

Nedbank Limited
Competition Commission
Terms of Reference Response

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1 Acronyms and abbreviations

Acronym/Abbreviation	Description
ABCI	Association of Bank Card Issuers and Merchant Acquirers
AEDO/AEDOS	Authenticated early debit order (system)
AFFINITY	A mutual benefit marketing programme comprising a suite of banking products that uniquely enables clients to support causes close to their hearts at no cost to client.
ATM	Automated teller machine
BASA	Banking Association South Africa (previously known as Banking Council)
BASEL II	International Convergence of Capital Measurement and Capital Standards
BESA	Bond Exchange of South Africa
CCA	Consumer Credit Association
CCTOR	Competitions Commission Terms of Reference
C/I Ratio	Cost-to-income ratio
CLC	Code line clearing
CLS	Continuous linked settlement
CSAB	Competition in South African Banking
DT/CR	Debit/Credit
DRP/BCP	Disaster Recovery Programme/Business Continuity Planning
EDO	Early debit orders
EFT	Electronic funds transfer
FAIS	Financial Advisory and Intermediary Services Act
FICA	Financial Intelligence Centre Act
FSC	Financial Sector Charter
IBPF	Interbank Business Payments Forum
IPS	Integrated processing solution
LOA	Life Officers Association
MFSA	Micro Finance South Africa
MFRC	Micro Finance Regulatory Council
NBA	National Bank Account
NAEDO/NAEDOS	Non-authenticated early debit order (system)
NII	Net interest income
NIR	Non-interest revenue
NPS	National Payment System
NPS Act	National Payment System Act No 78 of 1998
NPS Amendment Act	National Payment System Amendment Act No 22 of 2004
PASA	Payment Association of South Africa
PCH	Payment Clearing House
POS	Point of sale
PSSF	Payment Systems Stakeholder Forum
R&D	Research and Development
ROA	Return on assets
ROE	Return on equity
SAMOS	South African Multiple Option Settlement (system)
SANPAY	South African National Payment System Forum
SAPSA	SA Payments Association (also known as PayStrat)
SARB	South African Reserve Bank
SAIA	South Africa Insurance Association

Acronym/Abbreviation	Description
SBV	Standard, Barclays and Volkskas (outdated abbreviation)
SBS	Small Business Services
SME	Small and medium enterprises
SWIFT	Society for Worldwide Interbank Financial Telecommunications
STRATE	Share transactions totally electronic (the authorised Central Securities Depository for the electronic settlement of securities transactions)
TSS	TranSwitch Services
VDT	Voucher dispensing terminals
Vision 2010	High-level SARB strategic direction for the payment system up to 2010
ZAPS	Interbank Credit Payment System

2 Executive summary

Nedbank and other local banks have been approached by the Competition Commission to respond to a Terms of Reference document through which the commission intends to better understand key aspects of Nedbank's Retail Banking and payment-related business lines. It also wishes to gain insight into Nedbank's views, specifically on access to the National Payment System (NPS) and generally on the nature and level of competition in this environment.

Nedbank welcomes the opportunity to share information with the commission, as we believe there is scope for extending the understanding of the issues identified.

Nedbank is committed to growing its business faster than the other retail banks in what we experience as a very competitive environment.

To this end we have had to define and implement a clear strategy, through which we identified that Nedbank must make banking more affordable to all South Africans. Our actions during 2005 and 2006 demonstrate this commitment.

Nedbank does not believe that the profit levels in SA banking are extraordinary. Our analysis of the SA banking industry acknowledges that SA banks have generated strong profits in the recent past. We demonstrate, however, that this has been the result of exceptionally favourable economic conditions, particularly during the past two years, which have resulted in stronger-than-normal earnings growth in most sectors of the economy. This specific set of circumstances is extremely unlikely, in our view, to be repeated in the near future.

Nedbank also believes that four key analyses provide further evidence that there is nothing extraordinary about the profits and earnings of SA banks. Firstly, profits in the local banking industry are highly cyclical and dependent on the overall business cycle. Secondly, profits of SA banks are in line with those of other developing countries with similar risk profiles and at the same time not significantly out of line with profits of developed countries with much lower risk profiles. Thirdly, profits in the banking industry are not out of line with those other sectors listed on the JSE. Finally, the market has consistently underrated the overall banking industry relative to other sectors, because of the perceived high earnings risk of banks.

One would expect that these profits could be achieved with ease and sustained with little effort in an industry characterised by low levels of competition. This is not Nedbank's experience. We experience this market as very competitive and have to work hard to attract and retain clients and to meet earnings growth targets. We share our turnaround strategy since late 2004, and the ongoing challenges we face, to illustrate this assertion.

This competition is juxtaposed with the need for cooperation between banks in respect of the National Payment System. The NPS is a material component of the SA economy, exchanging payments to the value of R148bn per day. This equates to 33 times the SA gross domestic product. The mission-critical nature of this network necessitates stringent risk management. To this end the rules of entry and participation are established, monitored and managed by the South African Reserve Bank. To date these principles have been successful. The NPS has endured bank failures, facilitated the entry of the rand into international trade settlements via continuous linked settlement and has not experienced any failures. Nedbank supports the extension of access to the NPS to new players with the proviso that these stringent risk management principles are not compromised.

A key feature of this success has been cooperation between the clearing banks in the management and application of the NPS rules. Cooperation has also created efficiency and reduced payment costs for all stakeholders through the joint payment-processing infrastructure residing at Bankserv. Interoperability and maximum adoption of different payment types have been supported through cooperation in the application of interchange, which has encouraged the adoption of new payment streams by both issuing and acquiring banks.

2.1 Components of Nedbank's response

Nedbank's overall response to the Competition Commission Terms of Reference (CCTOR) reflects our views in respect of the key issues and is comprised of:

- A response to the factual data request issued by the commission in mid-August – Factual Information Response Documents 1 and 2.
- A general response to the CCTOR contained in this document.
- A review of previous research into the NPS, appropriate experiences in this context and an Early Debit Order Case Study as an annexure to this document.

2.2 Structure of our general response

Our general response to CCTOR and, where applicable, prior research into competition in South African banking is provided within the following structure:

2.2.1 South African banking industry

The investigation into the banks stems from an assumption that banks have been using oligarchic powers to earn super profits consistently at the expense of consumers. The Falkena Task Group (2004) initially introduced these assumptions in the Competition in South African Banking (CSAB) report. While CSAB adopts a broader approach, the current focus is on retail banking and specifically on fees. This narrows the study to individual profit lines and, where these appear excessive, to seeking out what anticompetitive forces may have produced this result.

In this section of our feedback we provide our view first on the overall context before considering individual product lines. We seek to answer the question as to whether banks are consistently making excessive profits as defined in CSAB. To attempt this, definitions of excessive profits are examined. These are then applied to banks as a collective across all product lines to see whether abnormally high profits have been achieved. Returns are also compared with banking sectors in other countries and also with other industries in South Africa. The consistency of returns over economic cycles is examined to establish whether structural features have played a part but may not in the future. Industries where consistently abnormal profits are achieved can be expected to be highly rated by the equity market. We examine whether banks have this distinction in terms of measures such as price-to-earnings ratios. We conclude this section by looking at the individual product lines that are under scrutiny to highlight that the squeeze on net interest income (NII) leads to a relative shift in bank earnings from NII to NIR (non-interest revenue).

The response is deliberately an economic and financial review and is not an analysis against the technical aspects of the current South African competition law regime.

2.2.2 Nedbank Group

The next section contextualises Nedbank within the broader South African banking environment by providing a high-level summary of the scope and context of Nedbank's retail banking business. This provides a base from which to illustrate to the commission that Nedbank views this market as very competitive, has identified the need to actively pursue a competitive strategy and is addressing identified weaknesses to achieve our aggressive growth objectives.

2.2.3 National Payment System

CCTOR's specific request for Nedbank's views on the feasibility of improving access by non-banks and would-be banks to the NPS, specifically to improve their ability to compete more effectively in the provision of payment services is addressed in this analysis. This analysis provides a high-level definition of the NPS and subsequently broadly identifies the advantages of requisite cooperation in the NPS and the minimum risks that the minimum required cooperative structures and processes need to address. This analysis includes an outline of the existing structures that facilitate this requisite cooperation. We highlight the additional advantages of cooperating to the necessary degree on a market infrastructure such as Bankserv, which facilitates general access by consumers to all

payments streams (interoperability), while providing economies of scale, without which the cost of providing such payments would surely escalate.

This subsection incorporates a closer look at the existing options for access and confirms our view that the integrity of THE NPS requires the regulation of access criteria. We concur with the view that access to THE NPS be extended on the basis that, as a minimum, new entrants be subject to a level of regulation that is proportionate to the level of risk that is introduced into THE NPS by the nature and extent of their access. To conclude the section on necessary cooperation within THE NPS we provide an overview of the concept of interchange to share insights into its purpose and the manner in which it has supported interoperability within THE NPS to date.

In the final subsection we share Nedbank's approach to competition in the South African payments environment. This section addresses CCTOR's request for clarity on Nedbank's view on the level and scope of competition in retail banking and payments generally. Nedbank believes that this is a very competitive environment, and we offer practical examples of Nedbank's application of the factors of competition as evidence of this perspective.

3 South African banking industry

3.1 Are South African banks consistently achieving 'excessive profits'?

NOTE: The term 'excessive profits' is used and analysed in this section as a result of the specific focus it received in the CSAB report.

3.1.1 What are 'excessive profits'?

CSAB (p7) states, 'If most or all suppliers have a return on capital greater than the cost of capital, this is likely to be indicative of 'excess profits' and prices and a lack of effective competition'. CSAB acknowledges many serious problems of measurement and definition, but appears to conclude that excessive returns are consistently being made, that these compare favourably with (are more excessive than) international peers and that they are also high compared with other industries in South Africa. However, these conclusions are made without any evident detailed data on the cost of capital. The observations are therefore based rather on some casual and period-specific data on various variables and are therefore in our view unscientific. CSAB does not apply the relevant sections of the Competition Act, 1998, to the facts at hand. We similarly do not do so, and only provide, as stated earlier, financial and economic input.

The return-on-capital measure is further complicated by measurement and definition problems. Historic ROE statistics may not be representative of the future as a result of changes to accounting standards. Two examples may illustrate this.

Firstly, the provisioning for bad debts. There has been a move away from an 'expected' approach to more of an 'incurred' approach for provisioning. It is anticipated that this will add more volatility to provisioning and would have the effect of increasing ROEs in benign economic conditions (such as the current circumstances), as incurred bad debt losses are less than expected bad debt losses.

Secondly, the treatment of goodwill. Previously, goodwill could be written off against share capital, thereby increasing ROEs. This is generally no longer possible.

ROE also has to be adjusted for risk. Investors require a certain rate of return, consisting of a 'risk-free' rate or satisfactory return on capital invested in a near risk-free investment and a risk premium or compensation for taking the additional risk of investing in this industry. Most analyses suggest that the risk premium attached to South African stocks is around 4% to 6% and the minimum required ROE for a bank in South Africa should be somewhere between 19% and 21%.

In the remainder of this section we extend this analysis and make some observations.

3.1.2 Cyclicity of earnings

The banking industry's performances are closely tied to the fortunes of the overall economy. Earnings growth is sensitive to changes in overall business conditions and especially to movements in interest rates. This is mainly because the performance of banks depends on the continued growth in advances, which in turn has a strong inverse relationship with changes in interest rates.

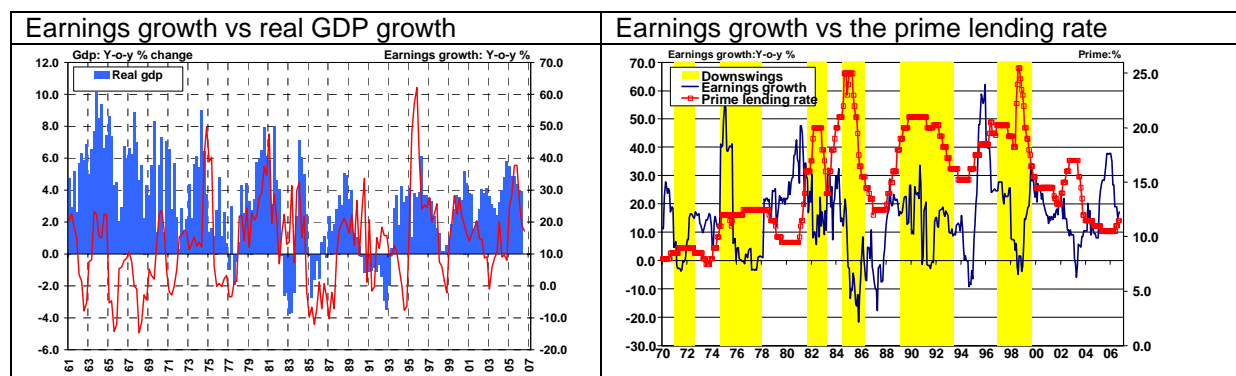
The banking sector acts as a stabiliser in the economy, absorbing bad debts in periods of economic downturn and rising interest rates and keeping facilities available to tide individuals and businesses over difficult periods. It is therefore necessary that banks build up resources during periods when conditions are favourable so that they do not compound downturns by, for example, cancelling facilities as they try to ensure their own survival in downturns. Bank failures also introduce systemic risk that further damages confidence and prospects for economic recovery.

CSAB looks at the period 1993 to 2002 as one that represents a more-than-complete cycle. However, it is notable that, although there were slowdowns in economic growth over this period as well as spikes in interest rates, there were no recessions. The period could also be seen as abnormal because political change, economic reforms and declining global inflation and interest rates created

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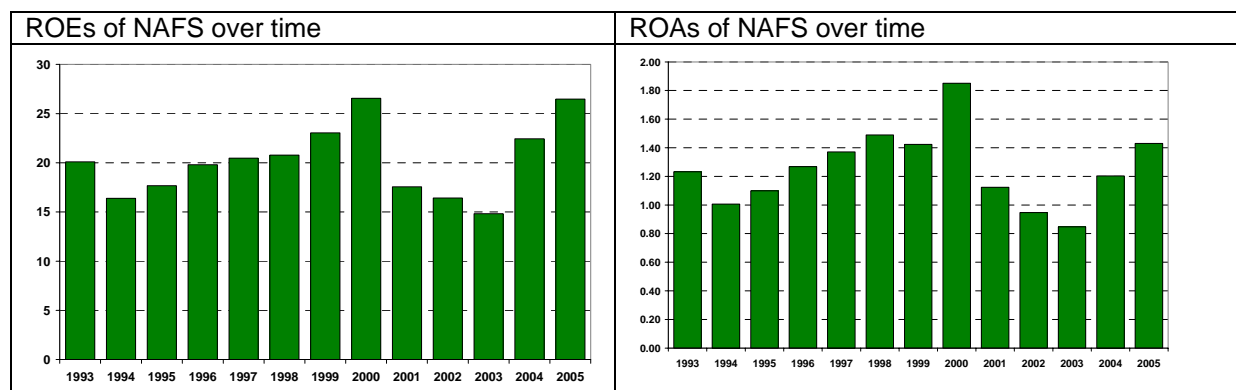
ideal conditions for banks – and many of their clients – to flourish in. (A review of the updated CSAB Task Group analyses provided by the commission does not materially change this conclusion.) The recent history has been exceptionally favourable with interest rates falling to 25-year lows, boosting both business and consumer confidence significantly and resulting in historically strong growth in domestic spending and surging credit demand, especially from households. As a result the banking industry experienced exceptionally strong growth in advances, earnings and profits during 2005.

However, past patterns show that the industry cannot and should not count on this performance being repeated in future years. The recent rises in interest rates and volatility in financial markets again underline that circumstances in a small, open economy can change significantly in a short space of time. Exceptionally strong growth in earnings and therefore profits are not a consistent feature of the SA banking industry as the two graphs below illustrate.



Source: Nedbank Group Economic Unit

The link between performance of other measures of bank performance, notably ROE, and changes in the business cycle are complicated by inconsistencies in the data and a lack of sufficient historical data. Most available series of ROE extend back to 1993 only, providing exposure to only one (very mild) economic downturn. ROE of Nedbank, ABSA, FNB and Standard Bank ('NAFS') shows some cyclicity and sensitivity to changes in the business cycle, but the period is largely unrepresentative.



Source: Nedbank Group Economic Unit

3.1.3 Comparisons with other countries

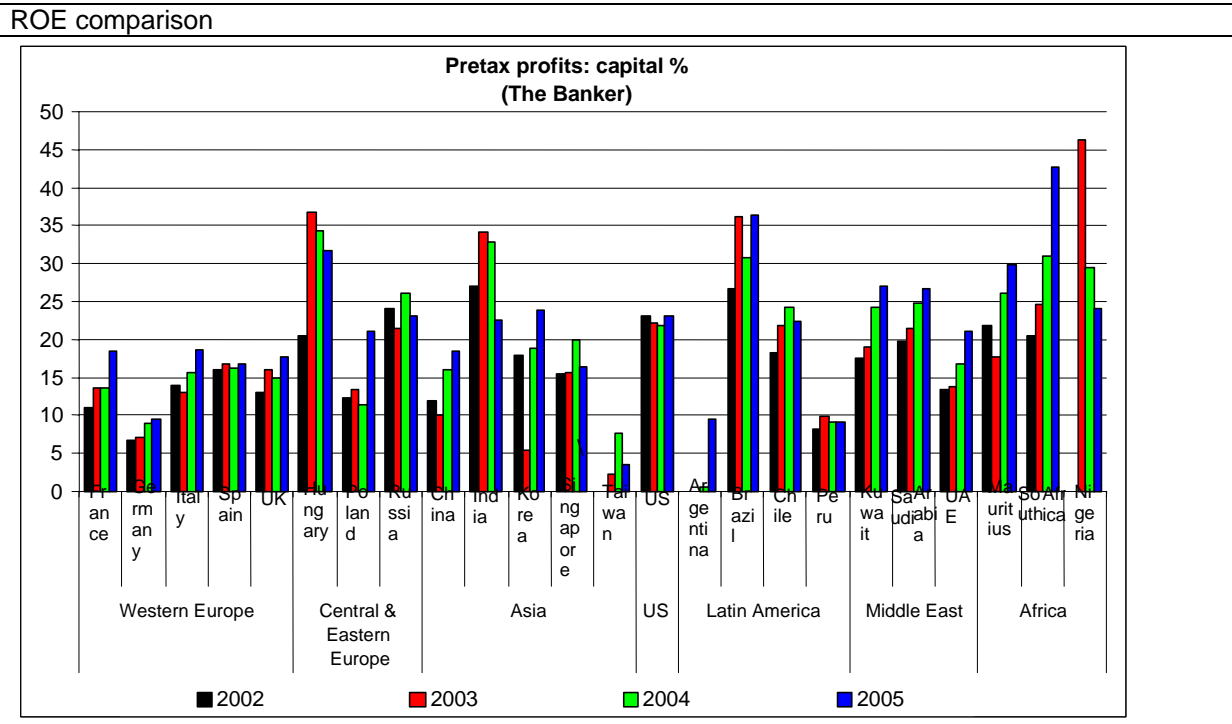
CSAB uses 2002 data from *The Banker* magazine (July 2003) for its international comparisons. The initial analysis therefore takes only one year into account. While the updated data extends the period of analysis, it remains limited by the choice of peer countries.

It is Nedbank's view that, with the exception of 2005 – where abnormal circumstances coincided to produce astoundingly good results – the profitability of South African banks is not abnormally high compared with that of other countries with similar risk profiles. From a country rating point of view, by risk, South Africa can best be compared with countries such as Bulgaria, Croatia, Korea, Mexico, Russia, Malaysia and Thailand (see table below).

Moody's foreign currency debt ratings				
	Government bonds	Country ceiling for foreign currency		Order
Australia	Aaa	Aaa		1
Hungary	A1	Aa1		2
Botswana	A2	Aa3		3
Bulgaria	Baa3	A1		4
Croatia	Baa3	A1		4
Korea	A3	A1		4
Mexico	Baa1	A1		4
Russia	Baa2	A2		5
South Africa	Baa1	A2		5
Malaysia	A3	A3		6
Thailand	Baa1	A3		6
Mauritius	Baa2	Baa1		7
Egypt	Ba1	Baa2		8
India	Baa3	Baa2		8
Colombia	Ba2	Ba1		9
Turkey	Ba3	Ba1		9
Brazil	Ba3	Ba2		10
Argentina	B3	B2		11

The comparisons of *The Banker* Top 1000 Survey from 2002 to 2005 show that since 2002 South African banks' ROEs are high, but very much comparable with those of other countries with broadly similar risk profiles. The comparison of annual ROEs across countries are also distorted by the year 2005, which was an exceptionally strong year for South African banks, and these abnormally favourable conditions are unlikely to be repeated consistently in the future.

If 2005 is excluded, South African banks' ROEs are below the ROE of Hungary (a country with a better risk rating) and in line with that of Russia (a country with a similar risk profile) as well as India and Brazil (both countries with worse risk ratings). ROEs of South African banks and of most other developing countries are clearly more volatile, which suggests that the banking industry in all these countries will struggle to compete for the attention of international investors with countries such as the US, which is a low-risk destination where ROEs have consistently been over 20%.



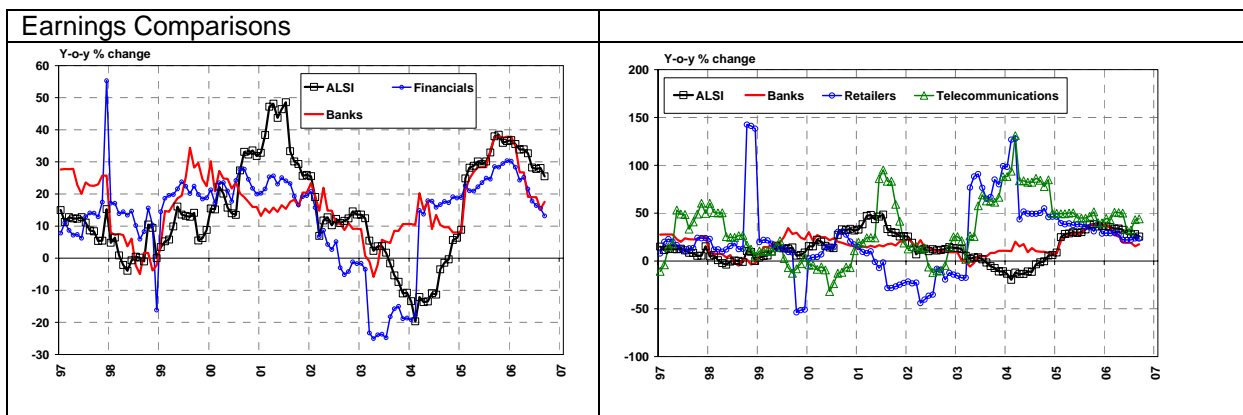
Source: *The Banker* Report: Top 1000 Global Banks, 2002 – 2005

3.1.4 South African banks compared with other sectors

Even within our own country, the local banking industry does not stand out to investors as a consistent creator of exceptionally high earnings or profits. When comparing banks with the overall market and the broader financial sector – as represented by the FTSE/JSE all-share index – the following trends are clearly visible in the data from 1997:

- There is a general volatility of earnings growth in South Africa.
- The banking industry's earnings growth is generally in line with that of the overall market and for the period from 1997 to date banks' earnings rarely exceeded that of the overall market.
- The banking industry's earnings growth is also not out of line with that of the overall financial sector.

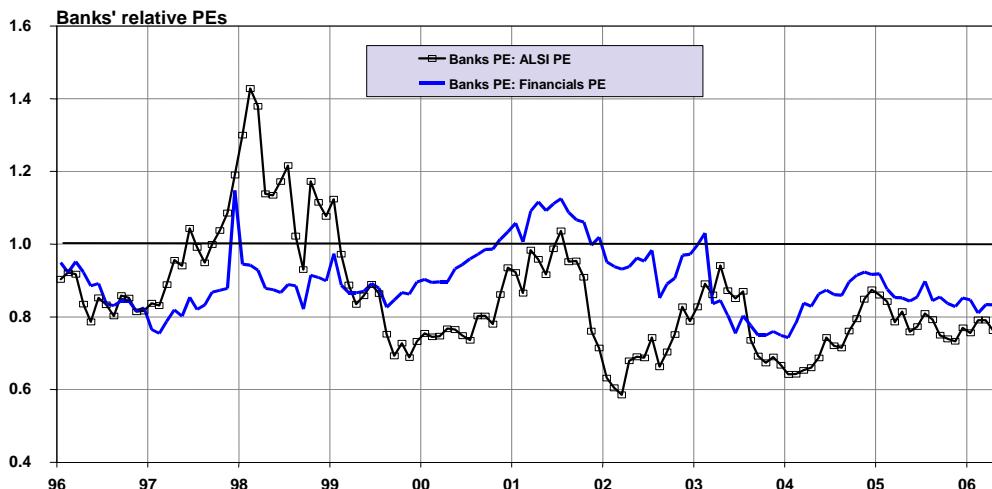
When this analysis is extended to other sectors, earnings growth in the banking industry does not stand out. The banking industry has not managed to outperform either general retailers or the telecommunications industry since 1997. It is also notable that banks were clearly not the only industry to benefit from the extraordinary conditions in 2005.



Source: Nedbank Group Economic Unit

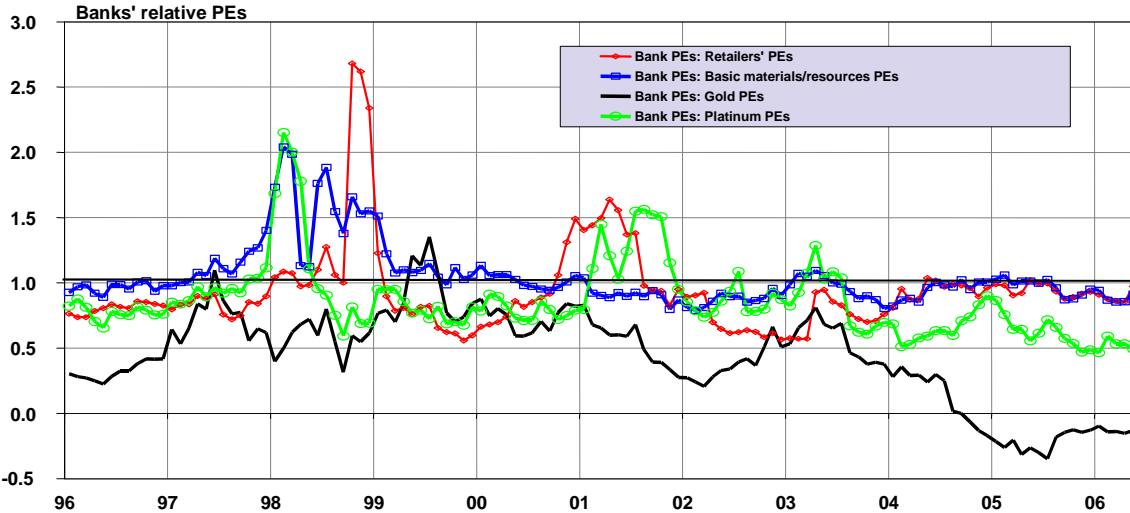
3.1.5 Market ratings

A sector that benefits from monopolistic returns is expected to be highly rated by the market. Investors and analysts clearly do not believe the banks to be in this position, as the market consistently underrates the sector. The graphs below show the banks' relative price-earnings ratios to other sectors. A ratio of below one suggests undervaluation and above one overvaluation. Apart from a brief period in late 1997 and in early 1998, banks have been rated badly by the market compared with other sectors. This trend suggests that investors have been consistently concerned about the earnings outlook for the banking industry, indicating that the perceived risks to the sustainability of earnings growth in the banking industry are considered higher than those of other sectors.



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Source: Nedbank Group Economic Unit



Source: Nedbank Group Economic Unit

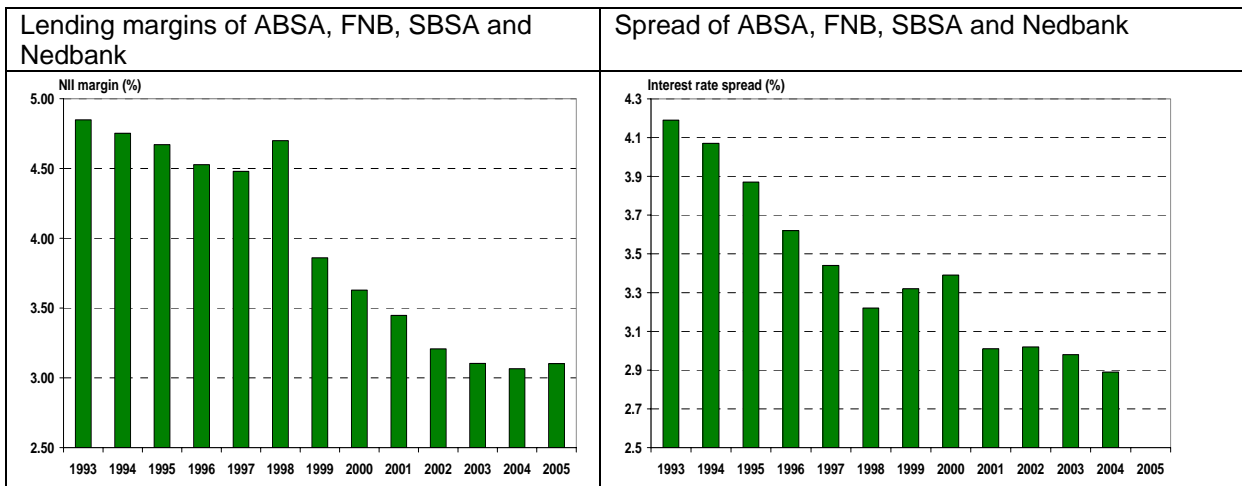
3.1.6 Individual product lines

Banks' earnings come from two sources – net interest income (NII) (earned on the difference between lending and deposit rates) and non-interest revenue (NIR) (earned on fees for services rendered, trading income and other sources). Over the past decade the relative contribution from these two sources has changed dramatically as margins have been squeezed by increased competition from within the sector and also externally.

Growth in NII slowed sharply during the 1990s, while growth in NIR accelerated sharply over the same period. The reason for the falling contribution of NII to the total gross revenue of banks, despite strong advances growth, is that lending margins and bank spreads have declined rapidly since 1999 in response to the following:

- Increased competition between banks.
- Growing competition from other industries, such as retailers and vehicle distributors, and increased disintermediation from mortgage originators, alternative sources of funding and others.
- Pressure from government and consumers in late 1990s.

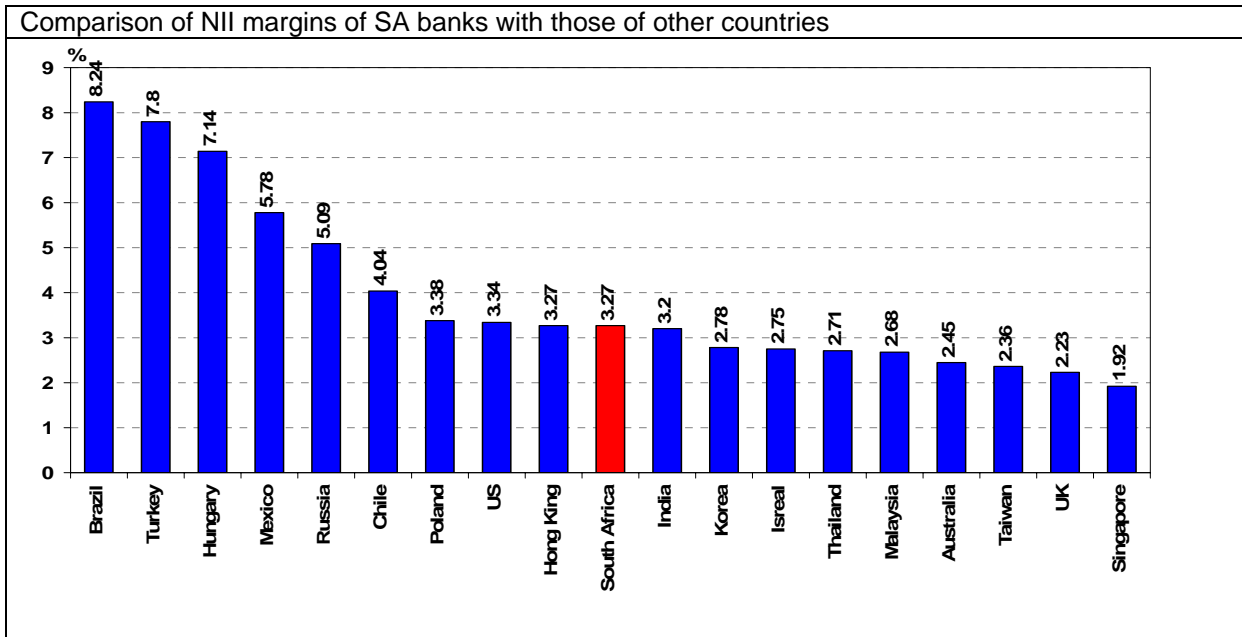
The lending margins of ABSA, FNB, Standard Bank and Nedbank have dropped from 4,85% in 1993 to 3,07% in 2004 and 3,10% in 2005. In total, lending margins declined by 175 basis points from 1993 to 2005. This decline partly reflected the impact of falling official interest rates from 1999 onwards, but the pure spread between the average rate on interest-earning assets and the average rate paid on interest-bearing liabilities also declined sharply, falling by 130 basis points from 1992 to 2004.



Source: *The Banker*. Nedbank analysis from Bloomberg

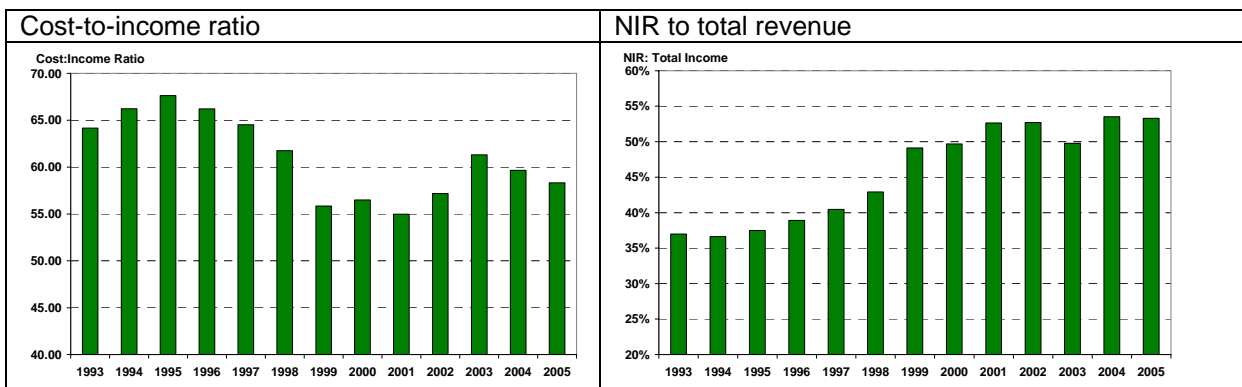
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According to a report by Citigroup dated 30 November 2005, the banking industry's margins now compare with those of most countries. South African banks' margins are similar to those of most developed economies with much lower risk profiles, and much lower than those of emerging economies with similar risk profiles, including Brazil, Turkey, Hungary, Mexico and Russia. This seems to suggest that the squeeze on lending margins is too low to offer a reasonable return on the costs and risks of doing business in South Africa.



Source: Citigroup, Analyst Report – Nov 2005

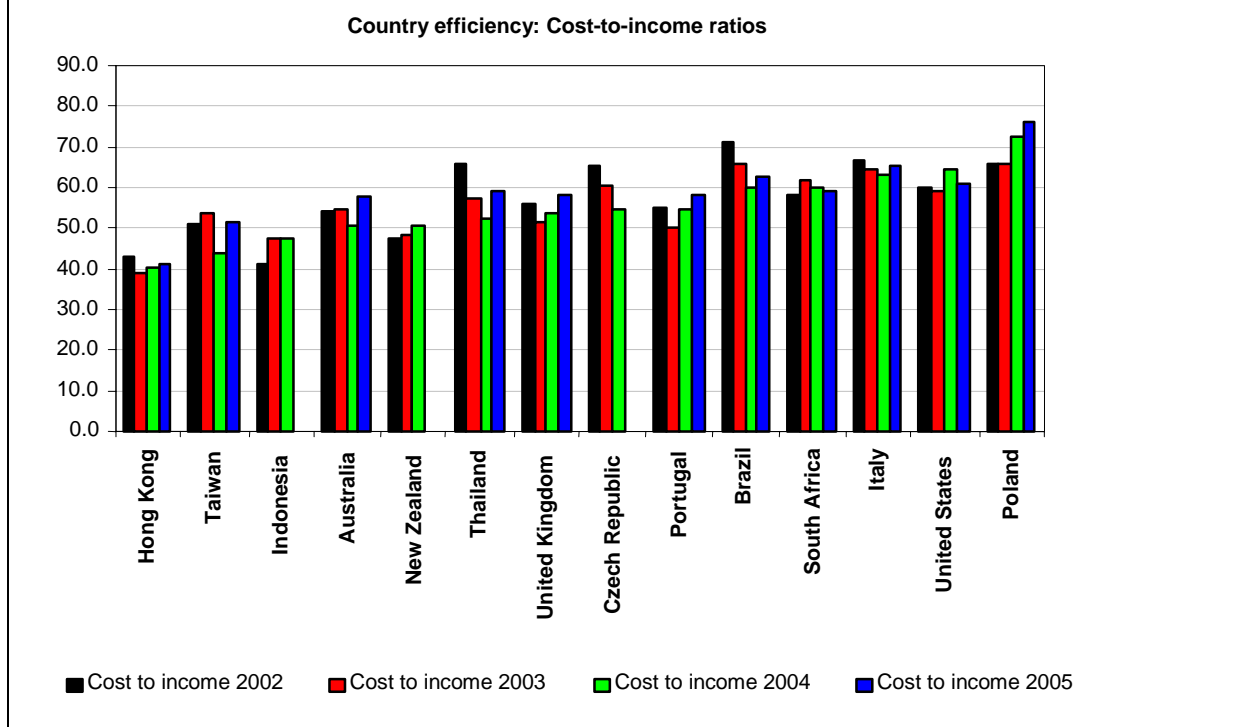
South African banks have also cut costs significantly over the past few years in response to these rising competitive pressures. The cost-to-income ratios of the four largest South African banks appear to have settled below 60%, which is even below those of countries such as Italy, Brazil and the US. This despite many new legislative and regulatory requirements being imposed, including the extension of infrastructure into the previously unbanked market in line with Financial Sector Charter commitments, on top of the normal competitive pressures to extend branch networks to service all clients. Increased volumes have most likely helped efficiency gains in the recent past, but the overall trend is strongly suggestive of an industry adjusting to the new competition resulting from disintermediation and innovation.



Source: *The Banker* – Nedbank analysis from Bloomberg

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Comparison of cost: Income ratios of ABSA, FNB, Standard Bank and Nedbank compared with those of other countries



Source: *The Banker* – Nedbank analysis from Bloomberg

The squeeze on NII owing to rising costs has increased legislative demands, and stronger competition has been compensated by higher non-interest revenue (NIR) among South African banks. NIR has increased from 37,9% of average gross revenue of ABSA, FNB, Standard Bank and Nedbank in 1993 to 53,3% in 2005. However, it is important to realise that much of this growth has been due to increased volumes rather than higher prices. It should also be appreciated that NIR consists of much more than fees for normal banking services. For example, it contains trading income, rental income, investment income, and commissions on non-banking products such as insurance.

4 The Nedbank Group

The Nedbank Group has been impacted by not only the increased competition between banks but also the entry of new competitors and pressure from government and consumers alluded to in the industry analysis. It has also undergone a total management, strategy and structural overhaul to address limitations in its previous approach to market.

4.1 Nedbank Group Limited

Nedbank Group Limited (formerly Nedcor Limited) is a bank holding company that, through its principal banking subsidiary, Nedbank, together with other members of Nedbank Group, operates as one of the four largest banking groups in South Africa.

The banking services are offered through three primary business clusters, namely Nedbank Capital, Nedbank Corporate and Nedbank Retail.

The scope of CCTOR is retail banking and includes products and services provided to small businesses, in addition to all individual clients. The focus of the following section will therefore be on Nedbank's retail banking business.

4.2 Nedbank Retail

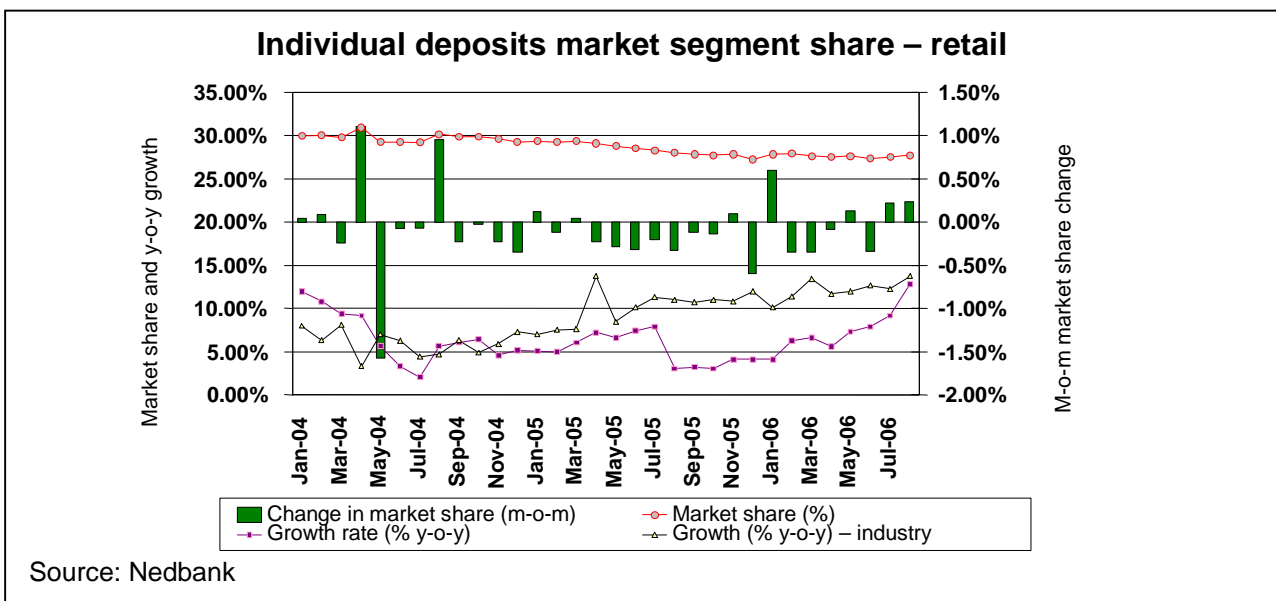
Nedbank Retail operates the following banking brands:

- Nedbank
- Pick 'n Pay Go Banking
- Old Mutual Bank

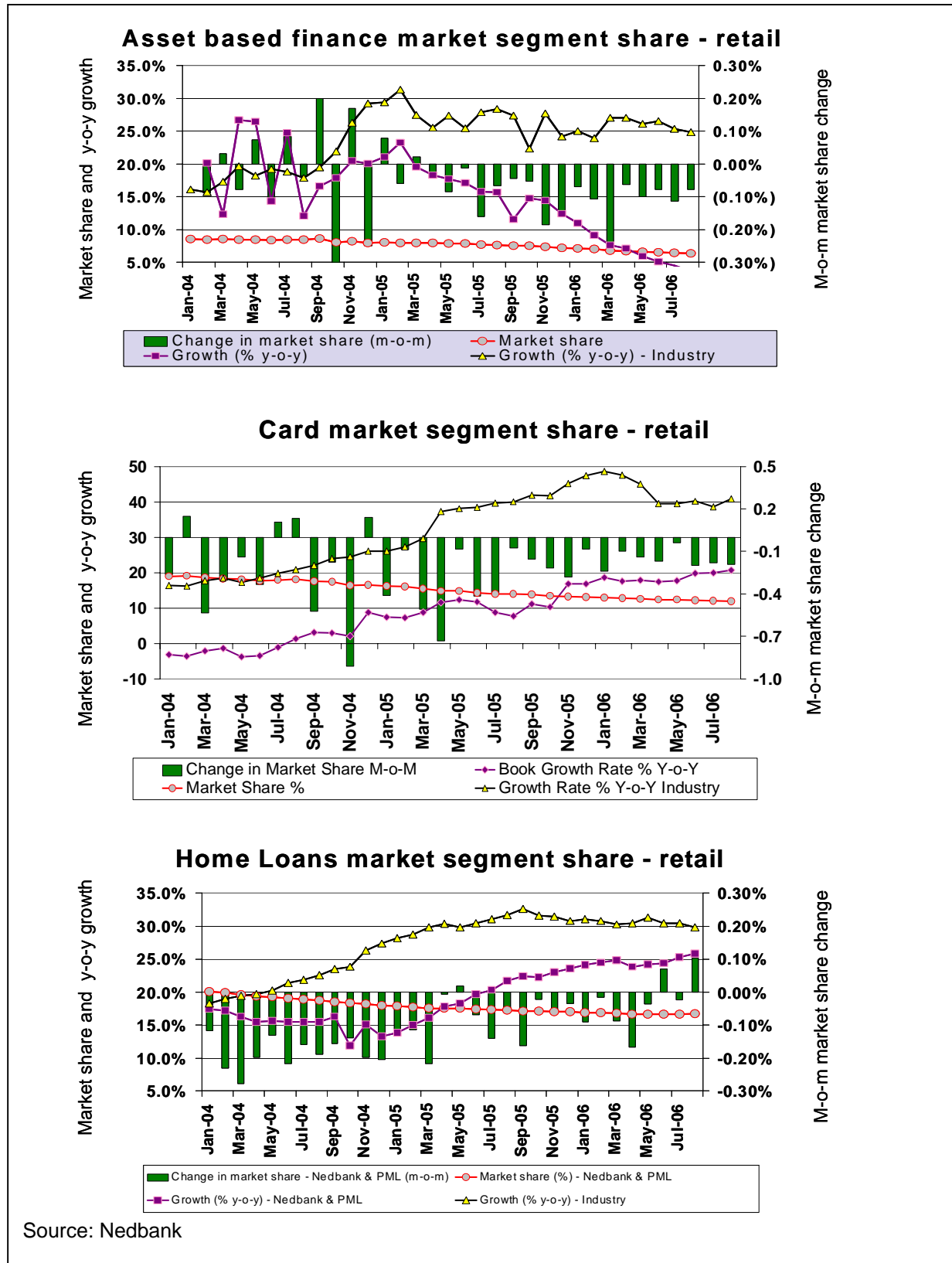
(Throughout this document, references to Nedbank should be read as applying to all entities operating within the Nedbank Retail entity.)

4.2.1 Nedbank Retail market share

Nedbank Retail's market share declined significantly from mid-2004 to an all-time low in late 2005. The aggressive, competitive interventions implemented by the new Retail management team since early 2005 facilitated a slight increase at the beginning of 2006, followed by an overall levelling from January to June 2006. This increase is also impacted by the merger of BoE, NBS and the other entities that were consolidated into Nedbank Group at the end of 2005 and beginning of 2006.



The diagrams below illustrate the trends in the Asset-based Finance, Card and Home Loans products in Retail Banking.

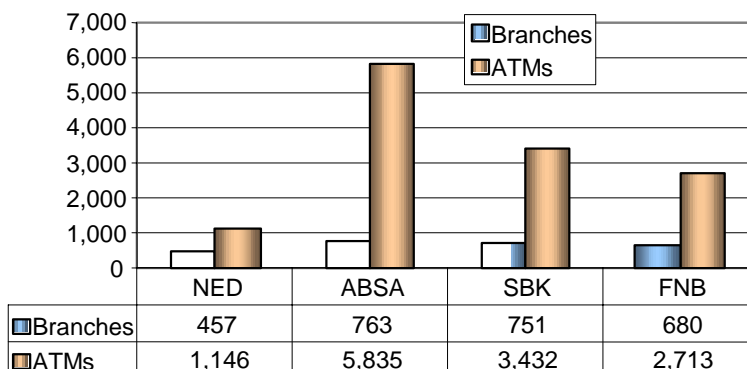


Nedbank continues to experience client churn, currently at 35%, on transactional accounts, which highlights the competitive challenge that Nedbank faces in acquiring the market share necessary to attain desired growth levels.

4.2.2 Nedbank retail footprint

Our previous niche focus resulted in a consolidated footprint considerably below that of our individual competitors. This legacy is impacting Nedbank's ability to compete for clients' transactional banking business. It has therefore been identified as a strategic investment requirement.

Number of branches and ATMs



Source: Nedbank Q3 2006

4.2.3 Primary-account penetration

It is Nedbank's view that the committed investment in our footprint is a critical success factor in reversing the current trend in our primary banking base, which reflects that although Nedbank Retail primary-account net losses are stabilising, there has been a decrease in the number of clients who consider Nedbank as their primary bank. (A primary-account client is one whose salary, wages, annuities and pension are paid into his or her account and subsequently used for transactional banking purposes.)

Number of primary banked clients

Month	Dec 04	Jul 05	Dec 05	Jul 06
Clients	723,512	699,583	698,022	697,372

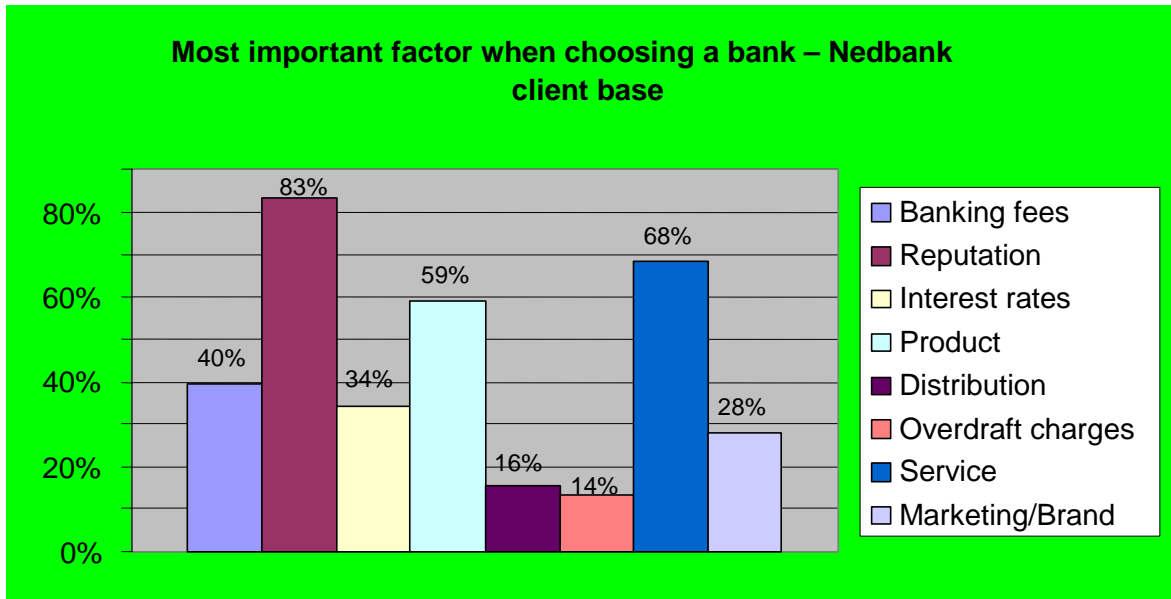
4.3 How Nedbank competes

The background information provided illustrates both the challenge (our footprint) and the opportunity facing Nedbank. We have the opportunity to harness our deposit client share for growth in Transactional Banking products, but we are currently poorly positioned to do this. If we do not address this issue proactively, existing and new competitors will continue to erode this opportunity.

Nedbank is committed to growing its business faster than the other retail banks in a very competitive environment.

4.3.1 Selecting our factors of competition

It is our intention to pursue the necessary strategies and tactics that will result in clients choosing to bank with Nedbank. To this end, research conducted in 2005 has confirmed that multiple aspects of banking are important to clients and must be addressed for us to compete effectively.



Source: Nedbank. Representative of total adult population living in urban areas (sample size 739 000)

The research further indicates that Nedbank needs to address both intangible (reputation; service) and tangible (product; banking fees) issues to succeed.

It is this type of feedback that Nedbank has used in identifying the most appropriate factors on which to compete.

4.4 Differentiation from competitors

To attract clients we need to consider the fact that the face of Nedbank's competitors are changing as new opportunities are pursued either by existing competitors entering into new services (eg life insurance companies offering competitive products) or by new entrants into similar products and services (eg MTN Bank, Woolworths Financial Services).

This intensified competition drives the need for Nedbank to clearly distinguish its products and services. Several key differentiators have been identified, based on client and market feedback:

Differentiator	Positioning	Enablers
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

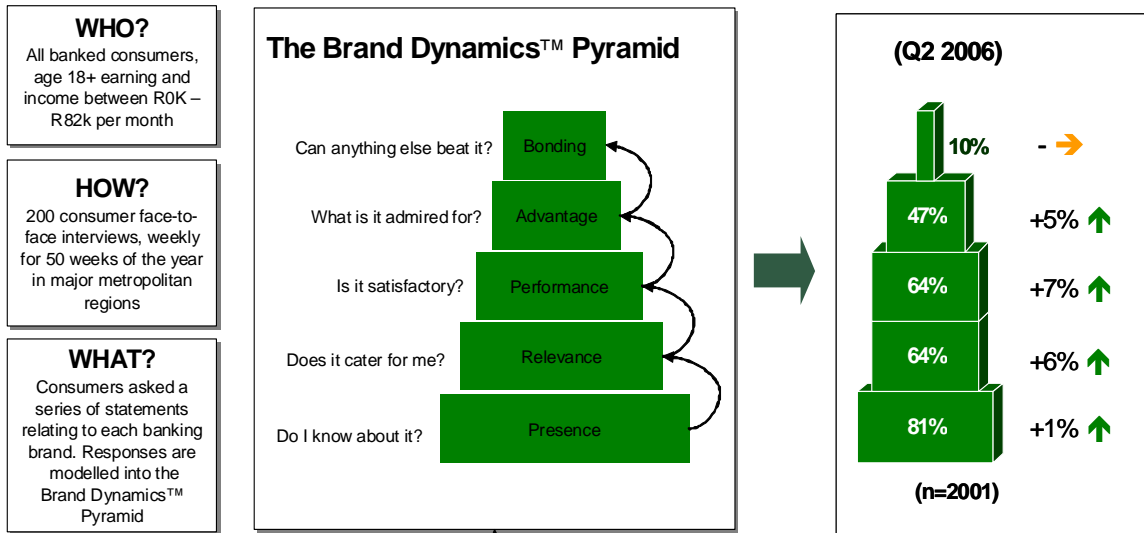
Differentiator	Positioning	Enablers
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

4.4.1 Differentiation on the Nedbank brand – 'Make things happen'

The Nedbank brand is a key intangible attribute by which we compete. Our key objective with our brand is to support these differentiators and to reposition Nedbank as significantly different from the other banks in order to encourage potential clients to choose to bank with Nedbank above other banks.

As part of our turnaround strategy Nedbank recognised the need to move from a brand portfolio approach and multibrand strategy to a single endorsed brand model. The remaining brands endorsed by Nedbank ('a division of Nedbank Limited') are Old Mutual Bank and Pick 'n Pay Go Banking. In support of Nedbank's turnaround strategy, the Nedbank brand has had to shift from a niche brand to a universal banking brand.

Nedbank has commissioned an independent, proprietary study to assist in monitoring the success of the brand in supporting Nedbank's competitive strategy. The latest results of the study illustrate the importance that clients attach to the brand promise. This research uses a specific methodology to explore the effectiveness of the Nedbank brand as a competitive factor. For example, it identifies the degree to which there is awareness of the brand and, where there is awareness, the model measures the impact thereof.



Source: Brand Dynamics

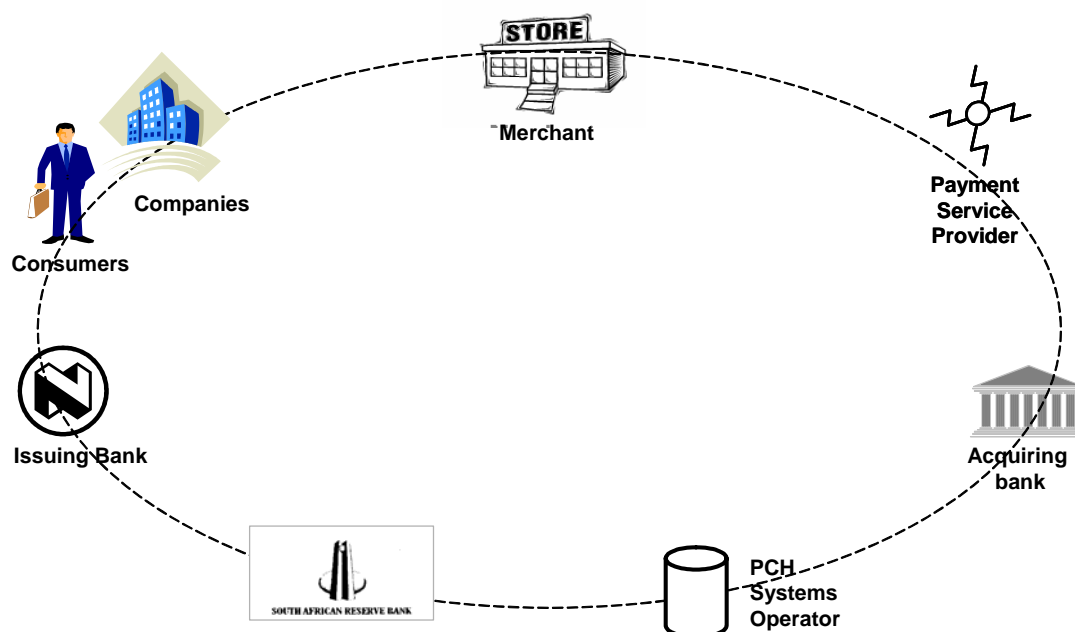
4.4.2 Differentiation on client understanding – 'Nedbank is listening'

Nedbank believes that clients would prefer a bank that is good at understanding and meeting their unique needs. To this end Nedbank conducts market research in the form of commissioned, syndicated and proprietary studies into general and specific client needs. This positions Nedbank better to offer clients appropriate products and services. Nedbank's client segmentation strategy, outlined in its response to the factual data request from the commission, facilitates a focused approach to better understand client needs.

Our recent brand message of 'listening' was introduced to communicate our intent in this respect to current and prospective clients.

5 National Payment System (NPS)

While Nedbank is pursuing distinctiveness, it simultaneously needs to cooperate in the NPS environment. This type of cooperation is not a unique feature of the South African environment. Global trends illustrate that cooperation between key stakeholders becomes ever more critical to sustaining a robust and innovative payment offering. The general consensus is that interoperability and ease of use by clients and the necessary collaboration among banks and with the key regulators remain critical success factors.



It is a virtual network that combines regulations, rules, technology and participants to enable consumers and companies to make and receive payments to and from all banks.

It includes all payment types – cheques and internet payments as well as debit card, credit card and ATM transactions.

The efficiency of this network is core to economic stability (it processes payments to the value of R148bn per day, 33 times the daily gross domestic product) and supports confidence in the South African banking system.

5.1 Creating trust in the NPS

The current efficiency and sustainability of the NPS is reliant on trust between participants in the direct clearing of payment instructions in respect of the financial and operational soundness of coparticipants in the system. To date, the South African regulatory framework has deemed payment clearing as the domain of banks on the premise that the broader requirements for obtaining a banking licence as well as the overall regulatory and compliance ambit within which banks are required to operate offer the desired trust for all participants and stakeholders.

The success of this approach is evidenced by the track record of the NPS. It has never failed, it has endured bank failures and its worldclass stature has offered broader economic benefits. For example, South African banks have been approved members of the Continuous Link Settlement (CLS) Bank since 2004. This membership gave the rand equal standing against other international currencies such as the dollar and euro in respect of trade settlements. These factors offer a clear indication that the NPS has established itself as efficient and of a first-world standard.

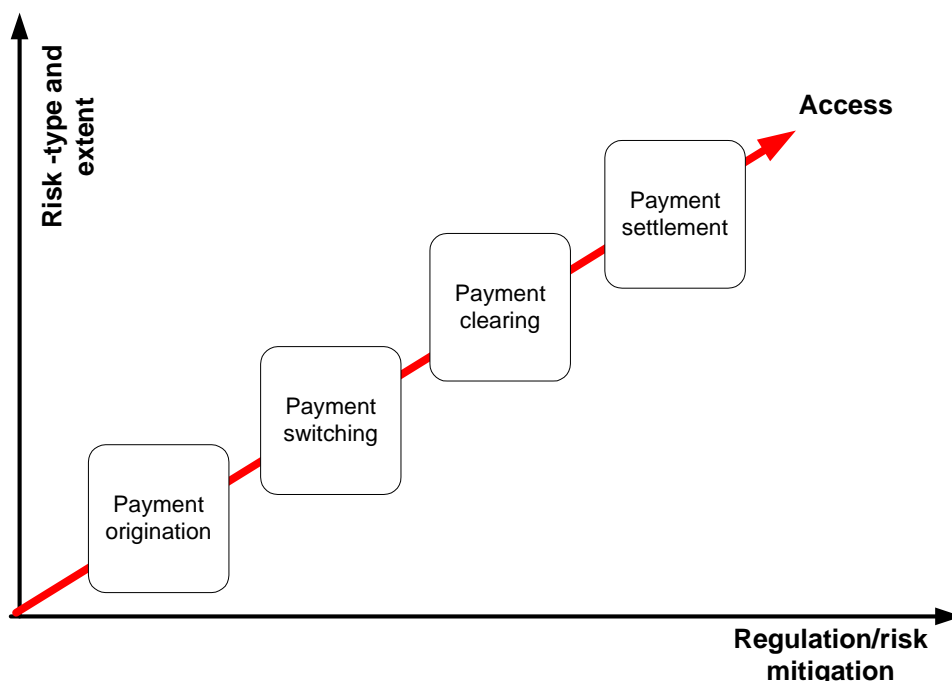
5.2 Risks that must be managed in the NPS

A general misconception is that banks own the NPS. The NPS is a virtual network and is not owned by any one party. [We defer to the current material and/or bodies that can provide a factual outline of the NPS, eg NPS Act (1988), SARB Vision 2010 and PASA.]

The current integrity of and trust in the NPS result from the successful management of the following key risks that arise out of payment services:

- Credit risk – the risk that a party within the system will be unable fully to meet its financial obligations within the system either when due or at any time in the future.
- Liquidity risk – the risk that a party within the system will have insufficient funds to meet financial obligations within the system as and when expected, although it may be able to do so at some time in the future.
- Legal risk – the risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks.
- Operational risk – the risk that operational factors such as technical malfunctions or operational mistakes will cause or exacerbate credit or liquidity risks.
- Systemic risk – the risk that the inability of one of the participants to meet its obligations, or a disruption in the system itself, could result in the inability of other system participants or of financial institutions in other parts of the financial system to meet their obligations as they become due. Such a failure could cause widespread liquidity or credit problems and, as a result, threaten the stability of the system or of financial markets.
- Compliance risk – the risk that parties within the NPS do not comply with regulation.

It is generally accepted that the exposure of the NPS to these risks varies, depending on the nature and extent of the services offered by different players and the concomitant risk mitigants applied. A provider involved in payment origination, payment switching, payment clearing and payment settlement (the highest level of access) also introduces the highest possible risk and needs to have the highest level of risk mitigation and regulation applied. This dynamic is illustrated in the diagram below:



It follows that any extension in the nature and scope of access by non-banks will result in a change to their current risk profile. It is for this reason that SARB Vision 2010 (paragraph 2.4.4.2) states, 'The level of operational, legal, systemic and reputation risks that any entity may introduce through their business determines their qualifying criteria'. This necessarily means that the economics that apply

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when operating as a user of the NPS are different when operating as a switch further along the value chain.

One should also bear in mind that there are mechanisms and structures through which parties can use the NPS to offer or use payment services. These are explained in the following section.

The higher up the value chain one participates, the bigger the scope and extent of compliance with PASA requirements and the higher the IT costs involved. New costs, such as those relating to minimum capital requirements, PASA BCP/DRP and anti-money-laundering compliance, are introduced only as participants move to the clearing and settlement domains.

5.2.1 Current access to and use of the NPS

There are currently a number of ways in which users can gain access to the NPS for the purpose of submitting payment transactions or offering payment services. While participation is currently open to users and service providers, it should be remembered that at present the regulatory burden falls onto the settlement banks. Pending regulation intends to apply more direct oversight to non-bank service providers.

Who	Payment service offered	Entry criteria	Legal basis	Example
Non-banks				
Sponsored user	Corporate client/Business submitting (bulk) EFT debits or credits can submit either directly or indirectly as a sponsored user of a bank to the PCH system operator	<ul style="list-style-type: none"> • Credit (sponsorship) agreement with a bank • Operational requirements • DRP/BCP requirements • Signed client mandates • Compliance with technical user requirements 	<ul style="list-style-type: none"> • Bilateral agreements between user, sponsoring bank and PCH system operator • Mandate provided by paying client to collect payment 	Insurance companies Subscription services Salary payments
Bureau	Submitting transactions for clearing on behalf of a sponsored user as a value-added service	<ul style="list-style-type: none"> • Currently regulated indirectly through role of banks as sponsors of transactions/owners of infrastructure • Regulatory ambit currently being extended to apply directly 	<ul style="list-style-type: none"> • Upon extension of the current regulatory ambit <ul style="list-style-type: none"> - NPS Act - SARB directive – under discussion 	Multi Data Cypher
Payment service provider	Providing payment services as an agent of either the beneficiary or the payer	<ul style="list-style-type: none"> • Regulatory ambit currently being extended to apply directly by the regulator 	<ul style="list-style-type: none"> • Upon extension of the current regulatory ambit <ul style="list-style-type: none"> - NPS Act - SARB directive – under discussion 	EasyPay NuPay Mycomax ALPS
System operator	Providing the infrastructure between payment service providers	<ul style="list-style-type: none"> • Regulatory ambit currently being extended to apply directly by the regulator 	<ul style="list-style-type: none"> • Upon extension of the current regulatory ambit <ul style="list-style-type: none"> - NPS Act - SARB directive – under discussion 	TSS ATM Solutions Direct Transact

Nedbank Limited

Who	Payment service offered	Entry criteria	Legal basis	Example
PCH system operator	Clearing services Settlement information provided to SARB	<ul style="list-style-type: none"> PASA PCH system operator entry and participation criteria 	<ul style="list-style-type: none"> NPS Act PCH agreement Service agreement 	Bankserv STRATE MasterCard Visa
Corporate client	Providing clients with payment services through their own banking relationships	<ul style="list-style-type: none"> Corporate/Non-clearing bank enters the payment system as a client of a bank 	<ul style="list-style-type: none"> Client/Corporate relationships 	Certain non-clearing banks
Sponsored/Dedicated Banks				
Sponsored non-bank	Normal client payment services similar to those provided by banks, for example: SASWITCH Debit card EFT	<ul style="list-style-type: none"> Sponsored by PASA member bank PASA Council approval SARB approval Clearing operational requirements These are PASA and SARB requirements 	<ul style="list-style-type: none"> Sponsorship agreement with PASA clearing bank PASA regulations and rules NPS Act provides that these entities may become limited members of PASA 	Postbank Ithala
Sponsored bank (non-PASA member)	Normal client payment services similar to those provided by banks, for example: SASWITCH Debit card EFT	<ul style="list-style-type: none"> Sponsored by PASA member bank PASA Council approval SARB approval Clearing operational requirements These are PASA and SARB requirements 	<ul style="list-style-type: none"> Sponsorship agreement with PASA clearing bank PASA regulations and rules NPS Act provides that these entities may become limited members of PASA 	None
Cooperative bank (anticipated)	Payment services through banking relationship on the same basis as a corporate client, eg providing a cheque in own name when requested by a client	<ul style="list-style-type: none"> Not yet drafted by the regulator 	<ul style="list-style-type: none"> Co-Operatives Banks Act – not yet promulgated 	Stokvels

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Who	Payment service offered	Entry criteria	Legal basis	Example
Dedicated bank (anticipated)	Normal payment services – same as those provided by clearing banks	<ul style="list-style-type: none"> • Not yet drafted by the regulator 	<ul style="list-style-type: none"> • Dedicated Banks Act – expected to be promulgated in 2006 	Possibly retailers, cellphone companies, etc

5.2.2 Participants and structures of participation in the NPS

Broadly speaking, the participants in the NPS include banks, the Interbank transaction system and SAMOS (South African Multiple Options Settlement System) but also individuals/businesses making payments using various payment instruments, such as cards, cheques and electronic transfers, and other key payment participants as can be seen in the diagram below.

Regulators	SARB – Registrar of Banks				SARB – NPS Department						
Consultative forums	SANPAY				NPS Strategy Team						
Payment system management bodies	PASA										
Payment clearing houses	EFT DB/CR	ATM	EDO	CASH	ZAPS	PAPER	CLC	STRATE	BESA	CARD DB/CR	
Interest groups	Banking Assoc	LOA	MFRS	MFSA	CCA	CIBA	SAIA	Plus several others focusing on different business needs in the economy			
Business forums	EFT	EDO	ATM	IPBF	These business forums are run under the Banking Association – PAYStrat						
Designated settlement system operator	CLS										
PCH system operators	SAMOS	Bankserv	Visa	MasterCard	STRATE						
Other system operators	SBV				IPS			SWIFT			
Banks	Clearing banks				Non-clearing banks			Other sponsored entities (eg Postbank)			
Payment service providers	Banks and payment service providers, for example: EasyPay NuPay ALPS Mycomax Net1 Large corporations										
Endusers	Individuals				Businesses			Government			

5.2.3 Increased access within the NPS

Nedbank acknowledges that the payment environment in South Africa has evolved, which includes a change in the nature and scope of the players involved in and impacted by the provision of payments since the inception of the NPS.

This change is acknowledged in SARB Vision 2010 (Section 2.6.1), which outlines a strategy to 'enable wider access to the payment system for participants by providing for different categories of participation'. This, in our view, paves the way for the extension of access to current the NPS structures to non-banks.

Nedbank supports the extension of access to the NPS on the basis that, as a minimum, new entrants are subject to a level of regulation that is proportionate to the level of risk that is introduced into the NPS by the nature and extent of their access, which is such that the current integrity of the NPS is not jeopardised.

5.3 Requisite cooperation to achieve efficiency and interoperability within the NPS

Not only does cooperation in the NPS provide a stable and robust network, it is also a platform to achieve scale in a relatively small market in payment terms.

5.3.1 Bankserv

Bankserv was specifically established to promote efficiency and interoperability between banks in the processing of cheque payments. As the nature of payment services offered by banks has evolved, so the services offered by Bankserv have followed to the extent that today it includes:

- Cheque clearing (ACB)
- ATM/SASWITCH
- Debit card
- Credit card
- Electronic funds transfer (EFT)
- Real-time clearing (RTC)
- Mzansi money transfer (MMT)
- Early debit order (EDO)

Bankserv has also become the major provider of mission-critical processing infrastructure, such as the ATM and card network switch (SASWITCH).

Nature of Bankserv's business

Bankserv is not a profit-maximising business. Its core focus is to provide economies of scale and interoperability within the NPS and to service the national interest.

While dividends are payable to the major shareholders, the bulk of profits are reinvested into the business. This enables Bankserv to run all payment streams regardless of volume and growth/decline (eg cheques are a declining payment instrument, but as long as there is a client need for cheque payments, Bankserv must continue to offer this service). This reinvestment further enables Bankserv to develop new, low-volume payment streams in the interests of industry obligations in the Financial Sector Charter (eg Mzansi money transfer) and the National Credit Act (eg early debit order).

5.3.2 Relationship between Bankserv and the NPS

Bankserv performs these services in its capacity as one of the licensed system operators appointed by the Payment Association of South Africa (PASA), ie it operates the systems and infrastructure to facilitate transaction processing. As a licensed system operator, Bankserv provides clearing and settlement services to the clearing banks within the NPS.

Ownership

Bankserv is owned by Standard Bank, Absa, First Rand Bank and Nedbank, in equal shareholding, and has a fifth shareholder, Dandyshelf (Pty) Ltd, that holds 7,5% of the company and represents a conglomeration of the smaller banks in South Africa (Investec, Mercantile and Capitec). Dandyshelf has extended an invitation to all the smaller clearing banks (eg Bank of Athens, African Bank and Teba Bank) to join this shareholding.

While the banks own Bankserv, this does not empower them to determine or authorise access to the NPS. The regulatory framework established at SARB determines access.

Competition

Natural competitors, in the form of the card associations of Visa and MasterCard, provide alternative processors for any of the banks. Participants of the NPS may use Bankserv services to send and receive payments that are processed on the Bankserv infrastructure or may opt to use another operator if so desired.

5.4 Interchange as a driver of interoperability

Interchange is a characteristic of payment systems globally. Different models have been applied in different regions, depending on political, economic and market pressures that apply in that region.

5.4.1 How does interchange support interoperability?

A study into the economics of interchange fees and the regulation thereof by Evans and Schmalensee (2005) concluded that payment systems have much in common with auction houses, exchanges and shopping malls. All are examples of two-sided or, more generally, multisided platform businesses.

Such businesses are intermediaries that add value only if they can appropriately coordinate the demands of two distinct groups of clients. Shopping malls must attract both retailers and shoppers, auction houses need both buyers and sellers to stay in business and payments systems need both consumers and merchants/device providers.

Credit and debit card industries are examples of two-sided markets. The distinguishing feature of two-sided markets is that they contain two sets of endusers, each of whom needs the other for the market to operate. In the case of credit and debit cards, the two enduser groups are cardholders and merchants.

5.4.2 What is interchange?

Interchange is a fee that one bank pays another for a service that it has provided for its client or a compensation for the use of the other bank's infrastructure that enables a bank to offer its client a service.

Interchange balances the equation between the two and ensures interoperability by compensating and rewarding both sides of a transaction (the acquirer and issuer), while affording each party the right to set its own fees with its respective client.

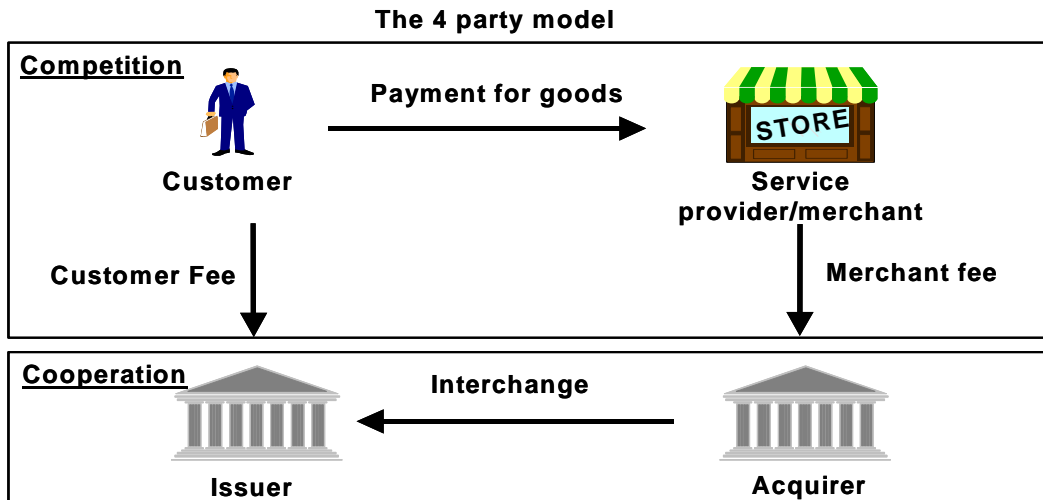
Interchange is comprised of two elements:

- Principles/Scope – This sets the parameters used in calculating the interchange level, eg cost elements and transaction elements.
- Level – This applies the principles to arrive at the monetary amount.

5.4.3 Distinguishing between interchange and client pricing structures

Interchange is one of the input costs incurred by a bank that participates in any payment stream. A further distinction is that interchange is determined in the cooperative arena of payments, while client and merchant fees are set in the competitive domain.

5.4.4 Interchange models: The 4-party Model



The Visa and MasterCard card payment systems, the authenticated early debit order (AEDO) and the electronic funds transfer (EFT) debit and non-authenticated early debit order (NEDO) payment streams are all based on the 4-party Model, so-called because any such payment involves four independent parties, namely:

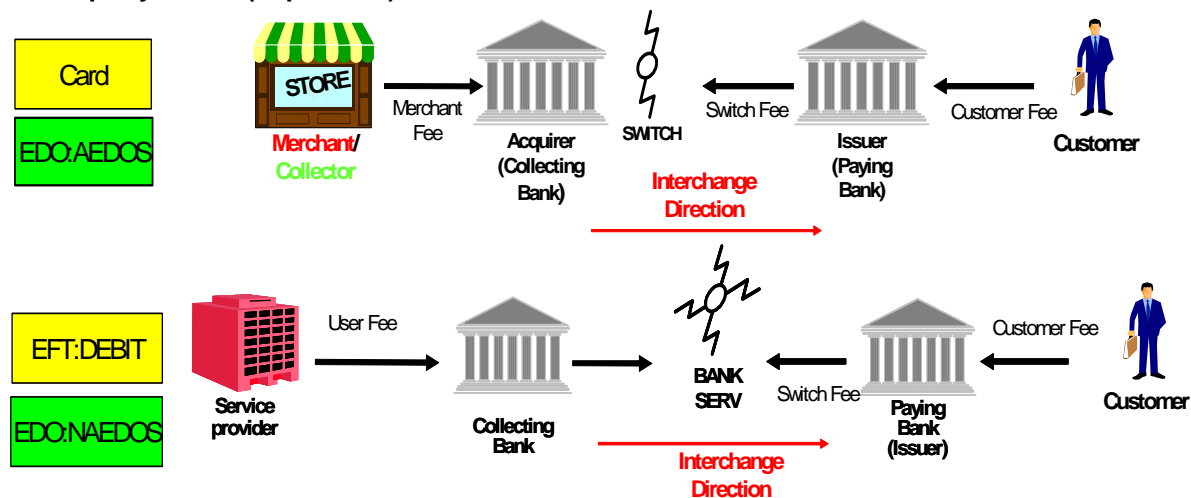
- Client
- Issuer
- Acquirer
- Service provider/Merchant

A payment network (Visa/MasterCard or Bankserv) facilitates the transactions across the four parties.

In a typical four-party transaction:

- The client obtains either a service (life insurance contract) or goods from a service provider or merchant.
- The client enters into either a payment contract or pays the merchant for the goods with his/her card.
- The service provider's/merchant's acquiring bank facilitates either the payment terms of the contract with the service provider or the payment for the goods offered by the merchant.
- The client's issuing bank pays the acquiring bank.

The 4-party Model (in practice)



Benefits to participants in a 4-party Model

Card-acquiring market interchange compensates issuers for the risk involved with guaranteeing a transaction, including the risk of cardholders defaulting on their payments and fraud. It provides issuers with an incentive to encourage card adoption and use. Over time, these benefits have been passed on to customers by way of reduced interest rates and financing fees, longer periods of grace, reduced annual fees and reward or cashback incentives. The benefit and costs associated with each party to the transaction is set out in the tables on the following page.

Party	Benefits	Costs
Cardholder	<ul style="list-style-type: none"> • Payment functionality • Not limited to cash on hand • Universal acceptance • Credit line • Rewards and discounts • 55 days' interest-free credit • Free travel insurance • Dispute and chargeback rights • Ability to reserve and prepay for car hire and hotel bookings • Safer than cash • Ability to draw cash 	<ul style="list-style-type: none"> • Annual card fee • Cash withdrawal fee • Interest on revolving balance
Issuer	<ul style="list-style-type: none"> • Interchange fees • Interest income • Cardholder fees • X-sell revenues 	<ul style="list-style-type: none"> • Acquisition and account setup costs • Cardholder acquisition costs • Account maintenance costs • Rewards costs • Cardholder default costs • Cost of funds • Fraud costs • Payment-processing costs • Funding costs for the interest-free period • IT systems • Cost of compliance with regulatory and association requirements
Acquirer	<ul style="list-style-type: none"> • Merchant service commission • POS rental and miscellaneous merchant fees 	<ul style="list-style-type: none"> • Fraud costs • Payment processing • Account setup and maintenance costs • Merchant servicing costs • Transaction-processing costs • Merchant default risk • Cost of funds • Network maintenance • Association assessment fees • Card-acquiring platform • Cost of compliance with regulatory and association requirements
Merchant	<ul style="list-style-type: none"> • Sales lift (increased footfall, higher transaction values) • Payment guarantee • Payment processing • Quick settlement (overnight) • No cash-handling fees or security issues • No employee fraud • No credit risk 	<ul style="list-style-type: none"> • Merchant service commission • POS rental
Payment network	<ul style="list-style-type: none"> • Transaction and subscription fees 	<ul style="list-style-type: none"> • Network build and maintenance costs • Brand costs

Party	Benefits	Costs
		<ul style="list-style-type: none"> • Cost of compliance with regulatory and association requirements

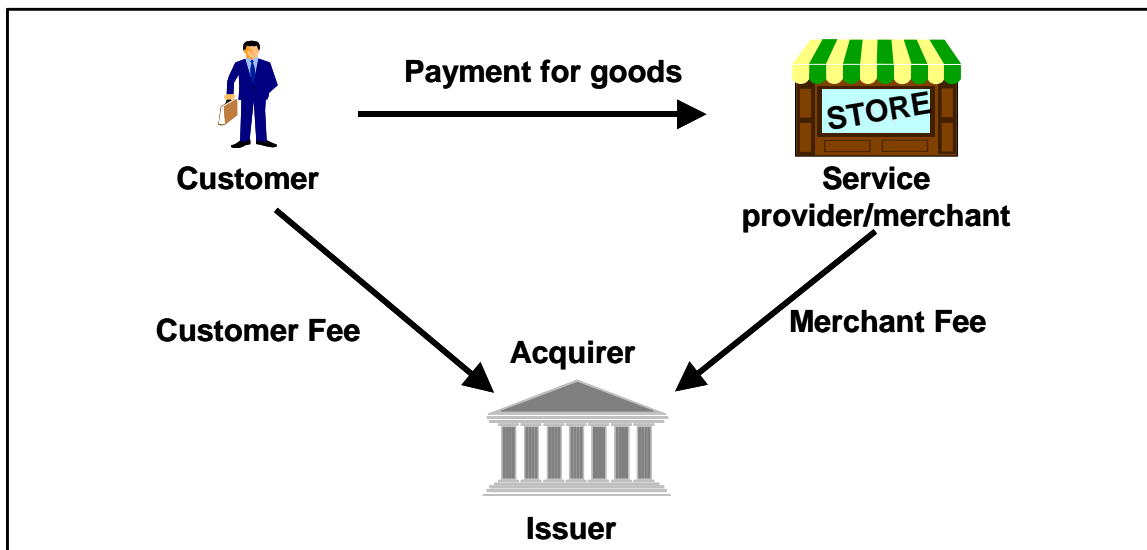
In the AEDOS acquiring market interchange compensates issuers for the workload of guaranteeing a transaction, processing the transaction and providing a payment solution to collectors in this market that is compliant with the payment requirements of the National Credit Act and the consequential amendments to the NPS Act. It provides issuers with an incentive to open this service up to their client base.

Party	Benefits	Costs
Cardholder	<ul style="list-style-type: none"> • No returned debit orders (penalty fees) • No fees for returned debit order • Access to credit from small microlenders • Reduction in overextension on credit (over time). 	<ul style="list-style-type: none"> • Annual card fee • Debit order transaction fee
Issuer (payig bank)	<ul style="list-style-type: none"> • Interchange fees • Interest income • Cardholder fees • Cross-sell revenues 	<ul style="list-style-type: none"> • Account setup costs • Account maintenance costs • Internal transaction-processing costs • Switch fees • Client enquiries costs • Client authentication costs • Payment-tracking costs • Notification of outcome of payment • Disputes and stop-payment costs • Return-payment costs for payments not provided for • Credit/Funding risk and costs • Internal overhead costs • Cost of compliance with regulatory and association requirements
Acquirer (collecting bank)	<ul style="list-style-type: none"> • Merchant service commission • POS rental and miscellaneous merchant fees 	<ul style="list-style-type: none"> • Payment processing • Merchant servicing costs • Transaction-processing costs • Merchant default risk • Network maintenance • Association assessment fees • Card-acquiring platform • Internal overhead costs • Cost of compliance with regulatory and association requirements
Merchant	<ul style="list-style-type: none"> • Payment guarantee • Support for lending in a volatile risk environment • Payment processing • Outcome of the transaction to improve earlier intervention in bad debts 	<ul style="list-style-type: none"> • Merchant service commission • POS rental
Payment network	<ul style="list-style-type: none"> • Transaction on their infrastructure, leading to economies of scale • Switch fees • Subscription fees 	<ul style="list-style-type: none"> • Network build and maintenance costs • Innovation costs • Cost of compliance with regulatory and association requirements

In the EFT and NAEDO environment, interchange fees (known as 'homing fees') are paid by the collecting bank to the paying bank to compensate it for the processing work done to apply the transaction to its client's account.

Party	Benefits	Costs
Accountholder	<ul style="list-style-type: none"> • Ability to have debit orders against accounts 	<ul style="list-style-type: none"> • Debit order service fee
Issuer (paying bank)	<ul style="list-style-type: none"> • Interchange income • Client service fees income • Compensation for exception processing 	<ul style="list-style-type: none"> • Account setup costs • Account maintenance costs • Internal transaction-processing costs • Switch fees • Client enquiries costs • Disputes and stop-payment costs • Return-payment costs for payments not provided for • Credit/Funding risk and costs • Internal overhead costs
Acquirer (collecting bank)	<ul style="list-style-type: none"> • Income from collecting-bank user • New offering to corporate and business banking clients 	<ul style="list-style-type: none"> • Infrastructure costs • Switch fee • Dispute costs • Recall costs • Counterparty risks • Internal overhead costs
Payment network	<ul style="list-style-type: none"> • Transaction on their infrastructure, leading to economies of scale • Switch fees • Subscription fees 	<ul style="list-style-type: none"> • Network build and maintenance costs • Innovation costs

5.4.5 Interchange models: The 3-party Model – Type A



A 3-party Model is one in respect of which a single bank plays both the issuing and the acquiring role.

The 3-party Model – Type A (in practice)

The American Express® payment scheme is based on the 3-party Model, where the bank plays both the issuing and the acquiring role.

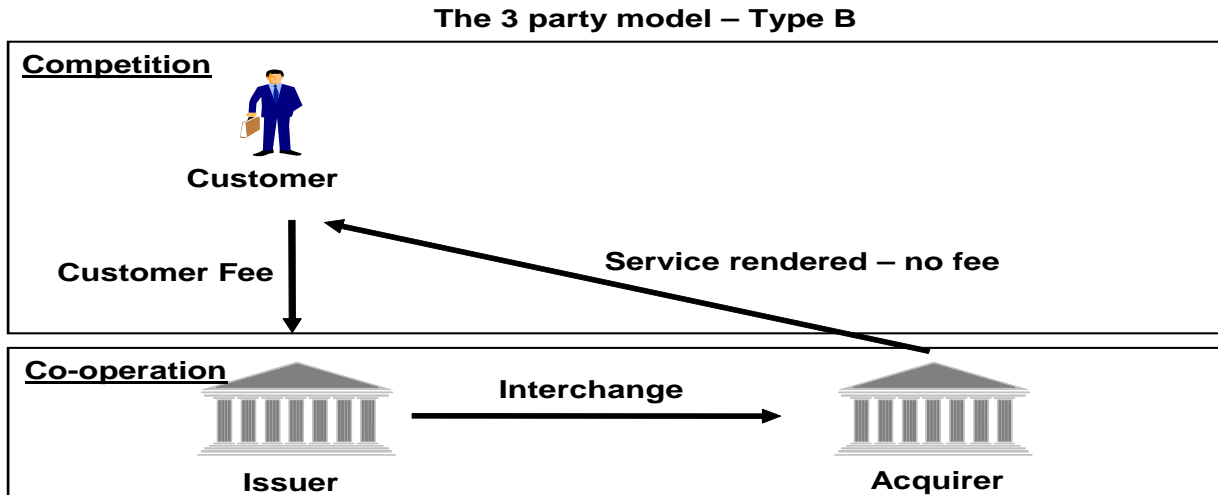
Nedbank is both an issuer and an acquirer of American Express® Cards in South Africa under an operator agreement with American Express®.

In the 3-party Model all the card revenues flow to the card issuer, so there is no need for an interchange fee. The merchant service commission is agreed at a bilateral level between the bank and the merchant.

Nedbank has bilateral agreements with the other acquiring banks in South Africa to allow acceptance of American Express® Cards over their POS devices. Nedbank pays a fixed fee to these acquirers for every transaction switched over their network.

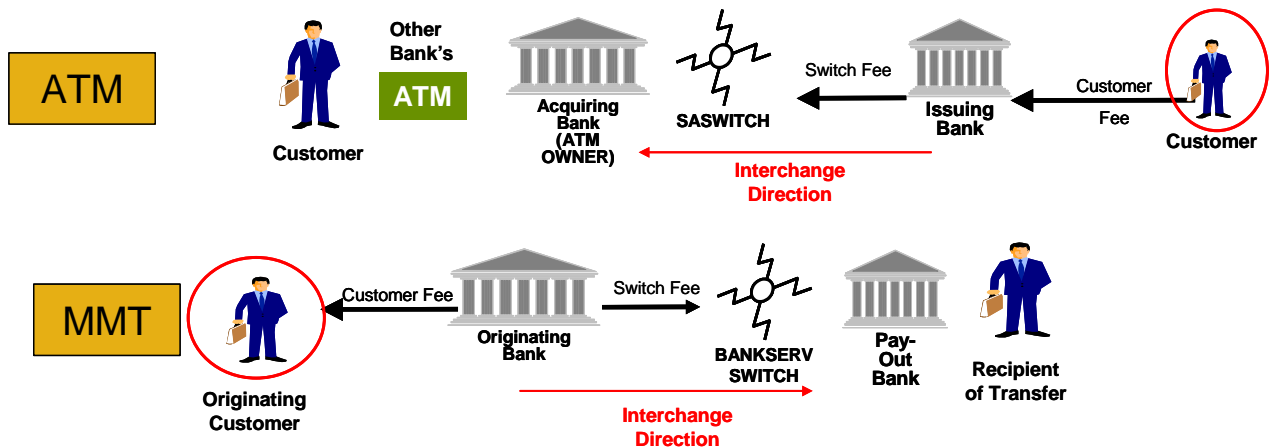
Nedbank fulfils all the acquiring responsibilities for American Express® merchants – this includes signing up the merchant, serving the payment needs of the merchant on a day-to-day basis and processing all American Express® transactions.

The 3-party Model – Type B



This model is applicable in both the ATM and the Mzansi money transfer payment streams. In this model the issuing bank relies on the footprint and distribution of the acquiring bank for the provision of a service to the issuing bank's client. The acquirer offers a service direct to the issuing bank's client.

5.4.6 Interchange models: The 3-party Model – Type B (in practice)



Benefits to participants in a 3-party Model – Type B

In the ATM market it compensates the acquiring bank for allowing access into a network to the issuing bank's clients and for maintaining the ATM devices (3-party Model above).

Party	Benefits	Costs
Cardholder/ Accountholder	<ul style="list-style-type: none"> • Access to cash from any bank's ATM • Access to prepaid transactions • Additional functionality, eg balance enquiries 	<ul style="list-style-type: none"> • SASWITCH withdrawal fee • Prepaid transaction fee • Fees related to additional functionality
Issuer (account- holding bank)	<ul style="list-style-type: none"> • Infrastructure saving costs, as other bank provides access to cash to the issuer clients 	<ul style="list-style-type: none"> • Account setup costs • Account maintenance costs • Fraud costs • Card-issuing costs • Internal transaction-processing costs • Switch fees • Client enquiries costs – helpdesk and branch • Interchange costs • Management information system costs • SASWITCH claims • Internal overheads • Marketing • Interbank representation and negotiations • Innovation costs on product • Cost of compliance with regulatory requirements
Acquirer (device owner)	<ul style="list-style-type: none"> • Transactions on their device, leading to economies of scale 	<ul style="list-style-type: none"> • Device costs – hardware maintenance, device insurance, parts replacement, depreciation • Cash-holding costs • Security costs • Transaction-processing costs • Homing fee • Operational costs (eg stationery, custodian time, rentals, merchant rebates, signage, merchant settling for rentals and/or rebates) • Cash delivery • Cash insurance • Interbank representation and negotiations • Helpdesk • SASWITCH claims • ATM balancing (shortages etc) • Internal overheads • Innovation costs • Cost of compliance with regulatory requirements
Payment network	<ul style="list-style-type: none"> • Transaction on their infrastructure, leading to economies of scale • Switch fees 	<ul style="list-style-type: none"> • Network build and maintenance costs • Innovation costs • Cost of compliance with regulatory requirements

In the Mzansi money transfer market interchange compensates the bank paying the money transfer for the risk of holding the cash, for the infrastructure it has to maintain and for the fact that only the originator is charged a fee when the transaction is initiated.

Party	Benefits	Costs
Originator client	<ul style="list-style-type: none"> • Ability to transfer money from any participating bank and Postbank without needing a bank account 	<ul style="list-style-type: none"> • Mzansi money transfer fees

Party	Benefits	Costs
Originator bank	<ul style="list-style-type: none"> • Opportunity of cross-selling other products to clients • Originating fee income 	<ul style="list-style-type: none"> • Cash-holding fees • Branch infrastructure costs • Infrastructure costs • Security costs • Switch fees • Client queries • Cost of compliance with regulatory requirements • Internal overhead costs
Payout bank	Interchange income	<ul style="list-style-type: none"> • Cash-holding fees • Branch infrastructure costs • Infrastructure costs • Security costs • Switch fees • Cost of compliance with regulatory requirements • Internal overhead costs
Payment network	<ul style="list-style-type: none"> • Transactions on their infrastructure, leading to economies of scale • Switch fees 	<ul style="list-style-type: none"> • Network build and maintenance costs • Innovation costs • Cost of compliance with regulatory requirements

5.4.7 How is interchange set?

Historically, interchange has been set using various mechanisms, depending on the nature and needs of the payment stream in question. In some cases a uniform fee has been necessary as a result of the inability of the system operator to apply different rates per bank.

Card
<p>Interchange has historically been set on a multilateral basis in South Africa. It currently applies to three types of card transactions:</p> <ul style="list-style-type: none"> • Credit – 1,71% • Hybrid (cheque) – 1,09% • Debit – 0,55% <p>The interchange fee is set in South Africa at a bank industry level, based on the outcome of an independent study by an independent, objective third-party consulting firm, Edgar Dunn and Company. Edgar Dunn follows a conservative methodology – endorsed by EU¹ and implemented worldwide – which calculates interchange, based on some of the costs incurred by the issuer in providing the following benefits to the merchant on credit card transactions. The costs used were:</p> <ul style="list-style-type: none"> • Funding of the interest-free period (up to 55 days). • Payment guarantee costs (bad debt, collections, fraud prevention, etc). • Payment-processing costs (authorisations, transaction processing, etc). <p>The costs for cheque and debit card transactions are similarly calculated, but are less than those for credit cards, as these cards offer less in the way of benefits (there is no interest-free period on debit cards, for example, because the transaction is paid for by the cardholder at the time of purchase).</p> <p>The Edgar Dunn methodology ignores other costs that drive cardholder demand and spend to the benefit of merchants, such as:</p> <ul style="list-style-type: none"> • Marketing, account acquisition and setup costs. • Cardholder billing and processing costs. • Client relations and promotions costs.

¹ In the EU Commission's Interim Ruling on Visa

- Reward costs.

The last multilateral interchange study in South Africa was commissioned by the Association of Bank Card Issuers and Acquirers (ABCI) in 2002 and resulted in:

- A reduction in the 'credit' interchange rate from 1,99% to 1,71%.
- A reduction in the 'hybrid' rate for cheque transactions from 1,21% to 1,09%
- The introduction of the 'debit' interest rate for debit card transaction of 0,55%.

The study was based on cost data submitted by seven banks including, Absa, BoE, FNB, Investec, Mercantile, Nedbank and Standard Bank.

ATM/SASWITCH

ATM SASWITCH interchange has historically been set on a multilateral basis for the principles (ie how and for which transaction interchange will apply), but on a bilateral basis for the level (ie the actual price). The current interchange rate is R3,25 + 65c per/R100.

EFT

The rates are currently set at 28c on debit and 38c on credit. The interchange has been set through both multilateral and bilateral processes.

Mzansi money transfer

Principles agreed multilaterally, levels agreed bilaterally.

EDO

Principles and levels agreed bilaterally.

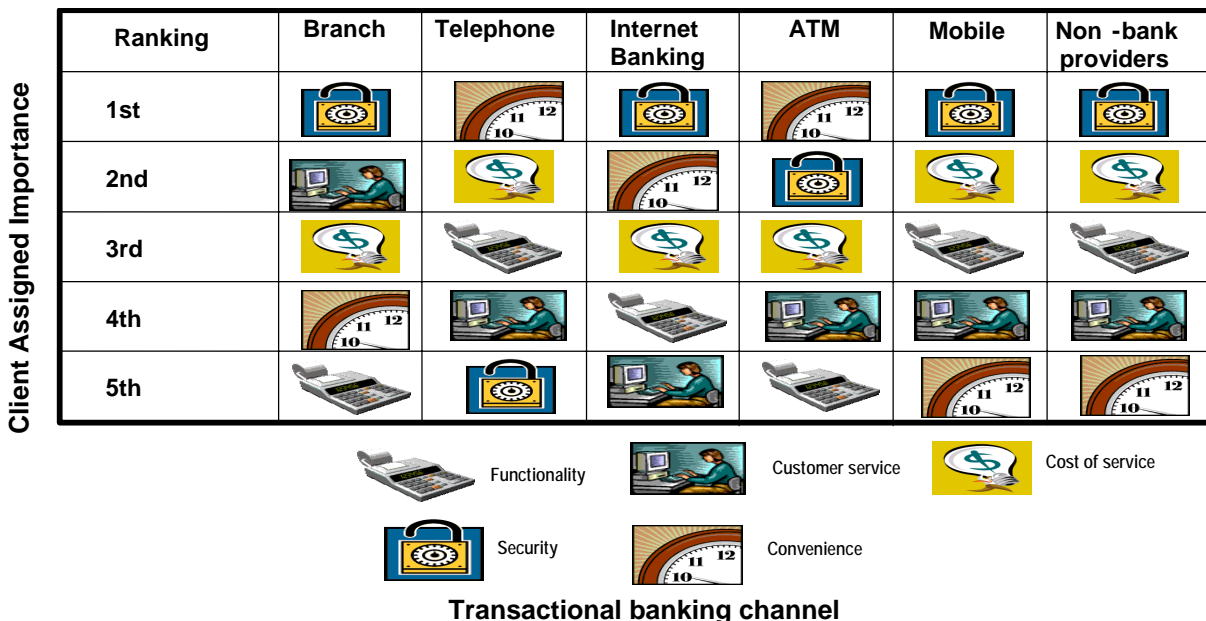
5.5 Competition in payments

Nedbank competes in payments through its Transactional Banking, and Payment Card products and services.

5.5.1 Factors of competition in transactional banking and payment cards – tangible and intangible

As in the broader retail business, Nedbank has identified that competition in the payments business is driven by multiple factors. This perspective is supported by client and market research, an example of which is provided below.

The diagram below is a summary of the critical factors that clients require from a transactional banking channel. As with our earlier example of the research into factors when choosing a bank, this multi-channel study highlights that the combination of tangible (functionality) and intangible (convenience) factors are key for effective competition.



Source: BMi TechKnowledge Group: Multi-channel Banking for Retail Financial Services; 2003

To illustrate our application of this perspective to our business, we provide examples of how Nedbank's recent activities have been influenced by the different factors.

5.5.2 Product

The term 'product' refers to tangible, physical products as well as the provision of services. A product-led competitive strategy uses attributes of the product, such as functionality, quality, appearance, packaging, brand, service, support and warranty, to acquire clients. A critical success factor of this approach is to determine the needs of the client in terms of product and service and to create a product that will satisfy these needs.

Product competition in practice

Nedbank has launched a number of new products to deliver against its strategic drive to grow its client base. The Nedbank positioning is to offer the best in market products to clients within its client segments.

To this end Retail transactional products are positioned according to a marketing model that identifies all the factors according to which a service or product competes and allows Nedbank to establish value drivers to support client needs for both tangible and intangible attributes. New products are therefore continually launched to better satisfy the needs of clients across all segments. Product and client research support Nedbank's product development initiatives.

Product development is a key driver in the transactional banking arena. Not only has Nedbank launched new products, but it has also introduced a number of improvements and enhancements on existing products.

New products	Key description
Transactor Account	<ul style="list-style-type: none"> • Transactor was launched in 2005. • Most of Transactor fees have been the cheapest in the market.
Affinities	<ul style="list-style-type: none"> • The affinities were launched to offer clients the option of giving back to the community, Nedbank donates a portion of the revenue from the account to the specified affinity. This is aligned to our differentiator of caring in or communities.
Everyday Account	<ul style="list-style-type: none"> • The recently launched Everyday Account offers clients a simple, affordable and easy-to-understand fee structure. • The product also rewards clients that have existing products with Nedbank by decreasing the monthly fee.
Enhanced products	Description
Mzansi	<ul style="list-style-type: none"> • This account services the previously unbanked individual. • Increased features such as stop-order and debit-order functionality have recently been added to the offering. • A pricing restructuring has been applied.
Design Save	<ul style="list-style-type: none"> • This offering was previously available to students only. • In a bid to access new markets, this product is now offered to all clients within the age bracket of 18 to 24.
Security on internet banking	<ul style="list-style-type: none"> • Nedbank responded to security concerns regarding internet banking by launching second-factor authentication on NetBank. • This feature uses SMS technology to increase the security and validity on electronic payments.

Bundling strategy

Nedbank views the provision of effective and client-centric bundles as part of its differentiation strategy.

Overarching principles

It is Nedbank's view that a bundled product offering must provide economic value to clients and that clients should have the option to choose between individual elements in the bundle, depending on their preference.

Current application

An outline of the current bundles offered is provided in Nedbank's factual response to CCTOR.

5.5.3 Marketing

This refers to the manner in which Nedbank informs target clients of a product, its feature function and benefits. This includes all types of marketing – selling, advertising, sales promotions, direct marketing and public relations. Marketing is a critical component of competition, particularly for new products or for addressing new markets.

Using marketing to compete

Nedbank has been aggressively promoting its new products as well as its fee reductions in print, outdoor billboards and television campaigns. This has been within the context of our new brand campaign, which has used the same promotional channels to impart Nedbank's updated brand image.

Other not-so-obvious promotional methods are client education and public relations. Nedbank views client education (enabling clients to make a more informed decision about a banking product and assisting them in understanding its functionality) as a form of competitive positioning, as it enables Nedbank to build trust and a relationship with the client through a product.

5.5.4 Distribution

The availability of a product or its related services to clients is a critical success factor in effective competition. The footprint of a retail bank is a key measure of client reach and incorporates the distribution channels for transactional banking, including branches, ATMs, internet, call centres and cellphones as well as direct marketing and direct selling efforts.

Competing through distribution

Nedbank has the smallest footprint among the large retail banks and, in some cases, does not have the same reach as some of the newer competitive entrants. Nedbank has committed to spending R1bn to upgrade existing components of and expand on its distribution network over the next three years in a clear bid to increase its competitiveness in offering banking products to a broader South African market.

Additional initiatives to increase Nedbank's distribution have been:

- Nedbank has increased its footprint through the acquisition and rebranding of Peoples Bank.
- The introduction of the branch-in-a-box and mobile-bank facility allows Nedbank to move into areas in which it was unrepresented or in areas that have insufficient infrastructure for a full branch to be established. Mobile banks are able to move to areas that do not have access to a branch and open accounts, educate clients and deal with queries. These two innovations allow Nedbank to expand its reach into previously disadvantaged areas of South Africa and offer previously unbanked members of the population access to services and products.

5.5.5 People

As described in our differentiation strategy, it is Nedbank's view that the attraction, retention and rewarding of talented people are fundamental in competing for new clients and retaining existing clients.

Competing through people

People form part of an integral service process. Nedbank commits significant resources to training its people to follow and conform to the correct procedures. This ensures excellent service for clients. Knowledgeable people are able to offer clients the necessary information for them to decide on the product that would best suit their needs.

It is Nedbank's belief that a people-centred approach ensures the success of products and growth initiatives.

5.5.6 Physical evidence

Physical evidence is anything a client could associate with Nedbank and, therefore, its products. The optimum application of this factor of competition conveys a consistent brand experience to Nedbank clients and supports its efforts to look different from its competitors.

Using physical evidence to compete

Nedbank applies focus to its corporate image to provide clients with a holistic experience when interacting with the Nedbank brand. This image is applied in branch layouts, ie the 'look and feel' of NetBank and letter and statement formats.

5.5.7 Operational excellence

Operational excellence supports service excellence. The procedures, mechanisms and the flow of activities through which clients interact with Nedbank, be it for the purpose of opening an account or applying for an overdraft, contribute to the client's overall satisfaction with Nedbank.

Operational excellence and competition

Nedbank has a strong bias in favour of process excellence to set it apart from competitors. The entry of new competitors into banking, such as Virgin Money, reinforces the need for Nedbank to 'get it right the first time' in support of client acquisition and retention.

5.5.8 Service

Nedbank has chosen to drive differentiation via worldclass service excellence. Nedbank's strategy involves a thorough audit of the organisation against recognised international best client service practices and an identification of the critical client management components that it needs to address over the forthcoming three years.

5.5.9 Price

Since the beginning of 2005 Nedbank has responded to the discontent within the market in respect of bank charges. In the light of this, Nedbank launched a number of initiatives that have driven the cost of banking/fees down. This clearly indicates that Nedbank is listening to its clients and the market and that it is creating opportunities to better satisfy client needs across all segments.



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Comparison of Nedbank Transactor with similar products in the market

					
		1-Jul-06	1-Jan-06	1-Nov-05	1-Apr-06
Average transacting entry level account profile		Nedbank Transactor	E-Plan	Smart Account	Flexi-Save
Red indicates highest	Value				
Green indicates lowest					
Monthly maintenance	None	R5.75	R6.50	R6.25	R5.90
1 OTC cash withdrawal	R 3,000	R22.00	R27.00	R44.50	R42.10
1 OTC cash deposit	R 860	R0.00	R10.74	R10.47	R9.45
4 ATM withdrawal	R 540	R17.80	R19.60	R40.00	R30.80
2 Saswitch ATM withdrawal	R 420	R11.95	R11.60	R10.75	R12.60
1 Denied ATM transaction	None	R1.75	R2.00	R2.65	R2.50
2 Debit order	R 300	R7.50	R9.80	R11.00	R9.50
1 POS transaction	R 300	R2.80	R2.00	R1.50	R2.50
Total		R69.55	R89.24	R127.12	R115.35

Source: Various banks' websites

- SME product

Nedbank launched a new Small Business Services offering in October 2006, which offers two years' free banking to small businesses that obtain a minimum startup or franchise loan with Nedbank. Specific transactional banking services that would be free are:

- Cheques
- Cash deposits
- Debit orders
- Internet banking

- Pricing changes

Nedbank has applied specific changes to its fee structure:

- Penalty fee reductions were implemented in March 2006.
- No fees were increased during our annual pricing review. Fees were either kept the same or decreased. A decrease of 13,1% of fees across the board in July 2006,
- Further reductions in penalty fees and internal debit orders were implemented in July 2006.
- Initiation and cancellation of stop-order fees were eliminated in July 2006.

6 Conclusion

We firmly believe that to achieve its goal Nedbank has to compete head-on with the current incumbents and with new entrants. In our view the current required levels of cooperation within the NPS benefit users through the stability, efficiency and economies of scale that it provides and we understand that it is an attractive competitive area for non-banks. Nedbank believes that new entrants are already competing with Nedbank in the sphere of payments provision, and we welcome the envisaged extension of membership categories within the NPS to better cater for the needs of an evolving payment system.

Our actions in the market since 2005 reinforce our position that this is a very competitive market in which significant effort is required to be successful. Since the decline in profits and market share losses in 2004, Nedbank has been hard at work to become a serious competitor in the provision of retail banking products and services.

Not only have we realigned our business to harness our client focus, we have also listened to the feedback from stakeholders in respect of our required areas for improvement. We heard a strong sentiment expressed in respect of clients' desire for value. To this end we have:

- had no fee increases across Nedbank Retail products for individuals since 2005 and Small Business Services (SBS) since 2004;
- reduced penalty fees – March 2006;
- reduced fees by 13,1% (average current account user) – July 2006;
- instituted additional penalty fee and internal debit order fee reductions – July 2006; and
- eliminated key fees – July 2006.

Nedbank has also used product innovation to improve its competitive positioning, including the following new product launches:

- Transactor Account – 2005
- Everyday Account – September 2006
- SBS free banking – October 2006
- Voyager Credit Card – September 2006
- Zero Annual Card Fee Go Banking Credit Card – October 2005
- iMPi Mobile Card Acquiring Solution – 2006

Finally, we have identified that to meet the needs of the South African market we need to:

- Invest in distribution
- Provide excellent service

This and future plans in this regard confirm Nedbank's commitment to offer value for money to clients, and we reiterate that it is the nature of competition in the provision of banking products and services in South Africa that drives us to deliver better and more affordable products into this market.

7 References

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- (2) Bitner, Zeithaml & Valarie. Service Marketing. 3rd edition, 2003. McGraw-Hill. pp 23 – 27
- (3) Brand Dynamics™ proprietary Nedbank study
- (4) Citigroup, Analyst Report – Nov 2005
- (5) Competition in South African Banking. Falkena Task Group, April 2004
- (6) Evans & Schmalensee. The Economics of Interchange and their regulation: An Overview
- (7) Financial Card in South African Euromonitor International, April 2006
- (8) Falkena, Davel, Hawkins, *et al.* Competition in South African Banking, 2004
- (9) Hawkins, P. The National Payment System and Competition in the Banking Sector, April 2006
- (10) *The Banker* Report: Top 1000 Global Banks, 2002 – 2005

Nedbank Limited
Competition Commission

Annexure

October 2007

8 Annexure 1: Previous Research into the National Payment System

In May 2003 the National Treasury requested a study on the competitiveness of the South African banking industry. A Task Group was established under the guidance of Hans Falkena to undertake this study and a report **Competition in South African banking** was released in April 2004. This led to a further study in April 2006, requested by the Competition Commission, **The National Payment System and Competition in the Banking Sector**. The report was compiled by Dr Penny Hawkins and became known as the FEASibility Report.

Both the Falkena Report and the FEASibility Report recognise that the South African NPS is regarded as a highly efficient and sound system and more advanced than similar networks in more economically developed countries.

8.1 Falkena Report

8.1.1 Implementation feedback

NOTE: This section needs to be read together with Section 2 of the Terms of Reference Response Document, which also addresses various aspects of the Falkena Report.

Since the release of the report the South African National Payment System, the South African banking industry and Nedbank have made significant progress on some of the recommendations made in the report.

Recommendation in Falkena Report	Feedback
Issue 1: Disclosure	
Government should introduce legislation that would compel banks to offer existing and potential clients unbundled service and pricing options. This would enable consumers to be charged only for the service or transaction used and not for a package that may be inappropriate for their needs.	<ul style="list-style-type: none"> The banking industry, including Nedbank, offers non-bundled pay-per-transaction pricing and bundled offers based on typical client behaviour.
Government should introduce improved disclosure requirements on banking services, which should cover savings services, transmission services and credit services, and which should encompass point-of-sale disclosure as well as disclosure in marketing and advertising material.	<ul style="list-style-type: none"> The National Credit Act obliges all providers of mass-market consumer credit products to quote and advertise credit in a standard way to ensure wider comparability. FAIS addresses disclosure requirements. Updates to the Code of Banking Practice.
Penalty fees charged by the banks together with charges for essential services or charges for services not open to competition should be on a cost-plus basis and open to regulatory oversight.	<ul style="list-style-type: none"> Nedbank penalty fees have been reduced since 2004 across a range of fees and products.
Issue 2: Increasing participation	
Government should introduce legislation that will enable sharing of client information (with client consent) so that if consumers choose to switch their accounts, information barriers to switching will be reduced.	<ul style="list-style-type: none"> We already share client information if client consent is given to share the data. The new AEDOS payment stream (launched in September 2006) will also offer a 60-day exposure report to microlenders (with the full consent of clients) enabling clients to gain easier access to loans.
Government should introduce a multi-tiered banking system, implementing legislation that will enable the formation of 2nd and 3rd tier banks as a top priority.	<ul style="list-style-type: none"> The government is currently working on legislation creating dedicated and cooperative banks, which will allow access to 2nd- and 3rd-tier banks.
A National Bank Account defined in terms of	<ul style="list-style-type: none"> The NBA, known as the Mzansi Account, was

Recommendation in Falkena Report	Feedback
price-fixing or collusion and/or a subsidy to one or more of the big banks will pre-empt competition and should be avoided.	launched and sees banks competing on price and product functionality in the previously unbanked sector.
Government should promote entry of and competition by foreign banks by adopting the EU approach in respect of home-country capitalisation for host-country branches as opposed to current arrangements, which require foreign banks to establish a subsidiary or be separately capitalised.	<ul style="list-style-type: none"> • Several foreign banks have entered into the South African market, more notably: • Barclays' purchase of ABSA • Standard Chartered's entry into SA • Virgin Money's launch and the Virgin Money credit cards
Issue 3: Payments system	
The principles of interoperability in the payments system and the transparency of access requirements to the payments system should be extended. Access by second-tier banks to the payments system on competitive terms should be facilitated.	<ul style="list-style-type: none"> • SARB, with assistance from PASA and input from system operators in the payment stream, is working on establishing entry and participation criteria for system operators providing payment services in the NPS. • Vision 2010.
Government should investigate the feasibility of implementing a narrow e-money directive that would allow suitably regulated non-banks to take part in electronic transmission facilities.	<ul style="list-style-type: none"> • SARB issued a position paper on Electronic Money (NPS 01/2006) in 2006. • Entry and participation criteria draft directive.
Money Transmission Services.	<ul style="list-style-type: none"> • As part of their FSC responsibilities the banks (including Postbank) have developed 'Mzansi money transfer', which is aimed at allowing people without bank accounts to transfer money between any two participating institutions. • Shoprite and Capitec Bank launched a similar service in 2006.
Issue 4: Competitive bias	
Government should prohibit a payment processing mechanism that results in favouring any institution.	<ul style="list-style-type: none"> • SARB issued a directive prohibiting the processing of preferential payments. • The National Credit Act also prohibits this practice. • Banks and various service providers (including microlenders and other collectors such as Life Officers) in the collection payment arena developed EDO, an early debit order payment stream providing non-preferential access to the payment system via AEDOS and NAEDOS systems.
General	
Access to banking by the unbanked.	Nedbank is implementing initiatives to allow the unbanked access to banking by: <ul style="list-style-type: none"> • Positioning more branches in rural areas via innovative solutions and partnerships. • Implementing different solutions for easier access to cash via mini-ATMs, cashback at POS and VDTs.

8.2 FEASibility Report

8.2.1 Considerations

Nedbank feels that the NPS and the challenges facing the banking industry are correctly encapsulated in the FEASibility Report, as Dr Hawkins consulted widely with various experts (including banks) in the NPS to obtain the information.

Nedbank's input into this report was limited to matters relating to the NPS and payment systems generally, and we were not asked to comment on assumptions and conclusions related to client fees, charges and pricing.

Some key issues where we have concerns are highlighted below (the issues are not all-encompassing):

Issue 1: Costs and revenues

Consideration 1: Exclusion of compliance costs

Section 2.5 (Table 2, page 19) is a cost overview of the NPS participation costs. It is stated that regulatory costs refer to the compliance and licensing requirements applicable to banks. These involve an annual fee and compliance with a number of regulations, of which only some emanate from the Registrar of Banks. The fee line noted in the table shows regulatory cost as 'Annual costs – License renewal of R150 000 for a large bank'. This item clearly does not include the full compliance costs, which run into millions for each bank each year.

Consideration 2: Transactional fee income

Another of the main findings in the report reads: 'Based on the DI 200 returns, transaction based fee income accounted for 38%, or R28.8 billion of banks' joint income during 2004.' (Page 27, paragraph 2, line 4.)

The report assumed that non-interest revenue (NIR), as reported by the banks in the DI200s, equates directly to payment system income. NIR, however, includes other sources of income in addition to payment-related fee income, such as:

- Income from African and international operations
- Merchant banking income
- Income from investments
- Fees and commissions from corporate advisory services and knowledge-based activities
- Foreign exchange trading income
- Insurance income
- Income from estate-planning activities
- Portfolio management income
- Income from administration services
- Guarantees and cash deposit fees

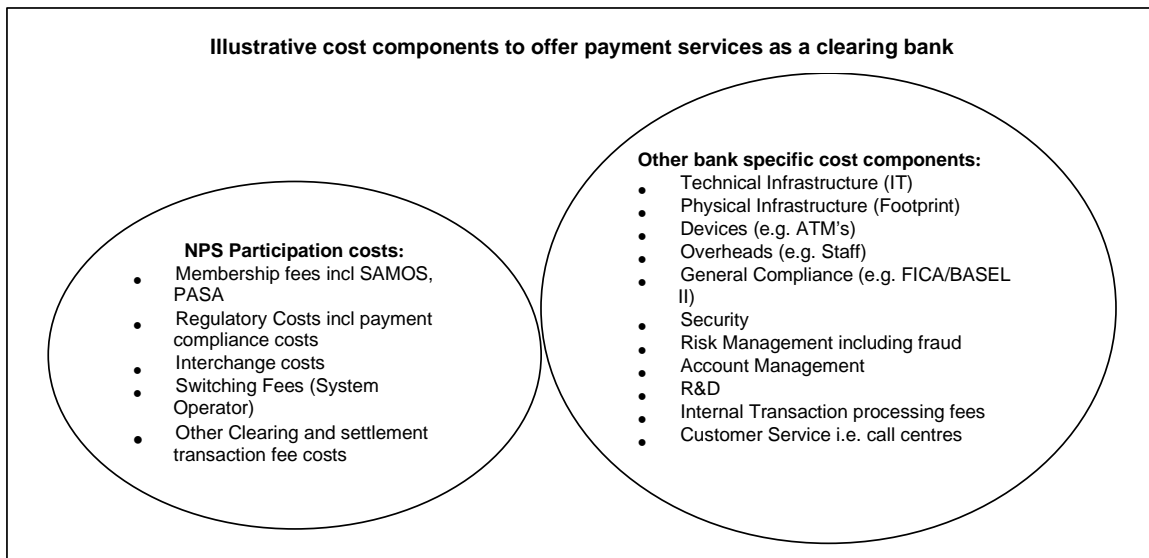
Consideration 3: Card association costs

The report also makes an attempt at identifying the costs associated with participation in the NPS. It is our view that in Section 8.3.3 (p148) and specifically Table 19 (page 150) not all the fee components related to the card association costs were included in the analysis. The fees payable also include the following components:

ASSOCIATION FEES	
Visa fees include	MasterCard fees include
<ul style="list-style-type: none"> • Licence fees • Association once-off service fee • Quarterly service fees • International service fees • VisaNet technology fees • Other operational fees • Risk management service fees • Visa documentation and ref guides • Regulatory fees • Transaction fees <p>Card association costs are usually calculated in tiers, based on the volumes.</p>	<ul style="list-style-type: none"> • Licence fees • Assessment fees • Cardholder assessments • Merchant assessments • Transaction and network interface fees • Warning bulletin fees • Interchange fees • Call referral service fees • BIN and ICA fees • Maintenance fees • Non-reporting penalty <p>Card association costs are usually calculated in tiers, based on the volumes.</p>

Issue 2: Relationship between costs and fees/charges

As the report correctly identifies in Section 2.6 (page 21, paragraph 4, line 4) there is no clear link between switching costs and the fees that clients pay. This is as a result of the fact that the overall costs incurred by the clearing banks participating in the NPS include a number of additional cost components besides the switching costs, as illustrated in the diagram below. (Refer also to Section 4.5.9 on page 43 of our General Response to CCTOR document.)



Issue 3: Questions raised by stakeholders

In Section 10.2 (page 172, last paragraph) the question raised by stakeholders is 'What proportion of the fees charged to consumers represents a mark-up for banks?'

This question appears to reinforce the confusion in the market pertaining to the distinction between the NPS and the broader topic of bank fees charged to clients. Nedbank's input into this report was limited to matters relating to the NPS and payment systems generally. We were not asked to comment on assumptions and conclusions related to client fees, charges and pricing.

Annexure 2: Early Debit Orders Case Study

8.3 Why EDO?

In its endeavours to broaden access to financial services and the NPS, the banking industry is faced with particular challenges in expanding electronic debit order services to small service providers and for low-income accountholders without access to liquidity lines such as overdraft facilities. In these circumstances access to and the efficiency and effectiveness of general debit orders have to date been unsatisfactory. This has contributed to:

- The retention and use of client bankcards and PINs by small lenders as a means of recovering repayments on loans through ATM withdrawals from debtor bank accounts and various exclusive preferential electronic and other early-recovery arrangements.
- The retention of identity documents as 'collateral' for loans.
- High levels of return debit fees on bank accounts owing to timing mismatches between salary credits and debit order strikes on bank accounts.

Under the auspices of the SA Reserve Bank, an industry wide consultative forum headed by Tim Store with representatives from Life Offices Association (LOA), Banking Association (BA), South African Insurance Association (SAIA), Micro Finance SA (MFSA), Consumer Credit Association (CCA), Payments Association of South Africa (PASA), SA Payments Strategy Association (SAPSA) and Micro Finance Regulatory Council (MFRC) has been engaged in seeking solutions for these challenges over the past three and a half years.

In addition to the above challenges identified in the 2004 report Competition in South African Banking, Falkena made a recommendation that the government should prohibit any payment-processing mechanism that results in favouring any institution. The rules of the NPS regarding the processing order of payment instructions should be transparent. Accordingly, the rules should disallow any preferential treatment of payment instructions in favour of an account-holding bank. This recommendation was then written into the National Credit Bill and the National Payment Systems Act and the compliance data was set for 18 September 2006.

The new electronic debit order (EDO) facility has been designed to address the needs of both the man in the street and the smaller service providers. Additional features are incorporated to ensure that the benefits enjoyed by current users of the EFT debit order system are not negatively impacted by the introduction of the new service. EDO includes two different payment types, namely authenticated (AEDOS) and non-authenticated transactions (NAEDOS).

EDOS (AEDOS and NAEDOS) will provide a flexible, cost-efficient and widely accessible electronic payments service that will increase the utility of the NPS. EDOS debits will also be run to coincide as closely as possible with salary and wage credits to bank accounts to minimise return debits (attracting unnecessary fees that clients can ill afford and causing inconvenience and unnecessary default on obligations). The various banks will also competitively provide value-added service enhancements on EDOS debits to further reduce cost to consumers and improve payment efficiencies in the NPS.

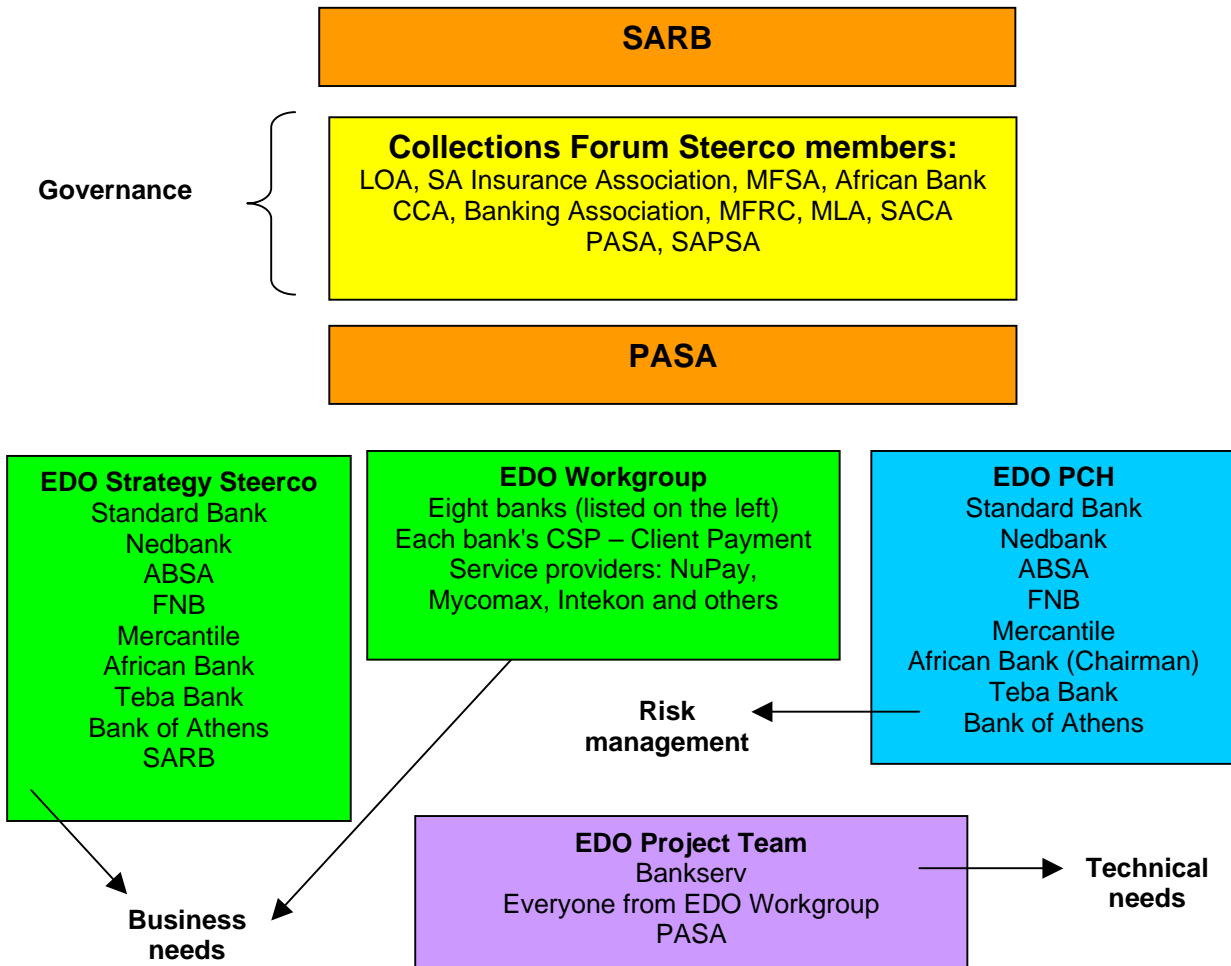
Debits in EDOS will be processed on a randomised basis, providing every user (including the client's own bank) with an equal and fair opportunity to recover payments due from the account. The solution should expand access to the NPS to more service providers and consumers, improve the effectiveness of debit order payments and reduce the incidence of returned debit orders and associated fees and costs. Service providers will have the option to utilise EDOS and pay for the enhanced service or continue to use the existing debit order system, where the enhanced service is not necessary. Specialised service providers operating under the auspices of banks will provide an interface for smaller users of EDOS into the NPS. These providers will operate competitively on price and service to ensure choice and efficiency for such users.

Easier access to the NPS, the certainty of payment provided through authentication in AEDOS and the enhanced collections efficiency should create an environment where unacceptable practices can be eliminated and persistent offenders effectively prosecuted.

8.4 Process of creating EDO

8.4.1 Who was involved?

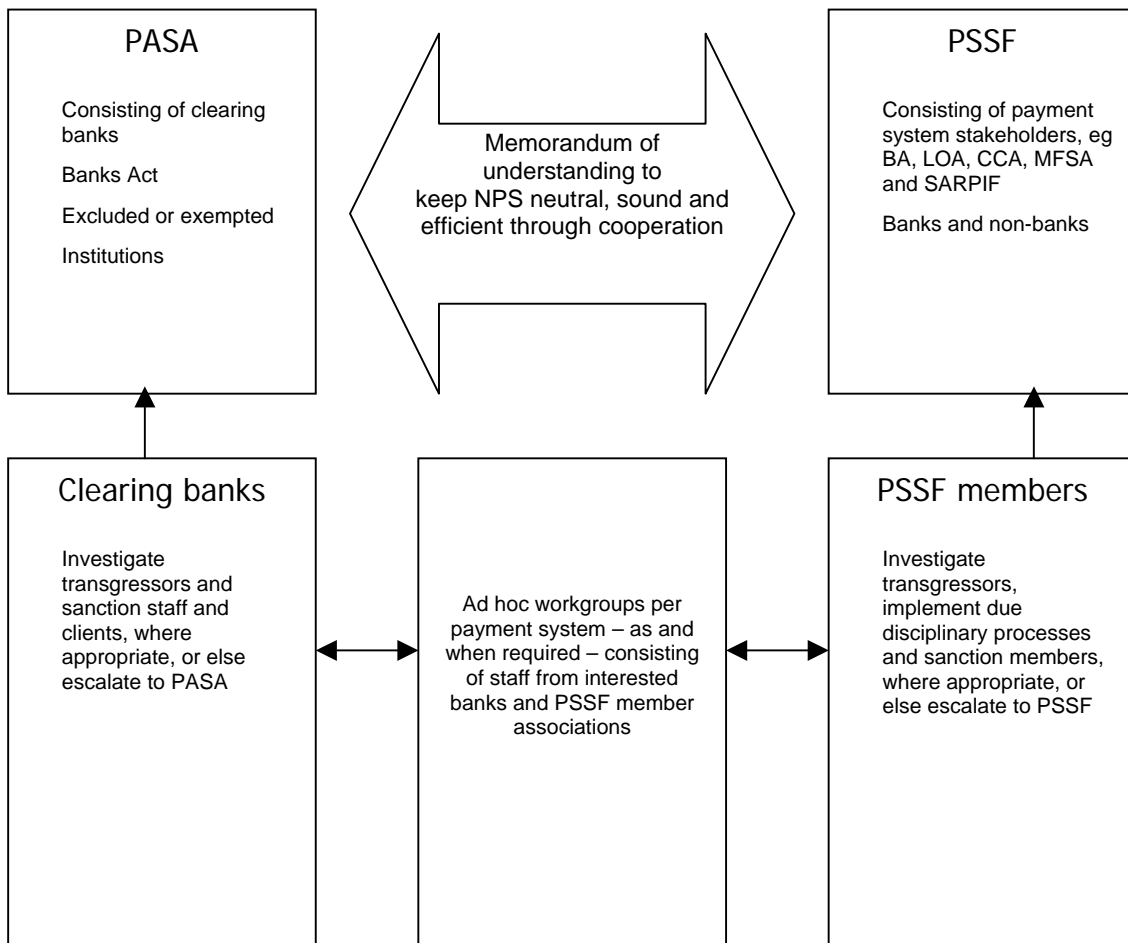
The Collection Forum Steerco, chaired by Johnny Pienaar from SARB, governed the EDO initiative. This body comprised members from all interested and affected stakeholders, with representatives from Life Officers Association, various microfinance bodies and retail associations. The Banking Association represented the banks.



EDO Strategy Steerco and EDO Workgroup addressed business needs. These two groups' ultimate goal was to ensure that the business needs of the various stakeholders were addressed and that the banks were able to deliver on the requirements. The EDO project team developed the technical requirements and specifications and managed the technical project delivery to ensure that the multistakeholder and complex project was delivered before the compliance deadline of 18 September 2006.

PCH's responsibility was to develop the clearing rules and PCH agreement, which is signed by the banks clearing transactions between one another. The purpose of PCH is the enactment of the business needs while ensuring that proper risk management is in place. The members of PCH are all the banks participating in PCH.

8.4.2 Future structures for management



8.5 Nedbank's experience in the interchange-setting process

8.5.1 Why was interchange needed in EDO?

The EDO payment stream supports service providers in the lending industry in their compliance with the requirements of the National Credit Act in respect of payment processing. For the acquirer/collecting bank to offer this service to its clients requires access to the issuing/paying bank's client account. The issuing bank had to develop very expensive and significant systems specific to EDO to allow this access into its account base.

In accordance with universal interchange practices, the issuer/paying bank is providing access to its infrastructure, and the issuer/paying bank needs to be compensated for this work. The acquiring bank/collecting bank receives revenue for the transaction from its merchant or user, and it is a portion of this revenue that is paid over in the form of interchange. If it were not for the interchange revenue received, it is unlikely that the issuer/paying bank would have enough incentive to provide for the transaction type.

8.5.2 Industry process in respect of EDO interchange

The interchange rates in EDO had to be determined before the new payment stream went live on 18 September. The purpose of interchange in EDO was to balance the equation of services being provided between the acquirer and the issuer in AEDOS and the collecting bank and the paying bank in NAEDOS. Should the EDO solutions not have been made available to the market before the payment stream went live, it may have resulted in reputational risk to the industry. There was also a possible legal risk because of possible non-compliance with the act.

At first the banks started with a bilateral negotiation process with the other banks with which they were going to exchange transactions. The Banking Association monitored the process to ensure that the bilaterals would be in place in time, as this could have significantly impacted the ability of the banks to go live on the compliance date.

Banks that were not able to reach agreement at a predetermined point in time were required to have the senior payments executives and business owners attend an EDO Bilateral Negotiation Day at the Banking Association. Each set of banks was given 30 minutes to reach an agreement. Nedbank went into this process with two out of the nine bilaterals outstanding, the others all having been agreed on before the day.

8.6 What do the processes followed with EDO illustrate?

- Good governance is key to the success of a multidisciplinary and stakeholder project.
- Engaging with the various stakeholders (banks and non-banks) so that the appropriate needs are met will ensure that an effective payment system that can be used by all stakeholders is developed.
- There is a need for ongoing discussion between the various stakeholders once the payment stream has been implemented.