

MERCANTILE BANK LIMITED

SUBMISSION TO “THE BANKING ENQUIRY”

Following the discussion between representatives of the Competitions Commission of South Africa and the Bank, in Sandton, on 12 October 2006, we hereby lodge our submission re the Banking Enquiry for your consideration. Mercantile Bank wishes to comment on the following topics:

1. Bankserv Pricing Structure

Currently Bankserv operate a price structure based solely on volumes. This means that the lower volume banks that utilise the services of Bankserv pay a much higher per transaction fee than those banks on higher volumes. It is our view that this structure creates a competitive advantage for the large banks, in that their effective unit cost prices from Bankserv can be much lower than those to the lower volume banks.

We have engaged with Bankserv for over a year to attempt to have this differentiation addressed, but have as yet been unsuccessful in addressing this issue, we suspect, due to the undue influence on pricing by the major banks. It must be said that Bankserv’s management have been receptive to our arguments, but have been as yet unable to accommodate our requests to level the pricing playing field.

An example of this follows:

Dated debit transaction	Mercantile Charges @ R1,000,000 bracket	Percentage of Fee	Large bank charge @ R45,000,000 bracket	Percentage of Fee
Bankserv fee - direct per transaction	0,1611	22,38	0,0857	11,90
Bankserv fee - fixed*	0,3226	44,81	0,0995	13,82
Homing fee	0,2300	31,94	**0,1725	23,96
External cost	0,7137	99,13	0,3577	49,68
Beneficiary pays	0,7200		0,7200	
Contribution to internal costs	0,0063	0,88	0,3623	50,32

*The fixed fee charge is calculated as follows:

- i) No. of transactions = guaranteed amount less fixed fee divided by variable fee
- ii) Fee per transaction = fixed fee divided by no. of transactions

**Assumes 25% of transactions are “on us” for larger banks based on average market share – see below.

From the simple example above, it is clear that the current pricing structure creates an opportunity for a larger bank to provide a price to the end-user at a level that is equal to or even lower than the base cost to the smaller bank. In the above example the larger bank can easily discount its price to the client a level of say 70 cents which is lower than the all in cost to the smaller bank of 71,37 cents. In this scenario the smaller bank will lose the business as it will incur a loss at the price of 70 cents but the larger bank will earn a contribution margin on cost of 95,69% ($0,3423/0,3577 \times 100$).

2. Homing Fees

The so called “homing fee” or interchange payable by sponsoring banks to issuing banks for EFT debit orders will always have a beneficial effect to those banks which control a high percentage of accounts. It is in their interest also to attempt to make this interchange as high as possible, as this will bring additional income, over and above the income earned from customer charges. Thus the banks take 2 fees for every transaction processed – they charge the customer a processing fee (on average between a minimum of R3,00 and a maximum of R27,00 depending on the value of the transaction), and effectively the beneficiary for providing settlement services.

The levels of costs associated with “settlement” are questionable. In the case of the large banks who control in excess of 25% of the account base, their on-us transaction flow will also provide them with an additional benefit where no homing fees are payable, and yet the cost of this is built into the beneficiary charge. The homing fee was introduced to compensate for the work done by the issuing bank on behalf of the acquiring or sponsoring bank, and based on international interchange precedent in order to foster ongoing interoperability between banks. Whilst we support the concept of interoperability, the level of compensation needs to be carefully evaluated to ensure that this is reflective of the underlying costs associated with the transaction. The higher the homing fee the more difficult it becomes for acquiring banks with a small customer base to compete effectively as is made clear from the table in (1) above.

3. Bankserv Decision Making Structure

The Bankserv Board is currently structured as follows:

- 2 Directors from each of the Big 4 banks – 8 directors
- 2 Directors from the Dandyshef shareholding Group – 2 Directors
These are all non-executive directors
- 2 Directors from Bankserv Management – no voting rights
These are executive directors

The Dandyshelf Board is made up of 1 director and alternate from each of the shareholding banks. The Dandyshelf board will then elect 2 of their directors to represent the interests of the Dandyshelf shareholders on Bankserv's board. Where a decision is required on the Bankserv Board, the Dandyshelf board must mandate its representative directors on such issues. Where there is no unanimous support on such an issue, a simple majority vote will be sufficient. Where this impacts on the view of one of the Dandyshelf shareholders, there is no real recourse, and such shareholder will be bound accordingly. An example of which is the recent call by Bankserv to amend its shareholders agreement, for which there was not consensus from the Dandyshelf shareholders, and a majority vote was cast in favour of supporting the proposed changes.

It is thus questionable whether the current structure of Dandyshelf actually provides the low volume banks with a meaningful say in the affairs of Bankserv.

We are aware of the changes currently underway in Bankserv in that the shareholders of Bankserv are busy with initiatives to allow the Bankserv Board and its executive management team more autonomy, but there is as yet no real consensus on some of the core issues, and this process may take some time to finalise.

4. Multilateral vs Bilateral pricing agreements

We do not favour the bilateral pricing structure for the following reasons:

- Potentially places the smaller banks at risk, as the prices agreed upon with the large banks may place one's ability to compete effectively in the market at risk. Some of the larger banks take a volume-based stance whereby they look for up to a 25% pricing differential between the largest volume and lowest volume banks in a particular stream. This obviously will have a detrimental impact on the ability of the low volume banks to compete.
- The number of negotiations required creates a major burden on all involved.
- The different price structures agreed to with each of the different banks creates a major billing problem, and will also create even more confusion in the minds of consumers, as different prices may be levelled for the same service, but depending on the bank rendering the service, there may be a different price. Also the systems required to administer such a complex pricing system become almost as complex as the payment system itself, adding additional costs to the payment system. Furthermore, the strong negotiating position of the major banks places a question over whether the price agreements reached are driven by competitive issues.
- There is also the risk of not reaching agreement on prices, which then creates even more uncertainty on the payment stream and its users, and also creates an additional burden on the banks in that they need then to submit to an arbitration process, which is uncertain.

We therefore support multilateral pricing with the proviso that there is independent oversight. Such oversight should not be in the form of government or regulatory oversight, but rather should take the form of an industry expert or experts, who understand the principles and parameters, and can ensure that prices follow such principles and are fair and reasonable.

A good example of the failure of the bilateral process, are the recent negotiations undertaken in the EDO payment stream. Interchange fees have been set at what appears to MBL to be at a very high level, on the premise that the issuing banks are providing a premium or preferential service which has cost a large sum to develop. Whether these fees are reasonable or justifiable is not measurable, and the unintended consequence may be that there is a low uptake of these services as the beneficiary fees will be set at a high level. These high fees may also prove to be a barrier to entry for acquirers or service providers not associated with the larger banks. By way of illustration, some of the large banks initially proposed interchange at a level of 1,75% of the value of the transaction. MBL rejected such proposals, and 6 months later an interchange of 0.55%, in line with the current debit card interchange, was agreed upon.

5. Saswitch

As MBL does not currently have a large network of ATMs, it would be difficult for us to provide a meaningful comment on the costs involved of running and maintaining such a network, and whether the current fees charged are justifiable based on the logistical and other costs, including capital costs.

As far as the Non ATM devices (NAD or mini-ATM) are concerned, whilst these are seen as an ideal service delivery platform, particularly in rural or township areas, there has been a concerted effort by some of the banks, supported by the card associations, to either remove these devices completely from the market (against card association rules) or to limit their usage. There is some justification for this based on the arbitrage opportunities whereby a merchant could force customers to utilise a mini-ATM either unknowingly or by design, so that the customer pays the fees, and the merchant does not pay a merchant fee as per a normal POS device. However, if there are proper rules in place to govern the deployment of such devices, the arbitrage opportunities should be minimised as the customer will be made fully aware by the signage and advertising surrounding such a device, that they are making use of an ATM based transaction, with the relevant cost implications. We feel that given correct signage, informing customers of the pricing, the choice should be left to the customer as to whether they wish to make use of the POS driven purchase transaction or the Saswitch driven ATM transaction, and that the regulators and card associations are attempting to govern consumer behaviour based on what may be interpreted as market protection. Another anomaly of these devices is that although the banks identify the transaction as being initiated via a NAD device, the fees charged to their customers appear to be the same as those charged by a full ATM device.

6. Comments on the FEASibility Report

The Feasibility Report published in April this year has formed a good starting point for an enquiry into what is a complex and intricate system, with many nuances that may not be apparent on the surface. The National Payments System (NPS) has become an integral part of the everyday functioning of the economy in terms of facilitating electronic payments in various forms.

The interoperability of the system between all participating banks needs to be recognised as an extremely valuable asset, particularly for the smaller banks entering the market, or already operating in the market, as this provides such banks with a level playing field in terms of access. The concerns raised by the Report surrounding the pricing of such interoperability are seen as valid by MBL. We are currently facing an environment in which the bilateral fee negotiation approach deemed to be the only approach that does not fall foul of the current Competitions Act, is seen as a major threat to the ongoing viability of the smaller banks in participating in the NPS.

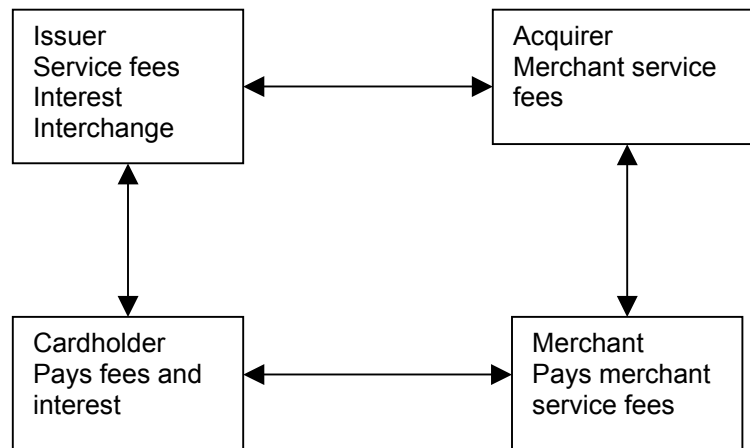
MBL would thus support the suggestion in the Feasibility Report where it states *“It is possible that the best outcome in terms of fairness for both consumers and small participants (including banks and retailers) would be to allow multilateral price negotiations, and to publish these prices and their changes so that consumers are informed and empowered.”* – FEASibility Report, Page 30, Paragraph 3, Lines 7 – 10.

We should however note that we welcome the current enquiry into both access and the level of fees, as we are of the belief that certain of the fees may be prejudicial, and not reflective of the underlying cost components.

7. Card pricing structure

The card industry is using a four-party model, which involves Cardholders, Issuers (Bank), Acquirers (Bank) and Merchants as per the graph below.

Acquirers earn a merchant service fee (payable by a merchant) of which a portion known as interchange is paid to the Issuer. The Issuer earns card fees, transactional fees and interest (payable by the cardholder) depending on the type of card product.



Card fees (annual or monthly) are charged on certain card products. New entrants in the market prefer not to charge a card fee but to rather implement higher service fees.

The interchange fee is agreed upon by domestic Issuers and Acquirers. The international interchange is set by the Card Associations.

As the Association of Bank Card Issuers and Acquirers (“ABCI”) is dominated by the large banks, the structure is without any capacity to negotiate or arbitrate on this fee. The current interchange fee is 1,71% on credit cards, 0,55% on debit cards and the “Hybrid” card interchange is 1,09%.

For issuers with a large account base Interchange is an important revenue stream to offset cost of managing and running the account base. There are risks involved in managing a card base such as fraud that results in related fraud prevention costs. The “liability” shifted from the acquirer to the issuer from 1 January 2005 in the case where a non-EMV card is used for payment at an EMV compliant merchant.

The real cost driver for the interchange charged on credit card transactions is the interest free period of between 45 and 55 days on purchases. No interest is earned when a cardholder settles the full outstanding balance on or before due date. IF NOT, interest is charged from the transaction date in which instance the full interchange fee becomes a pure transactional income.

Credit Cards

The interchange of 1.71% for credit cards is used to cover cost as follows:

Client settles full balance before due date:

▪ Transaction value	=	R1,000
▪ Interchange charged	=	1,71% x R1,000
	=	R17,10
◇ Allocated as follows:		
Funding cost	=	R1,000 x 9% (cost of funding @ Repo rate plus 1%) x 55 days/365
	=	R13,56
Transactional income	=	R3,54

Client settles minimum due @ 10%

▪ Funding cost	=	Covered by interest income as clients pay interest from transaction date
▪ Transactional income	=	R17,10

It is important to note that credit cards are considered to be one of the highest types of lending risk and provisions of up to 5% of the amount lent are carried by banks which places the above calculations into perspective. It is further important to note that no transaction fees are charged on credit cards.

Debit Cards

Issuers also earn an interchange on debit cards and a POS transaction fee is usually charged when a card is used at a POS. Transactions are authorised online in all instances. Risk and fraud is therefore minimised. The acquirer however has all the cost associated with the POS infrastructure. There is no funding component on debit card transactions since debit card transactions are a pure EFT transaction.

The interchange fee of 0.55% plus a transaction fee (average of R2,50 per transaction) is regarded as high.

8. Merchant acquiring

Card transactions are acquired by Acquiring Banks through merchants. Smaller Issuers in South Africa usually switch transactions through the Card Associations and through the local switch. It is possible to receive transactions direct from merchants (also known as sorting-at-source). Smaller banks will have a disadvantage if sorting-at-source is allowed since multi-connectivity points have to be established at a high cost. Numerous bilateral agreements will have to be entered into and the management thereof could be an onerous task. Charge backs will become very difficult to manage and separate arrangements will be required which will result in higher costs.

The current average merchant fee is 3.5%. The merchant bears the cost of the POS infrastructure and pays an interchange fee to the Issuer hence the higher the interchange fee the more pressure is put on increasing the merchant fee.

9. Governance structure (Local between banks)

The business rules are governed by the ABCI. Banks are allowed to become members of the ABCI by application. The five largest banks, in terms of Card Sales Volume, each have a representative on the ABCI. The next five banks have one representative. A majority vote of 80% is required to pass a resolution either by showing of hands or by a poll. Any member can ask for a poll. A poll is based on a proportionate vote based on Card Sales Volumes. This effectively gives the larger banks control over the card business rules. The structure does not provide a voice for smaller banks and it does not provide recourse to arbitration.

A further important factor is that local card rules can supersede Visa's International card rules to safeguard the local banks' interest in BankServ, for instance the restriction of cash-back on credit cards.

We support a multilateral pricing structure supported by an arbitration process

10. Governance structure (Card associations Local and International)

MasterCard and Visa Issuers and Acquirers have to comply with the International and Regional Operating regulations. Some of these rules are restrictive such as cross-border issuing and acquiring where a multi-national bank that is not represented in a specific country is not allowed to issue or acquire in that market if there are other Issuers/Acquirers present in that market.

Entry levels for acquiring are set in some instances to favour the bigger Issuers.

It is required in South Africa that an Issuer has 15% of the domestic Visa issuing base to qualify for a Visa Acquiring License.

MasterCard does not have any restriction on obtaining an acquiring license but banks that do not issue MasterCard are penalised with an incremental surcharge of 25% or 50% of the transactional fees on local and international acquiring activities.

11. Private label cards

The bigger issuers issue private label debit cards also known as garage or petrol cards. The Acquirers control these private label BINS for card acceptance at POS.

Forecourt merchants do not pay a merchant fee on garage cards but the cardholder pays a transaction fee when using the card. Please refer to the 2004 Edgar Dunn report that was released to the Commission under the auspices of the ABCI.

We support the use of branded credit and debit cards at forecourt merchants. The same fee structures should apply, as is the case for Retail merchants.

MERCANTILE BANK LIMITED