

ENQUIRY INTO COMPETITION IN BANKING

**SUBMISSION TO THE COMPETITION COMMISSION
BY
CAPITEC BANK LIMITED**

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TABLE OF CONTENTS

EXECUTIVE SUMMARY	3
1 INTRODUCTION.....	4
2 ROLE OF BANKS.....	5
3 NPS MEMBERSHIP AND COMPETITORS	7
3.1 Membership	7
3.2 Market Share	8
3.3 Level of competition	8
4 INTERCHANGE.....	10
4.1 Role of interchange	10
4.2 Zero Interchange Environment.....	11
4.3 Setting Interchange	12
4.4 Multi acquiring/ Sort at Source	13
5 COST OF PARTICIPATION.....	15
5.1 Capital investment.....	15
5.2 Operational cost	15
5.3 Regulatory cost.....	16
6 PROCESS OF SETTING FEES	18
7 ACCESS TO NPS OF NON-BANKS	19
7.1 Bankserv	19
7.2 Master Card and VISA	20
7.3 New operators.....	20
7.4 Service providers.....	21
8 CONCLUSION	22
ANNEXURE A	23
EVALUATION OF EDO BILATERAL PROCESS	23

EXECUTIVE SUMMARY

Capitec Bank provided its views on the issues at hand based on our experience over the five years that Capitec Bank has been in operation. We trust that this approach will provide a practical view and insight into the entry criteria and conditions under which banks can enter and participate in the National Payment System (NPS).

Banks are the custodians of deposits. They have a responsibility towards their depositors to protect the deposits and an obligation to ensure that access to such deposits is provided in a responsible and secure manner.

Other NPS participants that want to provide services that involve the transfer of funds from bank accounts need to prove their reliability and build trust. By having a process of registration this can be achieved for operators and service providers. This will create minimum standards and a level playing field for competition.

From our experience in gaining access to the NPS we did not find evidence that the large banks have deliberately abused their positions of power to make it difficult for us to become a member of the payments fraternity. The banks were willing to provide support and guidance whilst we were building experience in the various payment instruments.

Payments systems cannot be offered in isolation and relies on interoperability where banks accept instructions from their clients to transfer value.

In theory it seems that bilateral interchange negotiations will provide the most competition creating best value for customers. As a low volume bank we do not support this theory for banking. Bilateral interchange negotiations could penalise the low volume banks, making it more difficult to compete on client pricing as the large banks dominate most of the markets.

Multilateral interchange seems to benefit low volume participants when used as a benchmark, putting low volume users on par with the large banks, creating equal opportunity to compete on price. The process allows the large banks to negotiate the best possible price as equals whilst smaller banks can part take in the debate in setting the fees.

The practice of sorting at source or multiple acquiring may be an alternative to remove interchange but it is not ideal. The ability of a new entrant to obtain membership of a card association, get certified, issue cards and then immediately participate is vital. The new card issuer can compete from day one with differentiated service offerings to gain clients.

We believe that the banking industry is competitive.

1 INTRODUCTION

In 2001 Capitec Bank was the first new retail bank in more than ten years to be registered. We were one of the first new banks to enter the National Payment System (NPS) under the NPS Act. We shall, therefore, aim to provide our views on the issues at hand based on our experience over the five years that Capitec Bank has been in operation. This approach may provide a practical view and insight into the entry criteria and conditions under which banks can participate in the NPS.

This submission by Capitec Bank relates to the terms of reference that were issued by the Banking Enquiry. Some suggestions and views expressed may be hypothetical as the consequences have not been tested in practice.

In our submission we will not be elaborating on the various arguments and research previously done into interchange models. Where relevant we will provide our views on interchange as applicable to our business.

We believe that the report "The National Payment System and Competition in the Banking Sector", dated March 2006, prepared for the Competition Commission provides a reasonably correct view of the South African payment system.

2 ROLE OF BANKS

Banks are the only entities who are legally allowed to accept deposits from the public as a regular feature of their business. For this privilege banks are subjected to strict and costly regulation. The regulation of banks includes compliance to the Banks Act, NPS Act, FIC Act and many rules such as those for being a listed entity on the JSE. To comply with the provisions of all the regulators banks have to create specific compliance and reporting divisions that deal with these requirements. These costs are not directly allocated to all pricing decisions and are absorbed in operational cost.

Banks, as custodians of deposits, have a responsibility towards their depositors to protect their deposits and also an obligation to ensure that the access to such deposits is provided in a responsible and secure manner.

Banks operate as intermediaries for clients to facilitate the transfer of value. Interoperability between the banks is needed for the effective functioning of a payment system and the exchange of payment instruments. It is therefore necessary that banks play a role in creating and managing the risks associated with payment instruments, new and old, as these instruments will be homing in on the accounts of their clients. Banks need to know if the source and integrity of the payment instruction can be trusted before it can transfer the value for clients.

The payment services may be seen as basic services but the client experience has to be one of reliability. There can be no compromises when you deal with someone else's money. This is especially true in the lower income market where the clients do not have that many choices of payment instruments, a person probably has only one savings card. This instrument must be reliable or the client could be stranded. Reliability and interoperability of the payment system must be high. For this to be the case all participants need to be equally reliable as one participant's system failure can impact a client of another participant.

The regulators have been working on new classes of deposit taking institutions with the view of broadening access to banking services. We agree with the concept of wider competition between service providers. It is however important that the funds of depositors are secure and that the risk is properly managed. The test of competition is not only the ability to provide the service, but at what risk to the clients. To provide payment services to accounts can be a costly business but all the participants need to meet the minimum requirement to ensure that the consumers are protected.

Smaller banks are also perceived by the public to be a higher risk than large banks. 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. Many of these depositors use the small banks for investment purposes but not for their transactional business which is needed to increase the bank's payment volumes to optimise costs.

Treasury and the SA Reserve Bank have been investigating the introduction of a deposit insurance scheme in South Africa. The general public may then be more willing to move their deposits and transactional business to smaller banks that offer good value. We believe that a deposit insurance scheme will enable

the existing small and possible new classes of banks to attract more depositors at market rates, thereby increasing competition in payment services and fees.

3 NPS MEMBERSHIP AND COMPETITORS

3.1 Membership

When Capitec Bank applied for membership of the Payments Association of South Africa (PASA) in 2001 the bank had no history, no proven track record on which the banks could base their opinions of the bank. The bank's shareholders were PSG Investment Bank and many individuals. Other than in the case of Old Mutual Bank, Capitec did not really have a recognised big corporate that could step in, in case of trouble. It also targeted the low income market and micro loan segment. The member banks were not always sure how to handle the uncertainty and the possible risk exposure.

Capitec Bank had experienced bank staff, many from Boland Bank, who knew the payments environment who were able to establish the necessary systems needed to participate.

At the time the member banks did not have exact entry criteria against which they could actually measure the possible risk that a new entrant could introduce into the NPS. As such they were fairly cautious to allow us into any of the Payment Clearing House agreements. Capitec became a member of PASA and joined the Immediate Settlement PCH. It also wanted to join the EFT PCH. Our collection system was based on EFT debit orders and sort at source arrangements. This created a unique situation where Capitec was a corporate user of three of the large banks but also a clearing bank in its own right. The corporate EFT services, however, provided more features than the normal EFT and we could not make our collections via EFT without increasing our credit risk.

We therefore had to apply for an exemption to be allowed to operate under the dual roles. One condition was that we had to find an alternative collection solution to resolve the problem. Capitec suggested many solutions but finding a cost effective and workable alternative was almost impossible as each bank has different modes of operation. The market subsequently changed and the micro lending industry became a prominent force. In 2003 banks started to develop a solution for the low income segment. The system is known as the Early Debit Order (EDO) system and was implemented on 18 September 2006.

One of the lessons from this development is 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 dependent on the ability of the large banks to move with new ideas. The EDO case study is not really a success story as the banks were persuaded by the regulators to develop the system. If it had been left to the market forces it is very unlikely that the system would have been developed.

Capitec has since become a member and direct clearing bank in the Saswitch PCH, Debit Card PCH, EDO PCH and Real Time Clearing (RTC) PCH. We were recently accepted as a mentored member in the Credit Card PCH. PASA and the NPSD created a model by which banks can gradually enter the payments arena. It evolves from full financial and technical sponsorship to becoming a direct clearing bank. For banks that want to process and settle

their own transactions there is the mentorship phase. When a bank applies for membership of a PCH it is required to find a large bank that can act as its mentor in the payment stream.

The mentor relationship is there to formalise the guidance role that the large bank will play. The large bank will assist the mentored bank with the interpretation of rules, procedures and system requirements. A mentored bank can use the experience of the other bank in the development of its system. This improves the reliability of the services of the new entrants. For established foreign banks it allows the opportunity familiarise themselves with the local conditions. The mentored bank takes responsibility for all its processing and settlement obligations, Capitec was mentored by ABSA Bank in all the PCHs; they are again acting as our mentor in the Credit Card PCH. We found ABSA Bank, even other banks that were not our mentor banks, to be open and willing to assist when approached.

The payment environment is a complex environment and participants have to participate according to strict rules and standards. In the past these rules were difficult to obtain and version control lacking. PASA has played a big role to update the rules for each PCH. Procedures have been streamlined and documentation of processes improved. The rules have been centralized for easy access by participants. These rules are now available from PASA, however, rules are still treated as confidential. Potential entrants can however easily obtain the documentation from PASA.

PASA gained experience and the application process became more streamlined and transparent for new entrants. PASA Executive Office is very helpful and will provide assistance when approached. A number of banks have become members of PASA since Capitec joined. The application processes were handled in a professional and efficient manner.

3.2 Market Share

South Africa is in a situation where the banking industry has four large and a number of smaller bank participants. Under these smaller participants we include branches and subsidiaries of foreign banks such as ABN AMRO, CitiBank, Bank of Athens and Mercantile Bank.

We believe that the industry is competitive in the sense that the four large banks actively compete for their market share. They all strive to be the market leader in the respective markets; this includes retail and corporate market segments.

From our experience in gaining access to the NPS we cannot find evidence that the large banks have deliberately abused their position of power to make it difficult for us to become a member of the payments fraternity.

3.3 Level of competition

The large banks' service offerings are more comprehensive than smaller banks'. They can quote the prices on a package and not per product. This makes direct comparisons very difficult on an individual and corporate level. Corporate clients are managed on a basket of services; fees are based on the various services used (foreign exchange, cash handling, treasury, exports,

mortgage, financing, payments, etc). Large corporate clients have sophisticated needs and are normally multi banked.

Smaller banks have the ability to compete with the large banks, not directly with all the products, but they can specialize in a niche. Servicing a large corporate could be difficult as not all services are offered, thus making corporate conversions from large to small banks problematic. The offer needs to show value to client to convince them to move a small part of their business. The banks can compete on price, but have to work harder and provide quality service.

Higher volumes normally equates to lower fees.

In Bankserv there is a few cents difference in the switch fee between high and low volume banks. A smaller player should, through efficiency, be able to save that on processing cost.

4 INTERCHANGE

Interchange is the fee paid from one bank to another as reimbursement for processing payment instruction to and from their clients. This fee can be paid to the account holding, issuing, bank or the bank that is acquiring the transaction. The direction of such payments can flow in any direction either to the homing bank or the processing bank depending on what infrastructure is being used. This fee is found in multiple payment instruments which vary from traditionally the card environment where it is applicable for debit and credit cards, it is also found in electronic fund transfers such as debit orders and stop orders where a bank is being paid to process the instruction to its clients' accounts.

4.1 Role of interchange

When a bank decides to participate in a specific payment instrument it has to make two basic decisions. The first is the decision to provide a level of convenience to its customers by offering the specific type of payment instrument. The other is the income opportunity which can be generated from providing the instrument to clients. The income can be derived in many ways. One source would be a client charge, the other an interchange fee. Interchange fees can be received either through the transaction homing in on the client's account or by actually providing the network hardware to process such a transaction. The level of interchange derived from the interbank environment will also play a factor in the setting of client fees.

The level of interchange being paid in the industry can also determine the number of participants that want to participate in such a payment instrument. This includes operators that want to provide independent payment facilities to the banks in order to have a slice of the interchange. The higher the level of interchange paid the more probable the participation of non-banks in such an environment will become.

The direction of the interchange can flow in any direction and is an important factor for independent service providers. An example of this is the level of interchange paid on the ATM infrastructure, where the relatively high fee, that is currently charged, opens up the market for other service providers to provide ATM services on an independent basis, albeit under a sponsored clearing relationship with a bank. It can be deducted that there is sufficient margin in the interchange fee to make it profitable for independent operators to provide an acquiring service.

In providing payment services banks invest a lot of time and money into the development of these payment instruments. As such the banks have to recover the cost from the clients and other users of the systems. The costs are then recovered from the clients that use the service as well as other beneficiaries, such as merchants, who have the convenience of these services. Each party is charged a fee to recover a portion of the cost.

Interchange is a source of income for banks and can be a driver of innovation. The greater the probability of earning a reasonable return, the greater the chance of the bank investing in research and development of new products based on the innovation. Interchange that is set too high leaves little room for profit margins and competition on client pricing. High end-user cost will result in low acceptance and low volumes that can cause the service to fail.

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.

In the EFT environment the interchange is already at a very low level and has little impact on the end user pricing. Interchange benefits the deposit taking banks that have to manage the accounts, provide statements and interact with the client relating to queries. Interchange follows the direction of the transaction; the originating bank pays the receiving bank. Currently there are two different interchange fees for credit and debits. The processing is almost identical and the interchange fees could be the same. There are however differences such as funding of settlement obligations relating to credit and debit transactions; debit transactions pose a greater risk to the account holders and the paying banks than credits; debit orders can be abused by users and fraudulent transactions presented to accounts. The banks then have to protect and assist their customers in recovering such funds, using a lot of resources in the process.

The account holding bank has to ensure sufficient capacity to process the transactions seamlessly. EFT payments are not a constant flow and have a number of spikes on salary dates. Banks need to invest in technology and building capacity to cater for the peak periods whilst it is fairly under utilised for the rest of the month. These costs must be recovered.

4.2 Zero Interchange Environment

The impact of a zero interchange situation would differ from payment instrument to payment instrument, purely because of the different levels and directions of interchange charged for each one. Typically in the card environment card interchange is set based on the transaction value, whereas in the EFT environment it is a fairly low flat fee because it is based in the bulk processing environment done predominantly after hours.

Banks use the interchange as part of the proceeds to cover their processing cost. If this is not available then this cost would have to be passed on to the end user or the bank customer. In theory it could mean that there could be a reduction in the merchant fee that is payable. Whether that saving would be passed on to all the clients of the merchants or the retailers is unknown as prices would probably remain unchanged. Marketing practice reveals that prices are set using psychological barriers; an example of this is that a price of R999 is perceived to be much cheaper than R1000. Retailers will in all likelihood stick to the practice of setting the price at R999 rather than R994,50.

The impact of zero interchange on innovation would not easily be determined. Innovation would be based on the probable cost of providing a payment instrument as well as the income that can be derived from it. In cases where there is no expectation of interchange it might be more difficult for banks to sell innovative ideas to other banks if the other bank has no chance of actually getting a fee from such a service. The reason for this is that the other banks would have to do development to accommodate such a transaction to provide the service to their clients, yet it would be uncertain as to the income that can be expected from its participation.

In the case of Capitec Bank there would be a definite impact on our clients. Currently Capitec charges a zero fee for any purchase with a debit card. Should zero interchange be introduced the cost of processing such a transaction would have to be recovered from our clients which would mean shifting the charge to the client in the form of transaction fee.

This could mean that the purchasing client would be paying a substantially higher fee for the transactions than what he currently does. Currently the recovery of the processing cost of a transaction is split into smaller fee components such as the interchange and client fees. If zero interchange is introduced for the card environment, costs would have to be allocated to the bank's clients directly which might deter the use of safe and secure payment instruments and we may see people reverting back to cash based transactions.

A zero interchange scenario for cards would create a state of parity between debit and credit cards in the eyes of consumers. The card types have different features and risk elements that can entail different pricing models. Debit cards have better risk management features than that of credit cards; credit cards 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.

Cards are not widely accepted in the informal market which operates on a cash basis. The cash paid to a vendor for a purchase is used by the vendor to pay for stock and make other payments. The informal sector does not get the same benefits as their formal sector counterparts, such as a reduction in its cash handling fees, for accepting cards. These vendors are therefore reluctant to pay for installation of point of sale devices and the ability to accept cards. Zero interchange on cards will reduce the cost associated with card transactions for these vendors and influence the vendors to accept cards if they do not have to subsidise the transaction cost. We believe that such a scenario may stimulate the acceptance of card devices and electronic transactions for the low income market and reduce their dependence on cash.

4.3 Setting Interchange

The setting of the interchange can be done in many ways. One method is to have the interchange set by the operator who determines the level for interbank payments. It can also be done by independent third parties, in consultation with the participants, or as the case has been for the early debit order transfer system, done on a bilateral basis. The banks had to negotiate the appropriate interchange fees with each other. In the past South Africa has used independent consultants to determine the level of the interchange for the card environment. As such the banks agreed to a multilateral fee that was paid by every bank on the same level to each other, they also received the same fee. This allows banks to decide on the business case, to know what their interchange costs would be thereby simplifying the evaluation of a new payment instrument.

There are two simple methods of the setting of the interchange. The pure option requires that it should be done on a bilateral basis, the other where it is set on a multilateral basis and the same fee applies to all participants. Various methods can be used to determine the multilateral fee.

In the current environment the argument for bilateral interchange is the preference, to avoid possible accusation of collusion in setting interbank prices on a multilateral basis. However, as a small entrant into the market we are not in favour of such a practice. Large banks dominate the market with their presence, market reach for acquiring and number of clients; this places the smaller participants in a disadvantaged position as we do not have an equal negotiating power. The larger banks each have a substantial portion of the market whereas the smaller banks together probably hold less than 10% of the industry. When negotiating from a small base with a market leader, it makes it almost impossible to be able to negotiate a lower fee as the low volume banks have no leverage against the high volumes of the large banks.

A situation where the environment requires bilateral price negotiations for interchange creates an un-even playing field. This could probably only succeed if the market is truly a free market that offers many alternative payment options. Payments systems cannot be offered in isolation and relies on interoperability where banks accept and exchange instructions from their clients to transfer value.

Multilateral interchange seems to benefit smaller players when it is used as a benchmark. The process allows the large banks to negotiate the best possible price as equals whilst smaller banks can part take in the debate in setting the fees. Multilaterally agreed fees could be subjected to an audit by an independent party to ensure that the fees are set at a reasonable level and not at artificially high levels that may exclude other participants. We have not found evidence that the large banks deliberately influence interchange fees to a level where it is biased towards smaller participants.

The interchange negotiations for the new Early Debit Order system were done on a trial basis for true bilateral price setting. Our experience of this process is documented in Annexure A hereto.

4.4 Multi acquiring/ Sort at Source

If one bank cannot reach agreement on the interchange with another bank then there must be an alternate payment mechanism or operator that can provide the same payment service. It is easier explained per illustration. Currently in the card environment the principle is applied that a merchant should only use a single bank to acquire all the transactions for the specific card operator; or the same bank for all operators. It should not use the services of two banks for say VISA acquiring. This is also termed single acquiring. Therefore, if a VISA issuer bank cannot reach a bilateral agreement with the VISA acquiring bank, then in practice the issuer's cards would not be allowed at the merchants that the acquiring bank services. The VISA issuer then needs an alternative to obtain payment access to the merchant.

In such instances the issuer should have the option to negotiate directly with the merchant, also known as sorting at source, for access for the issuer's cards. The ideal will be to offer better rates to the retailer and compete for its account. It is not always possible to compete directly with the acquiring bank for the account of the merchant as many of the retailer operations are simply too big. The smaller banks may not be able to handle the volumes and related queries for the retailers.

It must not be assumed that the practice of sorting at source or multiple acquiring is ideal to promote competition. The ability of a new entrant to obtain membership of a card association, to get certified, issue cards and then immediately participate is essential. The fact that a branded card can be used at any associated retailer gives an immediate footprint and acceptability to the issuer. The issuer can compete from day one with differentiated service offerings to gain clients.

If this was not the case then new entrants would be forced to negotiate contracts with all the retail groups and other traders. This will take a lot of time and money before the new entrant will even be in a position to start issuing cards. Smaller merchants may never even be approached. The larger retailers will probably also squeeze the fees of a new entrant to ensure the best deal as the new entrant is relying on the retailer's goodwill. This could lead to a distortion of the service offering and fewer points of purchase for card holders. This situation will only benefit the large role players, banks and retailers, effectively reducing the competition. Clients will use the cards of the larger players that offer a greater footprint.

5 COST OF PARTICIPATION

One of the possible barriers to entries of new participants can be the cost of participation in a service. It is, however, important to differentiate between the cost to participate on an ongoing basis, the actual capital investment required to provide a payment service and regulatory cost.

The capital investment is required to create a platform from which to generate income. These services have been developed and carry a cost to purchase from their producers. To use an example, if a company wishes to race their car in Formula 1, they need to invest in the technology, skill set and vehicle suited for the race. They cannot enter a family sedan. The same applies to payments services. There is a minimum investment needed to ensure that a participant has the necessary capacity, skills and back up systems in place to provide a reliable service. One bad provider can cause reputation risk to other unrelated participants and the payment industry in general. Setting a minimum entry requirement for new entrants is therefore important. The best source is probably from existing users who are experienced in the field. A participant will have the choice in deciding in what technology it wants to invest in to achieve the entry criteria.

Once a participant has made the investment the operating expenses will become more important. This is the cost of providing the service that may have an impact on the ability to compete with established users. Typically this would include the cost of switching a transaction and telecommunication cost.

5.1 Capital investment

When Capitec Bank was established, the bank took a strategic view of the technology it would invest in. We knew that the technology platform would be a large component in our ability to compete with the other banks. A lot of effort has gone into the decision and development of the platform. It is state of the art technology built to meet our market needs. The cost of technology is reducing and new entrants can purchase powerful computers at better rates than existing participants who made their investments at higher rates. This effectively reduces the cost impact of investment for new entrants and giving them a technology edge.

Capitec Bank had the benefit of starting fresh. Development was a lot less complex as there were no existing or legacy systems in place which had to be considered. Established participants have many such systems and products and need a large effort to synchronise new developments with existing products. Our products could be custom designed to meet our business needs. This was one of Capitec Bank's strategies to be able to compete with existing players.

5.2 Operational cost

This cost relates directly to the cost associated with a transaction. These include network costs that are linked to the service selected, for example land lines versus satellite services, and is normally a business decision by the participants. In the terms of reference it was indicated that the Enquiry will

focus on the clearing or switching cost of the operator, which we will address. The main clearing services are provided by a single operator, Bankserv.

Bankserv is in the position that is a trusted entity with a proven track record. Other than a few exceptions all banks recognize Bankserv as the operator of choice. It provides for a single point of entry into a payment system. They have the technical specifications, rules and procedures available to any new entrant.

They are also aware of their key role and took care in setting prices for participants. They do not drive maximum return on investment for their shareholders. This in itself is a key driver for keeping cost of switching down. Another benefit is the interoperability they provide between participants' systems that increases the volumes with the resultant lower unit costs.

In recent times Bankserv has been reworking their pricing models to encourage new entrants and to reduce the overall cost of low volume players. The previous model was based on tiered pricing based on volumes to recover a fixed monthly fee. This created a fairly high unit cost for low volume users, especially as they progressed into the next tier of fixed fees. This model was replaced by a model where the bank made a pledge of expected volumes to Bankserv on which pricing is based. The fixed fees were removed from each individual payment system and replaced by a single fixed fee based on the bank's pledge. Bankserv then provided a structure based on usage and volume that lower the switch fees as you move to higher volumes.

When the model was first presented to us we had our reservations and felt it could be more expensive. By closer evaluation it was found that the higher fee was due to the phasing in of the new model. This was debated with Bankserv and the phasing in period was abandoned after one year. This was possible due the increased volumes that created sufficient income to meet Bankserv budget. When the phasing out structure was removed the unit cost of clearing reduced for lower volume participants. It can be argued that low volume banks need to have the same switch fees as the large banks, but it is a recognized principle that companies do give discounts for higher volumes. We do not see the price differentiation on the clearing cost as the biggest hurdle in competing with the large banks.

Bankserv is a specialized NPS operator owned and managed by the industry who understands the role Bankserv plays in the economy. Cost of clearing is low in relation to overall transaction cost. Bankserv also plays a role to promote innovation and the creation of new payment services.

As a public company Bankserv's shareholding could be sold to entrepreneurs with no interest in the payment industry other than profit and return on investment. Because there are no real alternate operators the shareholders could increase switch cost to maximize profits according to free market principles.

5.3 Regulatory cost

To establish a bank shareholders have to raise at least R 250 million in capital. The Registrar of Banks may even place operational and business restrictions on the new bank. From then on the bank has to submit returns on

a monthly basis to the Registrar's office. The bigger the bank the greater is the burden of compliance.

The NPS Act governs the payment system and its participants. In terms of the NPS Act the Payment Association of South Africa (PASA) was created as the payment system management body. The success of PASA relies on the participation of members in the various forums where each bank has the right to raise its concerns and needs. PASA has to be funded. This is done on an annual subscription basis where each bank contributes according to its volumes and values processed, the larger banks contributes the most.

6 PROCESS OF SETTING FEES

In this section we will provide an overview of the relation between the client pricing and the factors that are considered in setting the price.

Capitec's pricing philosophy takes cognizance of direct cost, opportunity cost and current market prices of similar products in order to create sustainable marginal income growth for the bank.

The direct cost includes those costs that are directly attributable to the provision of the service, such as operator switch fees for switching.

The opportunity cost relates to the cost of a transaction compared to the next best alternative. An example would be to allow clients to withdraw funds at a retailer at a reduced fee because the saving of not handling cash exceeds the potential income from a higher fee.

When dealing in a specific market it is important to run price comparisons with possible competitors. This provides a benchmark against which our client pricing can be tested.

In a new business it is not always practical to include overhead costs into a pricing model. Overhead costs do not change in direct proportion to the value and volume of services rendered. Excess capacity is not relevant to maximize marginal income. Capitec currently has the infrastructure in place to service the targeted mass market. It would not be practical to develop a system for R1 million and then pass the cost directly to the consumer. The first transaction cannot be priced at R1 million, a longer term view is adopted to recover investment and operating cost.

Our bank has a vision to be the dominant mass market bank. One of the strategies to achieve this is to provide affordable services to the mass market.

We believe that in the absence of legacy systems our focused and simplistic business model and our technology driven banking platform will enable us to sustain our current pricing levels at significantly higher volumes and thereby contribute to the growth and profitability of the bank.

When a new system is implemented assumptions are made on the rate of client acceptance and use of the service. This is factored into the decisions. After implementing a new system the volumes are normally low. The price has to be set at a level to attract clients to use our services. Prices are therefore not quantifiable by pure costing, but rather subjective based on the objective of the price. Only once a system has reached reasonable volumes and has a predictable behaviour can costing become more specific.

The drive is therefore focused on providing quality service but always keeping an eye on the overhead costs. The current income derived from transaction fees does not fully cover the overall cost of providing the services, but we believe that if we achieve our growth targets that the volumes will increase driving our marginal cost sufficiently down; then the payment services will be profitable. We therefore compete on client pricing with other banks and believe that this strategy is appropriate for our market segment.

7 ACCESS TO NPS OF NON-BANKS

In this section we will briefly look at the role of operators and their access to the NPS from a bank point of view. We cannot comment on the possible experiences of other users. Capitec Bank is a new entrant with relatively low volumes in all the payment streams. We therefore had no special bargaining powers and were treated as a normal bank.

The access to bank accounts is found in the transactional ability of the clients, including some of the enhanced payment facilities like debit orders where other entities can get access to the account as well. Banks therefore have responsibilities towards their clients as they are trusted by their clients to protect their deposits.

Access to bank accounts has to be provided in a responsible manner. This can include certification of operators and the service providers that provide payment services to banking clients. The banks need to play a role in setting entry criteria for new participants to certify that an operator or service provider can be registered as a trusted entity. Then the new operator or service provider may be given access to process payments to client accounts.

The only operators that Capitec deals with are Bankserv, Master Card and VISA. The latter two being international operators.

7.1 Bankserv

Bankserv is the main operator in the NPS that provides the clearing services for most of the retail payment instruments in South Africa. Bankserv was created out of a need by commercial banks to improve efficiency and interoperability in their payments environments. The banks established Bankserv and were responsible for the development of payments systems, rules and networks. Over years the banks bore the establishment cost and contributed in human resources. The large banks owned Bankserv and its subsidiaries. During this period the banks allowed lower volume banks to use the services of Bankserv.

In 1998 the low volume banks negotiated with the large banks for a stake in Bankserv. The low volume banks obtained a 7,5% share in Bankserv which is held in a company called Dandyshelf No 3 Ltd. This provided the low volume banks with representation on the Bankserv board with the subsequent participation in the future of Bankserv. Membership of Dandyshelf No 3 is restricted to low volume banks on a voluntary basis. The current members are Capitec Bank, Mercantile Bank, CitiBank, Teba Bank, Investec Bank and The South African Bank of Athens. RENNIES Bank is in the process of joining. The other low volume banks were invited to join but have shown no interest thus far. The 7,5% is currently in line with the volumes and income contribution of the low volume banks to Bankserv.

The banks in conjunction with Bankserv own the infrastructure and the intellectual property associated with the payment services. The original banks and the late subscribers continue to share ideas with the Bankserv, to improve rules and procedures to improve the system in order to reduce payment risk and optimise the payments services.

Ownership of the service provider, Bankserv, currently rest with the parties that invested time and money into the venture to create a reliable model. The

company is trusted and banks work closely with the company to ensure a high level of reliability and integrity of the systems.

The payment services offered by Bankserv have become the standard in South Africa and may be viewed by many as common property, possibly bordering on a national asset.

7.2 Master Card and VISA

Ownership of the international operators is well documented and we will not address the issue in this submission. These operators are fully operational in the South African NPS.

7.3 New operators

An operator can be described as an entity, other than a bank, that is in the business of clearing or exchange of payment instructions, which results in the movement of value between bank accounts.

The payment industry impacts on everybody. At some stage everybody has a need to use a payment instrument. Many service providers are developing payment interfaces to empower people. They are using the established Bankserv services for this purpose.

These new operators need to bring their unique service or payment product to the market as a proposition for consideration. By simply using the existing services offered by Bankserv with a value added feature does not necessarily qualify as a new payment instrument. Operators that compete with another operator cannot expect to be allowed entry to the other operator's services and build their own products on that. They need to be innovative, create their own instruments to improve the overall product offering to consumers. Simply latching onto existing payment services, developed over years by the participants, may not benefit the consumers as it may add an additional cost layer to payments

Due the high risk nature of the payment system and the level of trust that participants have to extend to each other it is suggested that new entrants adhere to a set of minimum entry criteria. Unqualified and opportunistic operators could enter the market and offer cheap payments. There is a risk that their systems use inferior security and lack redundancy and back up. Regulated entities have to adhere to minimum standards and have additional cost of compliance.

It is important that there is a level playing field between new operators and existing operators. This includes the safety features of the system, integrity of data, reliability, DRP and back up systems, documented standards and procedures, query handling, dispute management etc. If an operator is in the business of clearing or exchange of payment instructions then it is advisable that it registers that role and comply with the industry accepted risk measures. The operator will be subjected to the same regulatory oversight as the existing operators.

New operators need to recognize the role of banks as custodians of the public deposits and work with them in setting up the service. This cooperation creates

trust in the systems and establishes interoperability between the respective banks.

7.4 Service providers

A service provider is not directly involved in the clearing of payment instructions, but can operate as an access point for bank account holders to access their accounts. Typically the service provider will build value added service for existing payment instruments or services that they can sell to banks for the benefit of the bank account holders. Bureau services are examples of such providers.

Even in this relationship between the service provider and the client there is trust. The client has his account at a bank. The service provider, therefore, has to enter into an agreement with the bank(s) to gain access to the accounts.

The service provider cannot be innovating products on its own and has to obtain the approval of banks to implement the products. The banks remain responsible to their clients. Service providers can build a relationship with a bank or banks and provide services to their clients.

There will be less need for registration of a service provider if it operates in a close relationship and contract with a bank. The banks, as trusted members, will take the responsibility of managing the risks associated with the introduction of service provider(s) into the NPS onto them.

8 CONCLUSION

Capitec Bank has obtained access to the payment system as a new bank with no risk history. We have been able to build our bank and deem ourselves as a bank that can compete against any other bank. In the past five years we have not come across any deliberate anti-competitive behaviour aimed at stifling our ability to compete.

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.

Multilateral negotiations to set interchange fees should benefit the low volume banks; this places them at the same interchange fee structure as that of the large competitors. Bilateral negotiations of interchange may reduce the ability of low volume banks to compete with the large banks due to the un-even offerings.

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EVALUATION OF EDO BILATERAL PROCESS

This document contains Capitec Bank's observations and experiences of the EDO price negotiations.

Capitec Bank ended up with five different sets of prices and as many variations in calculating the successful costs.

The process started at the end of 2005 and was only completed on 15 September 2006 the Friday before live date. Some banks still have outstanding items on which fees they cannot reach agreement. It was a very complex process where banks had different principles and reasons for certain decisions.

In our experience it was one of the worst periods and the lowest level of trust in the interbank domain. The inability to communicate on open forums created serious delays in getting to some level of consensus on basic issues to create some frame of reference or basis for future negotiations. If we had a basic framework from which to work it might have been easier to negotiate the fees.

Each bank started with a clean sheet, setting its own principles for pricing, pricing strategies and chargeable items or processes. This meant that no two banks had the same departure level. Each bank had to do the round a number of times to obtain a feel of the thinking of each bank. After each round, banks had to realign their thinking and models try and accommodate other banks' views. This took months to get to a point where banks could start to look at fees.

Once some common ground was established, banks started to negotiate fees. However, banks had various pricing strategies and reasons for charges. This created large variations on approach and actual fees. The interbank fees (interchange) are crucial as this will impact on the ability of banks to on-sell the service to users.

The banks could not really negotiate as the platform for negotiations differed; each bank had valid reasons for their thinking on price levels. You cannot negotiate a lower price if a bank uses the risk of high volumes as a reason for setting the high price to limit the volumes of debits homing in on the bank. It does not make business sense to turn business away, but it is their prerogative.

Because it is a new service, some banks were reluctant to under price as they could not determine the behaviour of potential users and the risks it could bring to its clients. Risks are not quantifiable as long as it remains subjective, each bank will have its own views. The lack of statistics and past experience also caused uncertainty and possibly over-cautiousness in setting prices.

Smaller banks were corporate users of the large banks for early debits, they paid normal user pricing for the service that was moving to EDO. These corporate users were becoming clearing banks in their own right and therefore should be paying normal interchange rates for the services (excluding the mark up fee for clients). The banks therefore linked the current corporate fees to the interchange fee that they require to maintain their income stream. This made

the interchange levels unnecessary high and some banks could not adapt to the fact that the clearing world for early debits has changed.

Arbitration was an option if banks could not reach agreement. That process had serious flaws and would most probably not work. An arbitrator would sit with the same problem if there is no proper reference to base the process on. There has to be something in common against which behaviour or arguments can be measured.

The arbitrator should at least be able to identify the underlying processes and possible "charge points" when fees will be raised, i.e. when successful, when put into tracking, when rejected etc. This will reduce the permutations. Only then can the banks constructively debate the quantum of each process or "charge point". The challenge will most definitely lie in the basis on which to arbitrate. Many approaches can be followed, the most popular probably "input cost and profit levels vs. projected volumes and risk". Each bank will have different methodologies to calculate project costs and can "manipulate" the outcome as high or low as it wants; which cost will be used as benchmark, the highest or the lowest, thus potentially inflating interchange or under recovery leading to losses and termination of the service.

There is the risk that large issuing banks may raise high interchange fees if it does not have a balance between acquiring and issuing. Many smaller players tend to be more active in providing acquiring services. Higher interchange may provide a platform for large players to charge their users less for their on-us debits, thus being able to use their market dominance to keep out smaller participants on the acquiring side who cannot compete when the fees are set by the large issuing banks.

CONCLUSION

It is our opinion that the level of the interchange is too high and that the ability to debate the principles and objectives in an open forum could have lead to reduced interchange rates.

Interchange should be set in such a manner that it will promote competition at user and client level. It must be sufficient to cover development and process expenditure, but must not be at a level where it becomes a profit centre in its own right.

A single fee could be determined and be used by the industry as a benchmark for interchange on the interbank level.

In this case user fees will probably be higher than what it could be. For a bank to give a simplistic, comparative pricing model to its users, the user fees will possibly be set against the highest interchange fee with a possible over recovery on transactions exchanged with the cheaper banks.

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