

**ANNEX 5:  
REPORT ON INTERNATIONAL  
BANKING ENQUIRIES**

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## 1. Introduction

In recent years, banking sectors in a number of countries have come under investigation. In preparing this annex, the investigations in Australia, the European Union (ongoing), the Republic of Ireland, Nordic countries, Northern Ireland, and the UK have been reviewed. The annex highlights certain common patterns that may be of interest to the panel conducting the current Enquiry in South Africa.

It is important to note that each of these investigations will have taken account of the peculiarities that exist in banking in each country and therefore conclusions can not simply be applied from one country to another. Nonetheless, our review shows first that investigations of banking in other countries have in fact focused on a very limited set of banking activities, specifically:

- Retail or personal current accounts;
- Banking services to small and medium enterprises – again usually with a focus on current accounts; and
- Payment systems.

Banking investigations in other countries have not been concerned with other services that are offered by banks such as saving accounts, loans to personal customers, mortgages, vehicle finance, credit cards, or banking services to large companies since these areas are not usually identified as having competition problems. In most countries, the barriers to entry in these markets are found to be low and competitors are identified in each of these market segments limiting the competition concerns.

Our review also shows that the recommendations of banking investigations in other countries have been fairly modest. These recommendations typically have been limited to some, or all, of the following:

- A centralised source of data on the cost of products so that consumers can compare costs between different providers;
- The development of a “switching code” to agree standards of transferring information (especially related to regular payments) when customers wish to switch provider of current accounts;

- The availability of portable credit histories for SMEs;
- The accessibility of payment systems to be available on a transparent and non-discriminatory basis along with the possibility of indirect, or sponsored, membership of payment systems to enable low cost access to payments for smaller providers; and
- The setting of interchange fees on a multilateral basis according to agreed costs estimated by a third party.

Section 2 of this annex discusses the main findings and recommendations of banking investigations in other countries with respect to the three areas that have been the focus of most investigations – retail or personal current accounts; banking services to small and medium enterprises; and payments systems.

## 2. Main findings and recommendations across other countries

### 2.1 Retail current accounts

Retail current accounts have been a focus of investigations in most of the studies examined including: the Cruickshank Review in the UK, the ongoing EC investigation, the investigation in the Republic of Ireland, the ongoing investigation in Northern Ireland, and the review of competition in Nordic region.

Since current accounts have a money transmission, or payments, function some of the issues of relevance to current accounts overlap with those of the payment system and we consider those issues below under the payments system section.

In this annex, we first consider areas to do with the demand side of current accounts and then examine issues to do with the supply side.

#### 2.1.1 Demand side

On the consumer or demand side of personal current accounts there are two main issues typically raised – transparency of information and customer switching.

##### 2.1.1.1 Transparency and comparability

The first issue identified on the demand side is that of the transparency and comparability of information which is found to be weak in many countries.

In the case of the studies by the European Commission (EC) and the Nordic Competition Authorities, however, caution needs to be applied since, in the main, they discuss the difficulty of comparability *between* countries rather than *within* countries. This is found to be especially difficult since different countries operate with different pricing strategies e.g. in some countries it is common for transactions to be free and credit interest to be low, whereas in other countries it is more common to be charged for transactions but then to receive better prices for other services.

The concern regarding differences between countries reflects the desire of both the European Commission and the Nordic Competition Authorities to encourage greater cross-border competition to arise. However, these differences between countries, while important in the context of international integration, seem of less relevance in the South African context.

Nonetheless, many of the investigations have concluded that the transparency and comparability of prices for current account services within countries is also weak. For example, in Northern Ireland, the UK Competition Commission has provisionally found that pricing structures are complex and that charges are not always visible to consumers. In addition, the EC has noted that bundling of products may lead to a lack of price transparency.

These concerns have usually led to a recommendation of having a centralised source of data (typically provided through either the banking regulator, banking association or a consumer body) which consumers can use to assess the comparative cost of banking with different providers. Websites enabling such a comparison have been suggested in the Nordic area with recent initiatives in this area in Sweden and Denmark. Similarly, the Cruickshank Review in the UK recommended the use of comparative tables and such information is available from the Financial Services Authority's website on the charges applied on basic bank accounts.

It is worth noting that concerns about price transparency and comparability has *not* generally resulted in proposals to regulate prices. Indeed in the Northern Ireland investigation, the UK Competition Commission explicitly rejects this as a possible approach.<sup>1</sup> In addition in Ireland, which is very unusual in having price regulation currently, the Irish Competition Authority recommends its removal.

The UK Competition Commission's approach in the Northern Ireland investigation is in contrast to their earlier approach in connection to SME banking where price regulation was imposed on the four main clearing banks. That decision came under considerable criticism at the time including from:

- HBOS (the recently merged fifth largest bank) who argued that it would make it harder for new entrants to compete and believed it favoured the incumbent;<sup>2</sup>
- Treasury Select Committee who doubted that they would really benefit competition saying such "crude" controls could be damaging;<sup>3</sup>

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<sup>1</sup> Market investigation into personal current account banking services in Northern Ireland, Notice of Possible Remedies under Rule 11 of the Competition Commission Rules of Procedure, paragraph 35, page 8.

<sup>2</sup> The Financial Times, 27<sup>th</sup> March 2002.

<sup>3</sup> Treasury Select Committee, Banking, consumers and small business, 30 July 2002, paragraph 48.

- The Bank of England which was noted in the Competition Commission report as having “serious misgivings about such detailed intervention, which could damage rather than improve the provision of SME financing”,<sup>4</sup> and
- Don Cruickshank who stated that “It makes it less easy for new competitors to win business...Thank heavens there is a sunset clause and this aberration can be forgotten.”<sup>5</sup>

#### 2.1.1.2 Customer switching

The second issue identified on the consumer side is that of switching which is found to be low in current accounts in all countries investigated. In part this is due to relatively high customer satisfaction ratings received by many banks in many countries, suggesting that switching is low because consumers do not want to switch provider.

In some countries, direct switching costs in the form of exit penalties or costs for cancelling direct debits have been identified as causing barriers to switching. Within the Nordic region, this was identified as a problem in Iceland and Finland. Within the EC's investigation, “closing charges” on current accounts were highlighted as being common in Italy (where they amounted to €15-60), Austria, Portugal, Belgium, Slovakia and Slovenia. In South Africa, by contrast, such closing charges are not typical for current accounts.

In addition to the direct switching costs, however, it is also recognised that there is an indirect administrative and time cost imposed on consumers who wish to switch current account. Often this is linked to the need to transfer payment instructions such as direct debits or debit orders. In many cases, however, it has been identified that it is the originators of the direct debits such as utility companies that cause the difficulty in transferring payment instructions and this can only be rectified through altering the standards applied to the direct debit arrangements in the country. The wider issue of switching current accounts has led to Switching Codes being implemented by banks in numbers of countries (Ireland, the Netherlands, the Nordic region and the UK). These codes have typically involved agreeing the standards of transferring information to overcome this problem.

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<sup>4</sup> The supply of banking services by clearing banks to small and medium-sized enterprises, UK Competition Commission, March 2002. Paragraphs 8.24-8.26.

<sup>5</sup> The Financial Times, 19<sup>th</sup> July 2002.

## 2.1.2 **Supply side**

On the supply side of offering retail current accounts, an issue that is sometimes raised as being of concern is the role of branch networks and whether such networks represent a barrier to entry.

### 2.1.2.1 **Branches**

Historically, branches have been the primary distribution channel for banking services in the great majority of countries and as such have played an important role. It is sometimes argued that new entrants would therefore need to invest in a branch network in order to compete in the banking market.

In considering this issue, the Irish investigation of banking notes that branches are not an “asymmetric” barrier to entry. That is, the Irish Competition Authority recognised that the banks with existing large branch networks had to make the investment to have such networks and, as such, the investment is not an asymmetric cost faced only by new entrants. Hence it would not be reasonable to punish those with large networks for investing in their network in order to benefit those without networks (since the latter could also choose to make the investments in the network if they so desired).

In addition, it is recognised that branches themselves could be seen as a retail outlet. Generally there are limited concerns raised about the lack of retail space in countries. Indeed this description highlights the fact that retailers themselves represent competitors in banking in numbers of countries and, if banking were believed to be excessively profitable, could expand their offering with relative ease.

Furthermore, in many countries including the UK and the majority of the Nordic region, the number of branches is declining indicating that this channel is becoming of less importance over time. In the ongoing investigation in Northern Ireland, the Competition Commission found that the majority of people do not use the branch to transact the majority of their personal current account business. They also found that fewer younger people said branch location was important to them compared to those who were older. This suggests that the importance of branches will continue to decline over time. The declining popularity of branches is closely linked to technological developments. For example, the use of telephone banking and internet banking is becoming increasingly common in many countries.

In South Africa the position of branches is complex since the banks, are generally expanding their branch networks at present in order to reach the unbanked. However, this expansion often involves low cost methods of reaching customers such as through the use of portable branches. Nonetheless, the use of telephone, cellphone and internet channels is growing rapidly and these alternative channels represent close substitutes.

Finally, in those few areas where competition authorities have expressed a concern about the role of branches, appropriate options for improving this situation have been very limited. In the UK investigation of Small and Medium Enterprise banking, the Competition Commission recommended examination of the feasibility of branch sharing. However, this further analysis in fact found that branch sharing was not a practical solution and in particular that it lacked demand from smaller providers of banking services. Furthermore, agency arrangements were already available to any banks who wished to offer additional access to the branches of other banks (as indeed they are in South Africa) and there was no demand for additional access beyond this.

## 2.2 **SME banking**

The second area that has commonly been investigated is banking services to Small and Medium Enterprises (SMEs). Many of the issues that have been identified as problematic in SME banking are the same as those identified in personal current accounts and thus the discussion above is relevant to the SME sector as well as the personal sector.

### 2.2.1 **Lending**

Investigations into SME banking in both the UK and Ireland highlighted difficulties with loans because of the tendency for SMEs to borrow money from the same bank that provides their current account. In part this is because SMEs value the relationship with their bank and often prefer to have all of their banking services through the same provider.

In some cases, however, alternative providers of loans have less information regarding the SME than the provider of current account services who is able to assess the SME's riskiness partly on the basis of activity on their current account. For this reason, both the Irish Competition Authority and the UK Competition Commission made recommendations regarding making portable credit histories available on request which would represent a statement of the SME's credit

performance that could be passed to an alternative supplier. However, it has been noted by banks that SMEs are already in a position to give such information to a new provider since they can themselves supply information on their banking record.

## 2.3 **Payment systems**

The final area that has commonly been examined in banking investigations is that of payment systems. It is well recognised by all competition authorities that the provision of payment services necessarily involves co-operation between different providers of banking services. The two most commonly examined areas are access and interchange and we consider these in turn.

### 2.3.1 **Access**

All payment systems in all countries operate with some form of membership rules which regulate access to the system. Stringent controls, particularly of a technical nature, need to be in place in order to prevent the failure of payment systems. In addition, the actions of one member of the payment system impact other members and hence there is a need for co-operation on standards and other aspects in order to minimise systemic risk. It is the need to meet these requirements that typically leads to membership rules being in place.

Since the payment system has nearly always arisen out of the banking industry, and because of the concerns that the banking regulators have about systemic risk, restrictions have often been in place such that membership of certain aspects of the payment system is limited to licensed banks. Typically, these restrictions are found in the banking or payments legislation rather than being requirements imposed by existing banks. Australia is relatively unusual in having removed this restriction and allowing non-bank members.

The main requirement made by competition authorities that have examined payment systems is that the conditions of access be made transparent and non-discriminatory. For example, the Nordic authorities have proposed that this should be the case in order to have objective and proportionate terms of access. Thus there is a recognition that standards do need to be maintained in order to protect the integrity of the payment system, but that these standards should apply equally and fairly to all.

In some cases, concerns have been expressed where payment systems are operated on a bilateral basis rather than having a centralised system. For

example, the Irish Competition Authority recommended that the establishment of a centralised Automated Clearing House (ACH) should be investigated (although noted that this was complicated by the proposals for a Pan-European ACH within the euro zone) to replace the existing bilateral arrangements. Similarly, the EC notes that bilateral clearing arrangements make market entry more difficult.

It is also important to note that access to payment systems does not necessarily imply that all potential providers of banking services need the same level of access to all aspects of the payment system. In a number of areas (the EC, Ireland, Nordic area and the UK), competition authorities have highlighted the fact that it is possible to have indirect or associate membership of payment systems (equivalent to sponsorship in South Africa). In these arrangements, a direct member of the payment system undertakes payment activity on behalf of an indirect member.

Thus it is possible for indirect members to access all of the functionality of the payment system at a reasonable price without needing to meet all of the requirements for direct membership. In the Nordic investigation it was noted that indirect membership may be an inexpensive way to join the payment system especially for small entrants. Similarly, in the UK investigation of LINK, which operates ATM networks, the Office of Fair Trading (OFT) noted that the membership requirements of LINK did not represent a barrier to entry in part because of the ability of institutions to enter into sponsorship arrangements with existing members which it described as conferring similar membership benefits.<sup>6</sup> Indeed, it was particularly noted that this arrangement enables small banks to provide their customers with access a large ATM network without having to incur the costs of building a network themselves.

### 2.3.2 **Interchange fees**

The second area within payment systems that has received attention from many competition authorities is interchange fees. Interchange fees are commonly found in many of the payment systems in the countries reviewed. Connected to this is the fact that there are differences between countries as to whether the interchange fee is set through multilateral arrangements across all of the providers of the payment service or whether it is set through a series of bilateral arrangements between pairs of providers.

The first observation to make is that competition authorities have accepted the principle of interchange fees. There is a recognition that in a “two-sided market”

(for example, one market between issuers and cardholders and a second market between merchants and acquirers where the number of transactions on both sides must be the same), commercial arrangements need to be in place and that this may include the need for a payment from one side of the market to the other.

Competition authorities have accepted the principle of having interchange fees. For example, the EC when considering the Visa interchange fee recognises that the best outcome is not necessarily achieved with each bank simply charging its own customer. The EC's more recent investigation of payment cards also comes to the conclusion that interchange fees may be appropriate, and highlights decisions by the OFT in the UK, the Spanish Competition Tribunal and the Italian Central Bank all of which have allowed interchange fees. In addition, the Reserve Bank of Australia (RBA) has also accepted interchange fees.

The second observation is that where multilateral interchange fees have been examined in detail, such as by the EC and the RBA, competition authorities have endorsed the concept that interchange fees should be "cost based"; this has generally led to third party providers being involved in undertaking cost studies to establish the appropriate level of cost. For example, in the case of credit cards, both the EC in its investigation of the Visa interchange fee and the RBA in the ongoing setting of credit card interchange fees have accepted the inclusion of the following cost components in the interchange fee: the cost of processing; the cost of the free funding period; and the cost of the payment guarantee including fraud.

The third and final observation is to note that there are a small number of countries that have been identified through the course of the EC investigation where interchange fees are either not in place or are set at zero for debit cards. Considerable caution needs to be placed on the interpretation of this observation since all of these countries appear to be characterised by a single monopoly provider of acquiring services. As such these represent substantially different models to that which is present in South Africa.

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<sup>6</sup> LINK interchange network, Decision of the OFT, 16<sup>th</sup> October 2001