

STANDARD BANK RESPONSE TO NATIONAL PAYMENTS SYSTEM AND COMPETITION IN BANKING SECTOR REPORT

In the meeting between Standard Bank and the Banking Enquiry Task Team (on 24 August 2006), the Task Team stated that for the purposes of the Enquiry, it will assume that the Hawkins Report contains a body of knowledge upon which the Panel can rely. The Task Team has requested Standard Bank to point out any areas of the Hawkins Report that, in Standard Bank's view, cannot be relied upon in respect of the terms of reference of the Enquiry.

This document identifies and collates:

1. the body of knowledge we had provided Penny Hawkins on the national payment system (attached as Annexure 1)
2. the comments on the Hawkins Report already given to the Commission (attached as Annexure 2)
3. a few additional comments (attached as Annexure 3).

The development of this input took cognisance of our understanding of what is covered in the scope of the Competition Commission Enquiry, which terms of reference are:

“The Subject matter of the enquiry will be:

5. (a) the level and structure of charges made by banks, as well as by other providers of payment services, including:
 - I. The relation between the cost of providing retail banking and / or payment services and the charges for such services;
 - II. The process by which charges are set; and
 - III. The level and scope of existing and potential competition in this regard;
- (b) the feasibility of improving access by non-banks and would-be banks to the national payment system infrastructure, so that they can compete more effectively in providing payment services to consumers;
- (c) any other aspect relating to the payment system or the above-mentioned charges, which would be regarded as anti-competitive.”

Yours sincerely

Ian Sinton.

Annexure 1

The document is a power point presentation and is attached to the same email that delivered this input.

Annexure 2

By Fax
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The Standard Bank of South Africa

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9 June 2006

Dear Mr Ramburuth

RESPONSE TO NATIONAL PAYMENTS SYSTEM AND COMPETITION IN BANKING SECTOR REPORT

The Standard Bank of South Africa Limited ("Standard Bank") would like to thank you for the opportunity to respond to the findings of the report on "The National Payment System ("NPS") and Competition in the Banking Sector".

We appreciate and recognise the need for a proper functioning and fair national payment system and we acknowledge the importance of the concerns raised by the report.

Standard Bank will cooperate fully with the Competition Commission and looks forward to exploring the concerns and possible solutions in order to ensure that the banking system is accessible and appropriate to all South Africans.

Given that the Competition Commission will shortly be publishing the Terms of Reference for the general inquiry, Standard Bank appreciates the opportunity to correct and clarify certain factual statements as well as provide additional information and insights into some of the findings of the report.

FACTUAL STATEMENTS

Finding 1: Cost & Revenue

The report states that large banks contend that on balance, interchange (which is intended to compensate the banks for the differential between issuing and acquiring costs) should be neutral in respect of its cost impact. However, the impact of market share of the acquiring infrastructure (such as ATMs and POS devices) on the distribution of interchange between

small banks and large banks probably warrants further research with the report stating that Interchange only works in favour of the bank with a large infrastructure

A key requirement for consumers in South Africa is access to financial services. This requires interoperability between participants in the NPS for transactional solutions. In order to enable cost effective interoperability between participants within the NPS, interchange charges are necessary to enable the recovery of the underlying costs, including risk and fraud, incurred in handling an interbank transaction irrespective of the size of participants.

With the introduction of ATMs in the 1970's, the voluntary provision of access to an "essential facility" was made possible by banks to non-banks (e.g.the Post Office) and Building Societies through enabling interoperability across the industry. The success of this was based on the introduction of an interchange fee that was multilaterally agreed. There were no regulatory requirements on the banking industry to allow access to the ATM switch; this was done by the banks in good faith and provided that there was economic justification for all participants concerned. Initially two switches existed i.e. Multinet (Building Societies) and Saswitch (big volume Banks and Post Office). These were merged to provide economies of scale benefits to all participants within the system.

The recovery of costs via interchange is dependant on:

- i. the type of payment instrument (e.g. debit card or credit card), which determines the interchange fee flow and potentially the quantum; and
- ii. whether or not the participant is the issuer (party that issues the payment instrument to facilitate payment such as cheques, debit cards and credit cards) or acquirer (party that owns the payments infrastructure such as ATMs and Point-of-Sale devices("POS") of a specific payment instrument.

In those instances where a bank's issuing and acquiring bases are similar (relatively the same in volume and value size), such as Standard Bank, the net effect of interchange recovery / pay-away is negated. Also, the effect of interchange charges recovered by industry participants and/or paid to each other, is ultimately balanced to zero.

The following illustrates the net effect of interchange charges on an Issuing Bank and Acquiring Bank with varying issuing and acquiring bases:

Payment Flow	Bank	Issuing Base	Acquiring Base	Net Effect
Issuer pays Acquirer (e.g. ATM Cash Withdrawal)	A	Big	Small	Net Pay-Away
	B	Fair	Fair	Net Pay-Away negates Net Receivable*
	C	Small	Big	Net Receivable
	D	Small	Small	Net Pay-Away negates Net Receivable*
Acquirer pays Issuer (e.g. Debit Card or Credit Card Purchases)	A	Big	Small	Net Receivable
	B	Fair	Fair	Net Pay-Away negates Net Receivable*
	C	Small	Big	Net Pay-Away
	D	Small	Small	Net Pay-Away negates Net Receivable*

* Interchange received for issuing (e.g. ATM Cash Withdrawal) / acquiring leg (e.g. Debit / Credit Card purchase) is utilized to fund interchange paid away for acquiring (e.g. ATM Cash Withdrawal) / issuing leg (e.g. Debit / Credit Card purchase).

Illustrative Example 1 – Interchange flow within a 3-box model:

The 3-box model pricing principles are applied in those instances where there are 3 parties involved in the transaction:

1. Customer
2. Issuing Bank
3. Acquiring Bank

The following example assumes that for an ATM Cash Withdrawal transaction, interchanges fees have been set at a flat fee of R2.50 per transaction:

Payment Flow	Bank	Issuing Base Volumes (Nr. of transactions by your bank on other banks ATM infrastructure)	Acquiring Base Volumes (Nr. Of transactions by other banks on your ATM infrastructure)	Net Effect
Issuer pays Acquirer (e.g. ATM Cash Withdrawal)	A	1,000	100	Received: R250 Paid Away: R2,500 Net Effect: R2,250 Paid Away
	B	500	500	Received: R1,250 Paid Away: R1,250 Net Effect: R0
Interchange: R2,50	C	100	1,000	Received: R2,500 Paid Away: R250 Net Effect: R2,250 Received
	D	100	100	Received: R250 Paid Away: R250 Net Effect: R0

Illustrative Example 2 – Interchange flow within a 4-box model:

The 4-box model pricing principles are applied in those instances where there are 4 parties involved in the transaction:

1. Customer
2. Issuing Bank
3. Acquiring Bank
4. 4th Party e.g. Merchant, Beneficiary Bank or Vendor

The following example assumes that for a Debit Card or Credit Card purchase transaction, interchanges fees have been set at an advalorem percentage of 1% of the value of the transaction:

Payment Flow	Bank	Issuing Base Volumes (Values) of your bank transactions on other banks' POS infrastructure	Acquiring Base Volumes (Values) of other banks on your POS infrastructure	Net Effect
Acquirer pays Issuer (e.g. Debit Card or Credit Card Purchases) Average Value of a Transaction: R200 Interchange: 1% of the value of the transaction	A	1,000 (R200,000)	100 (R20,000)	Received: R2,000 Paid Away: R200 Net Effect: R1,800 Received
	B	500 (R100,000)	500 (R100,000)	Received: R1,000 Paid Away: R1,000 Net Effect: R0
	C	100 (R20,000)	1,000 (R200,000)	Received: R200 Paid Away: R2,000 Net Effect: R1,800 Paid Away
	D	100 (R20,000)	100 (R20,000)	Received: R200 Paid Away: R200 Net Effect: R0

In those instances where a bank is both the issuer and acquirer of a transaction (us-on-us transactions), the cost of interchange is still a real cost incurred due to internal transfer pricing that occurs between issuing and acquiring departments to compensate the other party (i.e. issuing or acquiring part of the Bank)

Does the market share of the acquiring infrastructure (such as ATMs and POS devices) impact on the distribution of interchange between small banks and large? The answer to this question is twofold:

- Yes, in those instances where transaction types are governed by a 3-box model e.g. ATM cash withdrawal transactions where the issuer pays the acquirer, thus the bigger the acquiring infrastructure market share, the more interchange is received, but may or may not be negated depending on the size of the banks issuing base.
- No, in those instances where transaction types are governed by a 4-box model e.g. Credit Card purchase where the acquirer pays the issuer, and **thus the size of the acquiring infrastructure market share is irrelevant.**

For banks with balanced acquiring / issuing portfolios there is no real effect. Banks choose to participate in acquiring or issuing only for multiple reasons.

Finding 3: Pricing

The report states that the interchange earned on a typical customer off-us ATM cash withdrawal transaction for the first R100 equals R3.90.

This current Saswitch interchange is set at R3.25 for the first R100 or less drawn, plus R 0.65 for each additional R100 or part thereof. Thus, in the example used within the report, the interchange earned of a typical customer off-us ATM cash withdrawal transaction for the first R100 should equal R3.25 and not R3.90 as stated.

ADDITIONAL INSIGHT AND INFORMATION

Finding 2 & 6: Access and Non-Banks

With regards to “Access”, the report concludes that the failure to date by SARB and the Payments Association of South Africa (“PASA”) to develop any regulations in respect of Customer Payment Service Providers (“CPSPs”) appears to be an oversight in terms of the Blue book strategy. This regulatory gap is of concern not only because it leaves a significant portion of the NPS un-regulated (and therefore potentially leaves the system open to risk) but also because the overall competitive space may be restricted to the detriment of consumers.

With regards to “Non-Banks”, the report makes reference to the fact “that in South Africa, there is a wide area of payment activity beyond the clearing and settlement space, which includes companies that facilitate third party payments and IT companies that provide the technology and infrastructure for non-banks and banks alike. They remain unregulated. The regulatory gaps remain in spite of the proposed rules in the Blue book, which set out the strategy for the NPS from 1995-2004. Non-banks may not, by law, be PASA members.”

Definition of Access¹:

“Given this broad scope of players, one might very well ask if access to the payment system is indeed a concern and it will then immediately become apparent that much depends on what is meant by access:

- *For some, access means access to the clearing and settlement system, an area that has traditionally been the preserve of banks.*
- *Access for the NPSD is access to the real-time high-value SAMOS system that it owns and operates, and the department points out that there are no barriers to entry – except of course that to operate in SAMOS one must be a registered bank.*
- *For some of the non-bank players, access means being allowed to enable clients to make payment against deposits.*
- *For yet others it means having access to bank accounts via their own system operator - rather than Bankserv - which is an operator that is wholly owned by the banks.*
- *And then of course, for would-be bankers, access is concerned with the problem of gaining entry to a restricted area.”*

Within the formal financial sector, clear conditions of governance (rules and agreements that regulate access, membership and participation in the NPS) exist for banks, under a dedicated regulator namely SARB with a delegation of certain powers to PASA.

Second-tier banks are free to participate in any payment stream under the existing Banks Act (the Dedicated Banks Bill, has yet to be promulgated) providing they meet all the existing entry and membership requirements:

- Risk, operational and liquidity management structures must be in place;
- Infrastructure must meet risk and interoperability standards and proper disaster recovery and business continuity planning systems and procedures must be in place;
- Financial and capital costs must be sufficient to ensure the safe, efficient and ongoing participation in each of the payment streams and initiatives within the industry.

Furthermore, access to the NPS by a bank can either be obtained directly or through a sponsoring bank arrangement.

Although non-banks and certain government departments are not governed under the Banks Act, it does not preclude them from participating in the NPS.

- Government departments such as the South African Post Office / Postbank can participate in the NPS as a sponsored entity given its exclusion and / or exemption from the Banks Act in terms of section 2 of the Banks Act, No 94 of 1990.

¹ Definition of the term Access as per the 2006 FEASibility (Pty) Ltd – The National Payment System and Competition in the Banking Sector (20 April 2006)

- Non-banks can participate in the NPS as Payment Service Providers i.e. they may collect funds from customers and pass funds over to banks / beneficiaries. For example the enablement of bill payments by EasyPay through Pick 'n Pay enables EasyPay to collect funds from customers paying their bills at Pick 'n Pay which is then held and passed onto beneficiaries as requested.

Standard Bank supports the notion of exempted banks and non-banks participating in the payments industry (as illustrated by Standard Bank sponsoring the South African Post Office / Postbank into the payments industry and our joint venture with MTN in cell phone banking), provided that it does not jeopardize the safety, soundness and integrity of the NPS.

In addition to the aforementioned, initial steps have been taken to address the issue of regulating the way in which these specific stakeholders participate within the NPS. These include:

- The Reserve Bank and PASA are in the process of drafting a directive, as part of the amendments to the NPS Act in October 2004, which would regulate the way in which non-banks issue and clear payment instruments;
- PASA is in discussions with both the Reserve Bank (NPS Department & Banking Supervision) to explore ways in which the South African Post Office / Postbank (and other exempted entities, entities who are not subject to the same compliance and regulatory requirements as banks under the Banks Act) could be regulated under the NPS Regulatory Oversight Framework with the purpose of managing their participation in the NPS.

The current presence of so many non-bank players in the NPS (e.g. Pick 'n Pay Go Banking, Shoprite Money Transfers, EasyPay etc.) is testimony to the fact that access to the NPS is not impeded or closed. In essence, what could be improved with respect to access is more rigour and oversight of these non-bank participants in order to protect the safety and stability of the NPS and moreover, ultimately the interests of the consumer

Examples of things that could possibly go wrong should non-bank participants be allowed to participate in the NPS without the appropriate rigour and oversight are:

- Float / Lack of Collateral
Should the "payment system provider" disappear without paying over the funds (float holding) to the 3rd party beneficiary and/or become insolvent this would result in losses to the public and 3rd party beneficiaries. This type of systemic and reputational risk could make the NPS highly vulnerable.
- New Payment Instruments
The creation of payment instruments by non-banks can lead to a "new economy" outside of the current regulated and oversees bank issued payment instruments.
- Unlevel playing fields
Banks are regulated, have capital maintenance and liquidity requirements and have a high cost of compliance, whereas non-banks do not. Furthermore, in many cases these non-bank payment facilitators use interest revenue generated from the float to off-set costs of payment processing, creating a perception that bank fees are high.

To further reiterate, Standard Bank has and continues to support the participation of non-banks within the NPS, however the conditions for their participation are currently unclear and there is a need for oversight and appropriate rigour in both closed and open loop systems. The original Blue Book as well as the recently launched Vision 2010 makes provision for the participation of non-banks within the NPS, nevertheless the questions of the "how" and "who" relating to oversight needs to be explored in more depth.

Finding 3: Pricing (with reference to interchange)

The report concludes that it is possible that the best outcome in terms of fairness for both consumers and smaller participants (including banks and retailers) would be to allow multilateral price negotiations, and to publish these prices and their changes so that consumers are informed and empowered. A multilateral price set in this way does not necessarily preclude bilateral negotiations, with the multilateral price the de facto ceiling.

World-wide, competition authorities or regulators investigations of interchange have indicated that interchange is necessary to ensure and maintain interoperability, and appropriate market behaviour. The real issue regarding interchange has been the principles and quantum of fee flow. It must be borne in mind that as a result of changes to the structure of the payments system, interchange set below or at cost, can in the long run result in a reduction in investment and ultimately competition.

Bilateral negotiations alone have proven to be non-feasible and impractical. For example, within the ATM / Saswitch payment clearing house, there are currently 9 participants and if each of these had to effect bilateral negotiations with one another, 72 bilateral negotiations would have to take place. And the aforementioned example only applies to one payment mechanism. Imagine the number of negotiations that have to take place for approximately 12 payment mechanisms, with each payment clearing house having between 4 to 25 member participants who would need to negotiate with one another. Further, given that the negotiation of bi-laterally agreed interchange fees hinges on volumes, small volume banks will immediately be disadvantaged relevant to their weaker negotiating position

For these reasons, world-wide bilaterally agreed interchange fees and processes have been practically unmanageable and have had unintended consequences for industry participants where was enforced, i.e.:

- high levels of interchange fees making it uneconomical for certain industry participants (especially smaller volume players);
- banks start to operate in silos (no interoperability) due to negotiation power of large volume players resulting in decreased access for consumers especially in less urbanized areas;
- it is simply not practical to implement (too many negotiations which have onerous implications on costs and resource requirements due to number of negotiations required);
- it could potentially lead to greater complexity in consumer understanding of bank fees and their ability to compare across banks due to different prices per bank and potentially per merchant chain.

The other option available is multilaterally agreed pricing which has proven to be by far the more widely used model worldwide given that it:

- enables uniformity of application of principles, fee flows, cost components and fees (standard model);
- is easier to implement (frequent reviews will take efficiency improvements into account which could result in lower fees);
- is small and new bank friendly (an average industry price is set which rewards players with economies of scale, without excessively penalizing small volume players).

Finding 4: Control & Ownership

The report states that the proliferation of a number of proprietary systems as an alternative to Bankserv would not necessarily lead to lower prices if it had a negative impact on efficiency.

Standard Bank agrees with this statement, but would like to highlight that currently within the NPS infrastructure we have numerous alternatives (Bankserv, SWIFT, Visa, and MasterCard) that are used in the clearing and settlement of interbank transactions. Furthermore we welcome the report's suggestion that in order to improve the governance of the NPS Operator (i.e. Bankserv), the regulator sits on the Board. In the past the regulator was present on the Board and we would welcome any proposals or views that the regulator may have with respect to expanding and expediting this function once again.

Nevertheless, it is critically important that the appropriate oversight and compliance rigour is maintained with respect to a NPS operator such as Bankserv in order to sustain its core function as a national utility, which enables the clearing and settlement of transactions through the provision of payments information to the Reserve Bank. The NPS operator needs to focus on its core purpose or else it may be detrimental to the functioning and stability of the NPS and could lead to:

- Elimination of economies of scale
- Reduction in transactional processing efficiency

- Less and less inter-operability within the NPS
- Exclusion of new and small players
- Resultant increased charges to the end-customer
- Inappropriate BCP / DR contingencies as well as security standards

In conclusion, provided that there are two banks that are willing to participate in an initiative, any entity may set itself up as a NPS operator, providing it conforms to the criteria, which relates to ensuring safety and soundness of the NPS.

TERMS OF REFERENCE

Finally, we would like to suggest that the following questions be taken into consideration in formulating the Terms of Reference for the general enquiry:

1. How should access be governed within the NPS Framework?
 - Banks
 - Sponsored banks
 - Excluded and exempt “banks”
 - Non-banks
 - Operators
 - Providers of payment instruments
 - Providers of services e.g. bill collectors

2. How should non-banks (as per the above categories) be allowed to participate, efficiently, responsibly and sustainably, within the NPS without introducing systemic risk into the system?

3. What is a fair and suitable method of setting interchange charges (which not only includes the quantum, but also the formalization of guiding principles, selection of the most appropriate charge / pricing structures e.g. flat fee or advalorem, roles & responsibilities of the negotiating parties and more) i.e. methodology and principles in determining interchange fees, method of setting interchange (bilaterally vs. multilaterally) and who should set the interchange
 - Independent 3rd party
 - Regulator
 - International precedent?

Given that the Competition Act recognises the need for an efficient economic environment that balances a variety of interests and focuses on development to the benefit of all South Africans, we assume that the Competition Commission will, in its investigation into the NPS, focus on issues beyond market structure. These may include the essential role the NPS plays in South Africa’s banking system, and economic and commercial life; as well as the need to ensure the NPS’s future stability, efficiency, ability to manage fraud, as well as continued expansion & innovation. We encourage the Competition Commission to ensure that the necessity of addressing these broader issues informs the scope of the enquiry as well as the composition of the technical team and panel which will conduct the enquiry.

We hope that the aforementioned provides further insight and understanding into the findings raised by the report and that it may assist with the shaping of the Terms of Reference for the pending general enquiry.

Yours faithfully

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Ian Sinton
Head, Legal (Corporate & Investment Banking)

Annexure 3

Three areas are highlighted for the attention of the Competition Commission:

1. Transparent pricing
2. Fees for dishonoured payments
3. Customer spend on bank charges.

1. The report makes reference to the fact that there is a lack of transparent (and unbundled) price guide for consumers. We do not agree that this is the case for Standard Bank.

Standard Bank have pricing brochures for all retail transactional and saving products, which are revised annually and freely available at our Retail Points of Representation (branches). Where considered appropriate, we also have brochures printed in multiple languages.

New customers are given a pricing brochure when opening the account and the fees and charges are explained to them. Given that existing customers have the choice of different pricing options (pay-as-you-transact, bundled options, rebate options), Standard Bank sends a pricing letter to these customers during November of each year. We confirm the pricing option that the customer is currently using. In addition, we quote the revised prices for all three options, which then gives the customer the choice to change to another current account option based on his specific needs.

Standard Bank has unbundled pricing options for all its products. At the low-income end of the market, we only offer unbundled pricing options. Bundled (a specified number of an assortment of transactions at a fixed monthly fee) and rebate (a portion of the fees are refunded provided a minimum monthly balance is held) options are created out of customer demand. No customer is forced onto a bundled option.

Furthermore, Standard Bank's pricing appears on our website, which also contains a "Pricing Calculator". Customers can capture transactions / details pertaining to their specific transaction usage profile in order to facilitate comparisons with other banks' charges. The tool also enables the customer to choose the most appropriate and affordable pricing option.

We agree that it is sometimes difficult (even by industry players) to compare fees between banks. This clearly demonstrates the varying pricing strategies that the respective banks apply to their diverse customer segments, rather than a lack of transparency. Irrespective of this, the Market Conduct committee of the Banking Association of South Africa continues its efforts to enhance the ability of customers to compare pricing between providers, however, a major stumbling block to providing a standard pricing template or structure continues to be that of being seen to be collaborative by nature, which is deemed as being anti-competitive.

2. The report makes reference to the fact that fees for dishonored payments range from R64.00 – R99.00. Standard Bank's fees for dishonored payments range from R31.50 to R99.00.

Within Standard Bank's transactional and savings products, fees for dishonored payments are as follows:

E-Plan Account:	R31.50 (capped at 2 per month);
Saving Accounts:	R55.00 (capped at 2 per month);
All other Current Accounts:	R99.00 (no cap per month).

3. The report makes reference to the Deloitte's Cross Bank Study which infers that on average customers spend 2% of their income on bank charges. Standard Bank's view is that this is not representative of the typical profile and income of the vast majority of customers.

It should be noted that the Deloitte Report used a "fictional transactional profile" for a family earning R500,000 per annum. This figure represents an upper niche market customer and does not represent the typical profile and income for the vast majority of customers as predominantly referred to in the report as "low and middle income customers".