



CORPORATE SERVICES

26 October 2006

The Enquiry Manager
The Banking Enquiry
Competition Commission
The DTI Campus
Mulayo (Block C)
77 Meintjies Street
Sunnyside, Pretoria

Dear Mr Frank

SUBMISSION OF INFORMATION

INTRODUCTION

Customer service is always at the forefront of Pick 'n Pay's philosophy and we have continuously grown our capability to provide the customer with facilities instore. In 1977 we were the first supermarket in SA to accept credit cards. Some other milestones are:

- Pick 'n Pay opened its first scanning store in South Africa in 1985 with all stores scanning by the time VAT was introduced on 30 September 1991. This made the transition from an add-on GST to the inclusive VAT as smooth as possible.
- Pick 'n Pay introduced secure, PIN-based Electronic Funds Transfer at Point-of-Sale (EFTPOS) in 1989. This enabled customers to use their debit cards (ATM cards) to both purchase groceries and to draw cash from any Pick 'n Pay checkout. **We established direct acquiring relationships with each issuing institution and the banks paid us for the provision of this facility.**

SASWITCH were unable, or unwilling, to process point-of-sale transactions from multi-lane stores such as ours and we were therefore compelled to develop our own "retail" switch which at the time was called PayNet. Over time we realized that the system needed to become available at all major retailers in order to grow as customers demanded freedom of choice. Since our competitors would not participate in a switch that was owned by Pick 'n Pay, we sold the switch to Prism and it became known as Transwitch Services; it has since been renamed EasyPay.

- We have accepted payments from customers on behalf of third parties, such as Telkom, Eskom, SATV and municipalities since 1993. This EasyPay facility was also developed by Pick 'n Pay and sold, concurrently with the retail switch, to Prism.

A DIVISION OF PICK 'n PAY RETAILERS (PTY) LTD. REG. NO. 1973/004739/07
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DIVISIONAL DIRECTORS

H.R. Herzfeld, A.Jakoet, G.T.K.Jones, I.A. Kelly, G.F. Lea, I.J. Webster-Rozon

CONTROLLING COMPANY PICK 'n PAY STORES LIMITED. REG. NO. 1968/008034/06

COMPANY SECRETARY

G.F. Lea

BOARD OF DIRECTORS

R.D. Ackerman* (Chairman), D.Robins* (Deputy Chairman), S.R. Summers* (Chief Executive Officer),
G.M.Ackerman, W.Ackerman*, D.G.Cope*, R.P.De Wét, I.S.Herman, C.Hultzer, C.Nkosi, D.M.Nurek, B.J.van der Ross

*Members of Chairman's Executive Committee which also includes: S.D. Ackerman-Berman, N.P. Badminton, I. Motaung, A.E. Zelinsky.
* German

- We launched a cost-effective pseudo credit union for employees in 1994, operated on our behalf by Boland Bank (and later BOE Bank) until we were compelled by Nedbank when they acquired BOE to convert all members to a standard card product offered by Nedbank.
- Homeshopping was launched in 2000, with product being picked at store level rather than supplied from a distribution centre.
- The provision of virtual prepaid airtime commenced in 2001.
- The purchase of prepaid electricity became available at all our till points in 2003; the system automatically caters for the provision of 'free basic electricity'.

CONSUMER/MERCHANT INVOLVEMENT IN THE NPS

- Pick 'n Pay has conducted itself in a responsible manner in the provision of services which the banks believe to be their exclusive domain, such as the use of our checkouts as ATMs to dispense cash to consumers. Nevertheless, we welcome the steps taken by SARB to regulate 'non-banks' (by directive) as this will allow for new entrants while safeguarding the NPS. We trust that administration of these regulations will not rest solely in the hands of bankers, for example, the issue of system operator licences, as we feel that their self-interest may influence their decisions.
- Consumers, merchants and system operators are key players in the national payments infrastructure and yet, with the exception of SANPAY, only banks are represented in the organizational and consultative structures, such as PASA. This means that only the financial institutions' voices are heard; this must both restrict access and create barriers to entry. We suggest that balanced representation is required on these bodies.

ACCESS TO THE NPS

- Retailers have a country-wide reach and most can offer ATM facilities, especially cashback, to all consumers. There is no need for a proliferation of bank-owned ATM's at huge investment and forex cost with maintenance and service overheads.
- Furthermore, we believe that the fee charged by the issuing banks to their customers for such point-of-sale transactions must necessarily be significantly lower than those suffered at an ATM as the merchant has supplied the infrastructure, hardware and system maintenance.
- So, far from encouraging this, banks are placing unreasonable obstacles in the way, including ATM-type fees and low transaction limits, distinguishing between the purchase of merchandise and cash-back. This illustrates a lack of endorsement by the banks of this ability to supplement the ATM network.

CREDIT AND DEBIT CARDS

The card associations require that

- Retailers honour all cards bearing a brand, e.g., Visa, for which they have a merchant agreement with an acquiring bank.
- Retailers do not discriminate against cardholders (either by surcharging for credit or debit card purchases, or by offering discount for cash payment); this is the non-discrimination rule.
- The acquirer pays the issuer an *ad valorem* interchange fee (MIF) to cover
 - Processing costs – this should surely be a fixed transaction fee (and partly flowing toward the acquirer?). Certain processing costs, e.g., air miles, should be for customers' account. Loyalty schemes are between the customer and the bank, but the merchant bears this cost.
 - Interest-free funding – this is a cardholder/issuer cost and definitely not a merchant cost! It is important to note that in excess of 50% of cardholders do not pay their credit card statement on due date, so there is no interest-free period in these cases.
 - Payment guarantee/fraud
 - There is no unconditional payment guarantee to the merchant. The merchant agreement drawn up by the acquiring bank usually stipulates that the cardholder has the right to dispute “any transaction” for a lengthy period, say, 180 days, that the acquiring bank has the right to charge back directly to the merchant's bank account, and that the merchant “will take up the resolution of disputes directly with the cardholder”.
 - Any fraud perpetrated by the cardholder is a matter between him and the issuing bank (who established his *bona fides* and gave him the card) and should not be an acquirer/merchant cost. If the banks issue a flawed product that is prone to fraud, why should the merchant pay? Merchants have no way of validating or auditing the banks' scoring system when they issue cards, so how can fraud perpetrated by the legitimate cardholder be for the retailers' cost?
- Perhaps the interchange fee moves in the wrong direction? The acquirer and the retailer incur costs for each transaction and yet the issuer is the recipient of this fee.
- The acquirer recovers the full amount of the interchange fee, plus a margin of profit, from the merchant. No attempt is made to isolate those costs which could/should be allocated to other participants in the transaction flow.

Who pays?

- Will a reduction in the *ad valorem* interchange on plastic lead to increased charges for the cardholder? Possibly, but at least the cost won't be spread over all shoppers, as it is today (refer non-discrimination rule above). Cash-paying customers are effectively cross-subsidising those using credit (and debit) cards

Interchange Cost Components

- The figures shown below were obtained from the card associations' European websites and are intended to be indicative only. It would be useful to monitor the disclosed cost components of interchange to determine if the ratios change over time, and why.

Interchange Fee		
MasterCard	Credit Components (%)	Debit Components (%)
Payment Guarantee Costs	51	Not Disclosed
Free Funding Costs	14	
Processing Costs	35	
	100	
Visa (Total)	Credit & Deferred Debit	Immediate Debit
Payment Guarantee Costs	50	61
Free Funding Costs	22	n/a
Processing Costs	28	39
	100	100
Visa (non Card not Present)		
Payment Guarantee Costs	51	63
Free Funding Costs	22	n/a
Processing Costs	27	37
	100	100
Visa (Card not Present)		
Payment Guarantee Costs	45	50
Free Funding Costs	20	n/a
Processing Costs	35	50
	100	100

Edgar, Dunne

- Edgar, Dunne compiled a report on behalf of the banks – retailers have only heard about it, never seen it. This is used as the justification for the interchange fee – certainly the processing costs part of it. It is interesting to note that interchange on credit card was reduced from 1.99% to 1.71% (November 2003) after this report was apparently completed. This would seem to be a clear indication that the fee had previously been too high. Despite requests, banks did not allow retailers to be part of the consultative process.

- How can one fee fit all issuers? Each bank's profile for the elements of interchange must be different. According to a major bank the interchange rate "reflects the actual weighted average of costs of the issuing banks (as calculated by an external party) for ALL transactions in that payment stream".
- By its very nature, this is anti-competitive. Banks that are more efficient should be able to offer lower rates to merchants and customers.

The Value of 'Plastic' (Credit and Debit Cards)

- The banks' assertion that the acceptance of plastic increases turnover is not valid because all merchants/retailers accept plastic – a refusal to accept plastic may, however, lead to a loss of turnover.
- It is a necessary and convenient form of tender and an accepted part of normal retail trade.

Why *ad valorem* on debit cards?

- All debit card transactions are PIN-based, online to the issuing bank and reference/access funded accounts. Despite this, banks still charge an *ad valorem* fee. If the components of the debit card interchange fee (in general) are
 - Recovery of processing costs
 - Payment guarantee/fraud

then clearly payment is guaranteed, fraud perpetrated by the cardholder is a matter between the issuing bank and its client (PIN reduces the opportunity for any other fraud), and processing cost is not affected by the value of the transaction. Any recovery of such cost should be a fixed fee per transaction.

Signature

- Banks still favour signature, e.g., credit cards, hybrid cards, EMV fall-back, when PIN is well understood and accepted in South Africa. If PIN were to replace signature then the potential savings in fraud reduction would be significant.

Hybrid cards

- Hybrid cards are usually debit cards masquerading as credit cards.
- They include various cheque cards, cards with "Debit Card" printed on the face but whose BIN identifies them as credit cards – and the merchant therefore pays credit card commission rates.
- A number of gift cards are appearing on the market with Maestro or Electron branding. A number of these cards are listed on the ABCI BIN table as 'Visa Electron credit'. These are all pre-funded cards.

Multiple acquiring/sorting at source

- The banks insist that a single acquirer be appointed for, at least, each of the card brands, namely, Visa, Mastercard, Electron, Maestro, Diners Club and American Express because sorting at source, and therefore multiple acquiring, is not permitted.
- The terms “multiple acquiring” and “sorting at source” are often used interchangeably by banks. They previously argued that since ‘sorting at source’ equated to ‘clearing’ and since only banks are allowed to clear, sorting at source was out of bounds for non-regulated entities, i.e., non-banks. Multiple acquiring was therefore not permitted by such entities since this was the same as sorting at source!!
- In October 2005 the Legal Services Department of the South African Reserve Bank concluded that ‘clearing’ is the domain of banks (in terms of the National Payment Systems Act), but that ‘sorting-at-source’ is not ‘clearing’. There are, therefore, no legislative grounds for the SARB to outlaw ‘sorting-at-source’ other than if the practice should lead to a form of systemic risk.
- The National Payment System Department of the SARB stresses that it is averse to arrangements that allow for the by-passing of the clearing system – it has no basis for prohibiting sorting-at-source but will ensure that institutions involved in such arrangements are regulated.
- A merchant with a single acquirer is totally exposed in that any failure in the system at the acquiring bank will leave that merchant with no means of processing any debit card transactions at any of its stores with massive disruption to its customer service and operation. Credit card transactions, too, will be restricted to the amount of the bank-imposed off-line limit, usually up to R200.
- A founder member of SARPIF, Pick ‘n Pay, had multiple acquirers for both credit and debit cards and enjoyed bilateral agreements with issuing banks from 1989 to 2005. It was then compelled to appoint a single acquirer for each card brand.
- SARPIF have already suggested to the South African Reserve Bank and to PASA that a system be investigated that allows qualifying retail switches (system operators) to accept transactions from merchants with Bankserv to ‘front-end’ the acquisition of all retail transactions, notifying the acquirer and forwarding ‘not on us’ transactions to issuers on acquirers’ behalf.
 - It would therefore not be necessary for a bank to acquire ‘not on us’ transactions.
 - Foreign card transactions could be routed to the merchants’ existing nominated acquirer for that card brand, such as MasterCard.
 - Bankserv substituting for each individual bank’s acquiring division could lead to massive infrastructural savings at each bank.

- The Competition Commission would already be aware of the large proportion of bank cost relative to the acquiring process which would be eliminated in the above scenario.
- Multiple acquiring would certainly promote competition among the large retailers and could **also benefit SMEs in that they would have the ability to purchase/rent terminals from a switch (system operator), negotiate bilaterals with issuing banks and route all transactions via the switch.**

EMV

- The date of the 'liability shift' for EMV enabled transactions in South Africa was 1 January 2005 – to date no South African bank has issued any cards (other than for testing purposes). However, merchants are expected to be EMV compliant and certified from that date. The shift in liability is from the issuing bank to the acquiring bank who will seek to pass the risk on to terminal-owning merchants.
- The cost to the major retailers who own their EFT terminals has been enormous – all terminals must be replaced and both they and the system must be certified. There has been no recognition of the investment made here. Possibly an interchange reduction of the processing cost component would be an acknowledgement.
- The declared benefit of EMV is a massive reduction in losses suffered by the banks due to fraud. Retailers expect to share in these savings with reduced merchant fees.
- If the liability shift is enforced, then interchange must be reduced, at least by the payment guarantee component.
- New 'merchant agreements' will need to be drawn up between banks and merchants but to date, retailers have not been privy to drafts of such contracts. The retailer is at a distinct disadvantage, not knowing what an EMV transaction is likely to cost, what form the chargeback rules might take, or how the liability shift is to be managed.

VISA EXEMPTION

- We believe that the exemption granted to Visa by the Competition Commission in terms of Section 10(4) of the Competition Act 1998 allows Visa to conduct itself in an uncompetitive manner and that, in any case, an exemption to 30 April 2013 is excessive and unreasonable. SARPIF have incurred significant legal costs in appealing this decision and believe that the Competition Commission itself should review the granting of this exemption.

MONEY TRANSFER

- Mzansi Money Transfer is currently available between the big four banks and SAPO and retailers have recently been approached to participate.
- The depositing customer pays the interchange fee as a fixed amount plus an *ad valorem* fee, which both get paid to the bank that pays out. This should mean that the fee goes to the retailer where he is paying out the funds and it could be passed on, in whole or part, to the customer, thus introducing competition amongst paying institutions. Shoprite have created a 'closed loop' system (deposits and withdrawals only at Shoprite stores) for a fixed fee of R10 whereas the lowest at the big four and SAPO starts at R13 (SBSA) with a high of R57.50 (ABSA) as the sum deposited increases.

CO-OPERATION

- It may be of interest to note that, as merchants, we are being compelled to cooperate with competitors in our industry in order to be heard. Retailing is a fiercely competitive industry, but here is an area of common interest where only through co-operation are we able to have a voice.

FICA

- The FICA requirements are extremely anti-competitive as customers will not change banks since this process makes a move from one bank to another so onerous.
- Banks should be required to send the customer's relevant documents to their new bank.

BANK CHARGES

- Fees charged by banks to both consumers and merchants are so different in their pricing mechanisms from one bank to another that comparison between banks is very difficult, if not impossible.
- When customers select from a basket of services being offered by a bank, they may find that the costs for these services are linked. This discourages them from moving from one bank to another, or even from splitting their requirements between different banks.

3D SECURE

- Pick 'n Pay launched a music download website called Pick 'n Play in September 2006. We entered into a single acquirer agreement with Nedbank in respect of all MasterCard and Visa credit card transactions processed through the site.
- We also entered into a "merchant licencing agreement" for the use of the Iveri System, which is a payment authorisation system to facilitate electronic payments including credit cards. The cost of this licence includes an activation fee (R1,000), a monthly merchant licence fee (R345) and an amount of R0.35 per transaction.

- Furthermore, we concluded a “merchant agreement e-commerce” for the acceptance of credit cards over the internet as a method of payment. This agreement includes the installation, by the merchant, of software designated “the 3-D Secure cardholder authentication program designed to reduce fraudulent purchases by attempting to verify purchasers’ identity during online transactions.” This means that “if a merchant enrolls into the 3-D Secure programme the burden of proof for qualifying transactions shifts from the acquirer and his merchant to the issuer”. The additional cost of participating in this programme is a monthly hosting fee of R100 and a 3-D Secure Authentication transaction fee of R1 per transaction. We have been told by our acquirer, Nedbank, that the R1 goes to Bankserv and is not negotiable.
- So the cost per transaction is the “usual” credit card *ad valorem* fee plus R0.35 plus R1.
- Surely, if 3-D Secure is implemented then the *ad valorem* fee must come down because fraud risk is greatly reduced or eliminated?
- It is interesting to note that both issuers and acquirers must be 3-D Secure enabled and at time of writing we have no formal assurance that any of the issuers are compliant. We are advised that Nedbank are enabled as an acquirer but not yet as an issuer.

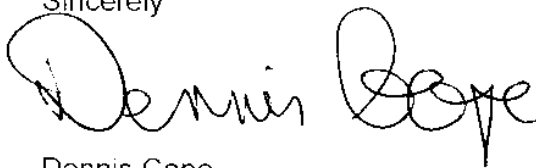
IN CONCLUSION

The lack of competition and transparency is evident from the above and we will willingly co-operate in increasing access to the national payments infrastructure for the benefit of all consumers.

The focus of our submission has been on credit and debit card; if required we will be happy to participate in a much broader investigation.

We are grateful for this opportunity to expose the above matters to public scrutiny and are confident of a positive outcome to your enquiry.

Sincerely

A handwritten signature in black ink that reads "Dennis Cope". The signature is written in a cursive, flowing style with a large initial 'D'.

Dennis Cope
Group Finance Director