2007/02/19	2007/02/19
12	Meeting with CR Card PCH Chairman	1.d	2007/02/20	2007/02/20
13	Meeting with VISA	1.d	2007/02/21	2007/02/21
14	Meeting with Master Card	1.d	2007/02/28	2007/02/28
15	Prepare business plan for MasterCard and VISA	43.d	2007/03/15	2007/05/14
16	Follow up meeting with MasterCard	1.d	2007/05/15	2007/05/15
17	Prepare transaction volume projections for MasterCard	1.d	2007/05/16	2007/05/16
18	Complete MasterCard membership application forms	1.d	2007/05/16	2007/05/16
19	Complete BIN application forms	1.d	2007/05/17	2007/05/17
20	Submit Grindrod Bank's Financials,banking licence and other docs to MasterCard	14.d	2007/05/18	2007/06/06
21	Follow up meeting with VISA	1.d	2007/05/28	2007/05/28
22	Check total costs of PCHs	12.d	2007/02/21	2007/03/08
23	Receive acceptance letter from SARB to join SAMOS	1.d	2007/04/03	2007/04/03
24	Meet potential mentor	1.d	2007/03/15	2007/03/15
25	Draw up mentor agreement	1.d	2007/03/16	2007/03/16
26	Receive signed mentor agreement	41.d	2007/03/20	2007/05/15
27	Retail Division Management Committee sign off PCH	1.d	2007/04/16	2007/04/16
28	Sign off PASA application	1.d	2007/04/17	2007/04/17
29	Submit PASA application	.d	2007/04/17	2007/04/17
30	PASA ExO ensures completeness	29.d	2007/04/18	2007/05/28
31	PASA Council grants provisional membership	1.d	2007/05/30	2007/05/30
32	PASA sends Grindrods' applications to PCH PGs	1.d	2007/05/31	2007/05/31
33	PCH PGs approves applications	1.d	2007/06/01	2007/06/01

103 Number of days taken to complete the task.

Step	Name	Duration[103]	Start	Finish
34	Send out letters of Introduction to all Banks and SARB	4.d	2007/06/04	2007/06/07
35	Receive letters of confirmation from all Banks	46.d	2007/06/08	2007/08/10
36	PASA Council approval of new member	1.d	2007/08/13	2007/08/13
37	Confirmation of membership by PASA ExO	1.d	2007/08/14	2007/08/14
38	PCH agreements provided by PASA ExO	1.d	2007/08/15	2007/08/15
39	Board Resolution From Grindrod Bank for signing agreements	1.d	2007/08/16	2007/08/16
40	Lodgement of signed PCH and other agreements with PASA ExO	1.d	2007/08/17	2007/08/17
41	Final sign off by PASA 3 days before going live	1.d	2007/08/20	2007/08/20
42	Receive SWIFT BIC application forms	1.d	2007/04/13	2007/04/13
43	Complete SWIFT BIC application forms	1.d	2007/04/16	2007/04/16
44	Submit SWIFT BIC forms to SWIFT fro non-live SWIFT BIC	1.d	2007/04/23	2007/04/23
45	Clear issue about getting SWIFT test BIC code	1.d	2007/05/15	2007/05/15
46	Receive test SWIFT BIC code	21.d	2007/05/16	2007/06/13
47	Receive non-live SWIFT BIC code	1.d	2007/06/04	2007/06/04
48	Load live BIN code on other bank's POS	91.d	2007/04/02	2007/08/06
49	Go live	1.d	2007/09/03	2007/09/03
50	Other PASA members	43.d	2007/06/25	2007/08/22
51	Meet members to obtain letters of confirmation	2.d	2007/06/25	2007/07/03
52	Receive letters of confirmation from PCH members	31.d	2007/07/03	2007/08/17
53	Letters of confirmation lodged with PASA ExO	2.d	2007/08/17	2007/08/20
54	Negotiate fees with other participants	1.d	2007/08/21	2007/08/21
55	Sign Bi-lateral agreements	1.d	2007/08/22	2007/08/22
56	Operator	6.d	2007/04/23	2007/04/30
57	Application to operator	1.d	2007/04/23	2007/04/23
58	Operator decides on no of test partners	1.d	2007/04/24	2007/04/24
59	Service Agreements provided by Operator	1.d	2007/04/25	2007/04/25
60	Operator Service agreements signed	1.d	2007/04/26	2007/04/26
61	Operator Service Agreements signed	1.d	2007/04/27	2007/04/27
62	Operator Certification of successful testing	1.d	2007/04/30	2007/04/30
63	Get Garage card	37.d	2007/04/02	2007/05/22
64	Contact SABS	1.d	2007/04/02	2007/04/02
65	Complete application form	1.d	2007/04/03	2007/04/03
66	Make payment	1.d	2007/04/05	2007/04/05
67	Submit application for IIN	30.d	2007/04/10	2007/05/21
68	Receive IIN	1.d	2007/05/22	2007/05/22
69	Make payment for standard	1.d	2007/04/25	2007/04/25
70	Submit application for standard	1.d	2007/04/26	2007/04/26
71	Receive Standard	14.d	2007/04/27	2007/05/16
72	SAMOS membership	44.d	2006/12/21	2007/02/21

Step	Name	Duration[103]	Start	Finish
73	Meet SARB NPS	1.d	2006/12/21	2006/12/21
74	Receive application forms	1.d	2006/12/22	2006/12/22
75	Gather all required information	6.d	2007/02/06	2007/02/13
76	Meet with SARB NPS technical	1.d	2007/02/06	2007/02/06
77	Follow up meeting with SARB NPS	1.d	2007/02/13	2007/02/13
78	Submit SAMOS application	.d	2007/02/21	2007/02/21
79	SARB Testing	80.d	2007/02/13	2007/06/04
80	Appoint SAMOS representative and security officers	1.d	2007/05/31	2007/05/31
81	Prepare letter of confirmation for SARB and IDs and photos	1.d	2007/06/01	2007/06/01
82	All to visit SARB	1.d	2007/06/04	2007/06/04
83	SARB operator determines no & type of test partners	1.d	2007/02/13	2007/02/13
84	Set up infrastructure	4.d	2007/02/14	2007/02/19
85	Acquire hardware	1.d	2007/02/14	2007/02/14
86	Install hardware	1.d	2007/02/15	2007/02/15
87	Acquire software	1.d	2007/02/16	2007/02/16
88	Install software	1.d	2007/02/19	2007/02/19
89	Establish network link to SARB	1.d	2007/02/14	2007/02/14
90	SARB settlement account opened	1.d	2007/02/20	2007/02/20
91	PASA ExO confirms Test may begin	1.d	2007/02/21	2007/02/21
92	Test partners agree to test schedule	1.d	2007/02/22	2007/02/22
93	Setup of test schedule by SAMOS Operator	1.d	2007/02/23	2007/02/23
94	SARB certification of successful SAMOS testing	1.d	2007/02/26	2007/02/26
95	SARB Settlement account	37.d	2007/03/06	2007/04/25
96	Apply for Settlement and loan account	1.d	2007/04/23	2007/04/23
97	SAMOS Service Agreement supplied by ExO	1.d	2007/04/24	2007/04/24
98	SARB Operator Service Agreement Signed	1.d	2007/04/25	2007/04/25
99	Apply for FIR account	1.d	2007/03/06	2007/03/06
100	Receive FIR account	1.d	2007/04/24	2007/04/24
101	Receive technical SAMOS training	1.d	2007/08/21	2007/08/21
102	Receive SAMEX training	4.d	2007/09/11	2007/09/14

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Glossary of Terms

Term	Definition
ABCI	Association of Bank Card Issuers and Merchant Acquirers
ABSA	Absa Bank Limited
AEDO	Authenticated Early Debit Order
ACB	Automated Clearing Bureau for the clearing of cheques and electronic payments
ACSS	Automated Clearing and Settlement System. ACSS is owned and operated by the Canadian Payments Association. (http://www.bank-banque-canada.ca/en/financial/financial_pay.html).
Acquiring	The service of accepting, processing, clearing and settling of payment transactions on the merchant's or beneficiary's side.
Ad valorem fee	A fee that varies according to the value of the transaction.
ALLPS	See Intecon
AMEX	American Express
APACS	Association for Payment Clearing Services. APACS is the UK trade association for payments and for those institutions that deliver payment services to customers. http://www.apacs.org.uk/media_centre/press/05_05_24.html
APCA	Australian Payments and Clearing Association
APRA	Australian Prudential Regulation Authority
ASO	Association of System Operators
ATC	Average Total Cost
ATM	Automated teller machine
BACS	(Originally an acronym for Bankers Automated Clearing Services). This is one of the three constituents of APACS and is responsible for bulk clearing of electronic payments between bank accounts by using direct debits and credits, as well as standing orders. http://www.competition-commission.org.uk/rep_pub/reports/2002/fulltext/462glossary.pdf
Bankserv	Bankserv is South Africa's major Automated Payment Clearing House System Operator. http://www.bankserv.co.za/
BASA	Banking Association of South Africa
BESA	Bond Exchange of South Africa
BIN	Bank Identification Number
BIS	Bank of International Settlements
BSD	Bank Supervision Department, a division of the SARB
CAGR	Compound Average Growth Rate
Carriage fee	In the case of ATM transactions, this represents the compensation paid from the issuing to the acquiring participant for the use of their infrastructure.
Cash Withdrawal Fee	Fee charged by issuing bank to its customer for a cash withdrawal transaction. The fee is currently levied regardless of whether the customer uses the issuing bank or foreign bank's ATM.

Term	Definition
Cashback	A facility that allows a bank's account holders to use their payment cards to obtain cash at Point of Sale (POS).
CC	Competition Commission
CEMEA	Central and Eastern Europe, Middle East and Africa
CHAPS	Clearing House Automatic Payments System, a constituent of APACS. This system is a electronic bank to bank payment system that guarantees same-day payment for high-value transactions. http://www.competition-commission.org.uk/rep_pub/reports/2002/fulltext/462glossary.pdf
Chargeback	This is the ability of the Issuing bank to 'charge back' a transaction to the Acquirer unpaid. The acquirer will usually then have recourse against the merchant. payment card schemes usually require that issuing banks only be entitled to make chargebacks to acquirers, and acquirers to merchants.
Churn rate	Also called the attrition rate. In the context of the Enquiry, it is broadly a measure of the number of customers entering into a relationship with a bank or ending their relationship with a bank. Often used in business to measure a business's contractual customer base.
Clearing	The exchange of the payment instrument or of the relevant payment information between the payer's and the payee's financial institutions and the calculation of claims for settlement.
CPA	Canadian Payments Association
CPSPs	Customer Payment Service Providers, e.g. a third party processing debit orders or an independent ATM provider.
CPSS	Committee on Payment and Settlement Systems
Convenience charge	See Saswitch premium
Dankort	A debit card scheme developed by Danish banks as a joint venture. http://www.nationalbanken.dk/C1256BE9004F6416/side/Payment_Systems_in_Denmark_publ/$file/kap08.html
DI	Deposit-taking Institution
DvP	Delivery versus Payment
EDC	Edgar, Dunn & Company.
EDO	Early Debit Order
EFT	Electronic Funds Transfer
EFTPOS	Electronic Funds Transfer Point of Sale
EMV	Europay, MasterCard and Visa.
FATF	Financial Action Task Force
FBS	Absa's Flexi Banking Services which provides personal banking services to the mass market
FICA	Financial Intelligence Centre Act, which imposes KYC obligations on banks and is aimed at combating money laundering.
First Tier Bank	A full-service commercial bank registered under the Banks Act of 1990.
Flat fee	A fee charged for a transaction that remains fixed at a certain level regardless of the value of the transaction.
FNB	First National Bank, a division of FRB

Term	Definition
Foreign ATM	An ATM of a bank at which the customer's account is not held.
FRB	FirstRand Bank
FSA	Financial Service Authority
FSC	Financial Sector Charter
FSCC	Financial Sector Campaign Coalition
GPRS	General Packet Radio Service. A type of telecommunications technology that allows fast connectivity at relatively low costs.
GNS	Global Network Services. An American Express business model.
HACR	Honour all cards rule
HHI	Herfindahl-Hirschman Index also referred to as the Herfindahl Index. Used as an indicator of concentration.
Homing fee	Interchange fee in the EFT payment stream
Honouring fee	This is also called the Excess Item or Excess Availment Fee. These fees have been charged when a bank made the exceptional decision to honour a cheque or debit order presented for payment against an insufficient balance, based on the bank's knowledge of, and relationship with, the customer in question.
Intecon	Information Technology Consultants (Pty) Ltd, a customer payment service provider trading as ALLPS.
Interchange fee	An interchange fee is a balancing payment from one side to another in a two-sided market. Interchange in South Africa is a transfer made by interbank arrangement, whereby in the context of a payment made by the customer of one bank to the customer of another bank, one of the two banks contributes a part of its revenue to the other bank.
Interpay	Interpay offers payment processing and clearing services in the Netherlands. It also switches, authorizes and processes the majority of debit card transactions. http://www.kkv.se/upload/Filer/Trycksaker/Rapporter/eca/eca_report_retail_banking.pdf
Issuer	The institution that issues the payment method (such as a payment card) used to transact at a POS or ATM, for example. These institutions are typically banks.
KYC	Know Your Customer
LVTS	Large Value Transfer System
MBL	Mercantile Bank Limited
MCI	MasterCard International
MFSA	Micro Finance South Africa
MICR	Magnetic Ink Character Recognition
MIF	Multilateral Interchange Fee
Mini-ATM	A cashless device supported by a float of funds at a merchant – which provides basic transactions similar to those provided by an ATM. The device issues a slip which the merchant honours by paying cash to the customer.
MSC	Merchant Service Charge
Multiple Acquiring	In the case of multiple acquiring, the beneficiary will have more than one bank acquiring its transactions. A retailer, for example, is able to process different brands of payment cards through different acquiring banks. The current rules in South Africa 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. Where multiple acquiring is limited in this

Term	Definition
	way, it is likely that the majority of the transactions will still be off-us.
NaBanco	National Bancard Corporation
NAEDO	Non-authenticated Early Debit Order
NCA	National Credit Act
NPS	National Payments System.
NPSD	National Payments System Department, a department of the SARB
OBSSA	Ombudsman for Banking Services South Africa
on-us transaction	A payment transaction where the payee and payer in the transaction have their respective accounts at the same institution.
off-us transaction	A payment transaction where the payee and payer in the transaction have their respective accounts at different institutions.
OFT	Office of Fair Trading. This is non-ministerial British government department that is responsible for promoting and protecting consumer interests throughout the United Kingdom, whilst ensuring that business practices are fair. http://www.oft.gov.uk/about/what/
PASA	Payments Association of South Africa. This is the payments system management body appointed by the South African Reserve Bank as specified in the NPS Act of 1998 as amended (Act 22 of 2004). The body organises, manages and regulates the participation of its members in the payment system.
PBS	Payments Business Services. Historically Dankort's only acquiring institution.
PCH	Payment Clearing House. This is an arrangement between two or more South African Reserve Bank settlement system participants that governs the clearing of payment instructions for settlement between those Reserve Bank settlement system participants.
PIN	Personal Identification Number
POS	Point of Sale. A device deployed at merchants, used to process payment card transactions.
PSD	Payment Services Directive, which provides the legal foundation for the creation of a single market for payments in the European Union. http://ec.europa.eu/internal_market/payments/framework/index_en.htm
PSF	Payment System Forums. These are forums where the interests of all NPS stakeholders are discussed. http://www2.resbank.co.za/internet/Publication.nsf/LADV/4B64C0FDA8DF140742257089003C2445/$File/SARB+INTERNET++INFO+MANUAL.pdf
PTA	Personal Transaction Accounts
RBA	Reserve Bank of Australia
RBS	Absa's Retail Banking Services which provides personal banking services to the middle market.
Reverse interchange fee	See carriage fee
RTGS	Real-time Gross Settlement
RTL	Real Time Line
RSV	Retail Sales Volume
SAMOS	South African Multiple Options System. The SARB provides an interbank settlement account service called SAMOS. Each settlement bank has a SAMOS account with the SARB.

Term	Definition
	http://www.bis.org/cpss/paysys/SouthAfrica.pdf
SAPO	South African Post Office
SARB	South African Reserve Bank, the central bank of the Republic of South Africa.
SARPIF	South African Retailers Payments Issues Forum
Saswitch	The South African ATM network switch, owned by Bankserv
Saswitch premium	Also called a convenience fee, disincentive fee or disloyalty fee. A fee levied by a bank on its own customers for using the infrastructure of another institution (normally an ATM device) to carry out a cash withdrawal.
SBSA	Standard Bank South Africa
SEPA	Single Euro Payments Area. This is an area covered by the Euro (official currency of the European Union) in which all electronic payments are considered domestic. http://www.europarl.europa.eu/registre/docs_autres_institutions/commission_europeenne/sec/2007/0106/COM_SEC(2007)0106_EN.pdf
Settlement	The act of discharging obligations in respect of funds or securities transfers between two or more parties. This signifies the completion of a transaction wherein the seller transfers their securities/financial instruments to the buyer and the buyer transfers money to the seller. http://www.bis.org/publ/cpss00b.pdf?noframes=1
SIPS	Systemically Important Payment Systems
Sorting at source	In the sorting at source model, the beneficiary of transactions would have multiple bank accounts with a number of different banks (typically those that suit its clients' banking profile). The beneficiary would sort the payment instructions per bank and 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 beneficiary did not itself have an account, these transactions would be processed through a system operator. In sorting at source, it is likely that only a minority of transactions would be off-us.
SSNIP	Small but significant non-transitory increase in price
Systemic risk	The risk that failure by one participant in the settlement system to meet its required obligations will result in other participants being unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and as a result threaten the stability of the entire payment system. As defined above, systemic risk is associated with settlement risk, but given that the payments system is a network, other risks such as legal, liquidity, credit, operational or reputational risk can be transmitted through the payment system.
UK	United Kingdom
UKCC	United Kingdom Competition Commission
VIOR	Visa International Operating Regulations
WWB	Webber Wentzel Bowens