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COMPETITION COMMISSION
PRETORIA

For Attention: Keith Weeks

Per e-mail: keithw@compcom.co.za

PRIVATE AND CONFIDENTIAL

Dear Keith

SHOPRITE CHECKERS (PTY) LTD'S RESPONSE TO THE COMPETITION COMMISSION'S REQUEST FOR SUBMISSIONS REGARDING THE REPORT BY FEASIBILITY ("FEASIBILITY REPORT") ON CHARGES WITHIN THE BANKING SECTOR

We act on behalf of Shoprite Checkers (Pty) Ltd ("Shoprite"). Shoprite instructed us to submit the undermentioned in response to the Commission's call for comment on the issues raised in the Feasibility report.

Shoprite's contribution includes examples of its own experiences with the Banks that, in its opinion, make it imperative that the costing structures of Banks are carefully examined. Shoprite believes that the issues that are raised by it will not affect the efficiency or efficacy of the National Payment System ("NPS").

1. **INTRODUCTION**

Shoprite is a national food and household goods retailer, catering mainly for the LSM 3 to 8 consumer. Its retail operations generated a turnover of about R16 billion for the six months ending December 2005 (an estimated R32 billion per annum). Shoprite's business is still mainly cash driven, but as appears from the table 1, the use of credit and debit cards in its retail operations is on the increase, whilst tender of cash and cheques has reduced by nearly 15% over a three year

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period. This is in line with change in payment instruments usage in the NPS (Feasibility report page 12).

[CONFIDENTIAL]

The notable swing to the use by the consumer of credit and debit cards in recent years (to nearly [CONFIDENTIAL] of Shoprite's total annual revenue) underscores the need to examine the fairness of the transactional costs levied by the Banks on card/cash free transactions. Currently, Shoprite's costs arising from the payment of merchant's fees amount to approximately [CONFIDENTIAL] a year. Over the past few years, Shoprite has attempted to reduce these costs, *inter alia*, by negotiating more beneficial terms with its bankers, made possible not only through the value of its account, but also by questioning existing services, explanations and methods of the Bankers relating to payment systems, particularly those which appear to be indefensible and constitute evidence of entrenched conventions that disregard new developments and the needs of the consumer/customer.

Shoprite's experiences with other costs levied by the Banks such as cash handling fees, lead to its conclusion that these too should be investigated as apparent barriers created by the Banks at the retail level of the NPS, seem to hamper new entry, and the use of new technology and chill innovation, and thus, in Shoprite's opinion, serve to maintain present abnormally high fee structures.

2. **SORTING AT SOURCE (OR MULTIPLE ACQUIRING)**

The single acquirer rule obliges merchants, such as Shoprite, to take all transactions to one acquiring bank, from where any transactions not "on us" at the merchant's acquirer (i.e. not cards issued by the acquiring bank), will be batched and be cleared via Bankserv and SAMOS to the various card issuers. Transactions on cards issued by the acquirer are not cleared via Bankserv and SAMOS, but are administered only within the acquiring/issuing bank. The NPS is thus not involved in the clearing of "on us" transactions.

2.1 **RESERVE BANK'S MORATORIUM**

Shoprite is a member of Sarpif, an organization of retailers affiliated to the Consumer Goods Services Council (CGSC). Sarpif together with Shoprite and other retailers is involved in proceedings before the competition authorities against VISA NO, a firm owned by several South African banks, under case number: 106/EA/DEC04. The decision of the Competition Commission to grant the exemption sought by VISA NO, subject to the Reserve Bank ("Resbank") regulation from time to time, is on appeal.

The single acquirer rule formed a subject of this application, ostensibly because the rules of the card associations, VISA and Master Card, require single acquisitions of card transactions, i.e. that retailers/merchants send all payment instructions, or rather card transactions, to one acquiring bank only. That under guise of the protection of intellectual property rights. The Banks deny the existence of such rules.

Absa, in a letter addressed to Shoprite dated 12 April 2006, indicated that a rule against single acquiring is also incorporated in the South African Credit Card Payment Clearing House ("PCH") and Debit Card PCH agreements and the card associations, VISA and Master Card, are supportive of the four party model. All this is allegedly fundamental to efficient payment systems and global interchangeability. In apparent contradiction, Absa also states that the Payment Association of South Africa ("PASA"), and VISA and Master Card, actually allow multiple acquiring, but bypassing of the acquiring system is not countenanced. A copy of Absa's letter is attached hereto as annexe "S1".

At a stage during the mentioned proceedings, Resbank issued a moratorium preventing retailers and the Banks to enter into sorting at source relationships, *inter alia*, on the basis that its role to oversee money flow in the NPS would be hampered thereby. A copy of this letter is attached marked "S2".

2.2 **RESBANK'S VOLTE FACE**

This year Resbank advised PASA to the effect that sorting at source was not a prohibited clearing activity after all, i.e. it did not involve the NPS and therefore multiple acquiring is possible. A copy of the Resbank's letter dated 3 January 2006 is annexed hereto marked "S3". Several banks can therefore acquire card transactions from a single retailer. It is now possible that retailers sort the card transactions on a certain basis, e.g. per issuing bank or per card association brand and enter into several acquiring arrangements with banks.

2.2.1 **Failed attempts to introduce multiple acquiring**

Since publication of annexe "S3", Shoprite's suggestions to the various issuing banks to acquire their transactions on cards issued by them have elicited varied responses.

- a) The main argument is that the cost of processing these "on us" transactions, will lead to Shoprite having to pay a higher merchant's fee as the interchange fee dictates the basis of the merchant's fee. The interchange fee is allegedly based on the actual weighted costs of all the issuing banks taking account of all transactions in the NPS, independently determined. It is not clear whether only clearing activities are taken into account in the determination of the interchange fee or all card usages.
- b) The other argument is that economies of scale and efficiencies will be affected in that an issuing bank will receive several smaller batches of transactions from several retailers, instead of one large batch from one acquirer.
- c) A further reason advanced by the Banks is that the card associations, VISA and Master Card, levy fees that are borne by the Banks.
- d) A further unfounded proposition for a bank's inability to adjust a merchant's fee is that a certain "transaction fee" would fall away

if they did so. No better explanation is given nor can it logically relate to any other transaction other than that for which the merchant's fee is raised. Unless it involves another party unknown to Shoprite.

2.2.2 **Shoprite's views**

- a) Shoprite does not accept that the costs of going directly to the issuing banks can be higher than when only one acquiring bank is involved. Most issuing banks are also acquiring banks and their systems must be capable of processing both "on us" and "on them" transactions, or exclusively "on us" or only "on them" transactions, if that is what they want. Logically, the costs should be less, by at least the interchange fee, as no clearing activity is involved in "on us" transactions. (Currently, the interchange fee is at 1.71% on credit and 0.55% on debit card transactions.) Or at least not cost any more, as the transactions batched by a retailer still remain payment transactions, not necessarily involving clearing. No additional "on us" transactions or additional VISA and Master Card fees can be involved, except that some might actually be "saved" as less handling is involved by multiple acquiring, especially if transactions are sorted per card associations' cards brands; alternatively per the cards issued by the particular bank. The batching costs and effort are actually borne by the retailer in those instances.
- b) As stated in the Feasibility report, the full detail of the interchange fees is not available to Feasibility, and this is one aspect that requires far more investigation. In this regard, the report commissioned by the banks referred to on page 28 of the Feasibility report, the so-called Edgar Dunn ("Dunn") report, resulted in a drop in interchange fees from 1.99% to 1.71% on credit cards and from 0.75% to 0.55% on debit transactions in

November 2004. The Dunn report was never made public and does not appear to have been made available to Feasibility. It is reasonable to conclude that Dunn must have motivated a reduced interchange fee on a basis acceptable to all banks. No doubt, access to the Dunn report will elucidate the composition of the interchange fee and other charges for using the NPS. Interestingly enough is that although the interchange fee was reduced in 2004, the merchants' fees have not been reduced proportionately. For example, Shoprite received a 0.24 % instead of the 0.28% reduction. That proves the point that the merchant's fees are unrelated to the interchange fee and the NPS, contrary to the Banks say-so as recorded in 2.2.

2.3 **THE EFFECT OF SINGLE ACQUIRING**

The problem of single acquiring as experienced by Shoprite is twofold –

2.3.1 **No business**

If a single acquiring bank's systems fail, Shoprite is unable to process any debit cards (and only credit card transactions involving value below the floor limit). Under these conditions, Shoprite's business comes to a complete standstill. If Bankserv's systems fail, Shoprite is unable to process any of the mentioned transactions that are not "on us" at its single acquiring bank. In this case -

- a) Only the "on us" transactions of the single acquiring bank can be processed; thus in Shoprite's case affecting about 65% of all card transactions whilst Bankserv systems are inaccessible.
- b) The fact that the acquiring bank is in a position to process the transactions on cards issued by it, illustrates to Shoprite that Bankserv and SAMOS are not involved in the "on us" acquiring transactions; and this in turn casts a suspicion on the card

associations' alleged assertions that a four party model is essential to the efficacy of the NPS (see 2.1 above). An acquiring bank processes all of the transactions involving cards issued by it in-house. The Resbank has no insight into this activity nor are the acquiring banks required to report these transactions to the Resbank. Resbank then does not see the entire retail volume of card transactions.

2.3.2 **High Merchant's fees**

As the Feasibility report and Shoprite's experiences highlight, there appears to be no correlation between the interchange fee and the size of the merchant's fee claimed by the banks. An obvious benefit of having several acquiring banks is to save costs, first by avoiding the interchange fee and second, by negotiating the merchant's fee with each acquirer due to the batching activity actually undertaken by Shoprite's switch. The various explanations, proffered to Shoprite thus far, why the merchant's fee cannot be reduced if multiple acquiring is allowed, make little sense. The Banks' collective/common resistance to change indicates to Shoprite that merchant's fees have a relevance or origin that may be derived from relationships between competing banks at the retail level of the NPS, whether formal or through trade usage.

2.4 **SUMMARY**

The Banks' resistance to negotiate merchant's fees and to simplify the acquiring processes is not attributable to any technological constraints nor does it appear to relate to the use of the NPS. One can only conclude that it may be ascribable to the exercise of market power.

Currently Shoprite's budget for the next financial year for merchant fees charged by banks is [CONFIDENTIAL]. This amount, coupled with the significant investment of capital by Shoprite in order to comply with the banks' and card associations' requirements for Europay/Master/Visa ("EMV") to process credit

and debit cards in accordance with their requirements, makes the cost of processing of cards very expensive for retailers. For EMV, the capital investment for Shoprite is in the region of R32 million. That does not give Shoprite any additional security, reduce any costs or generate additional income - only the banks and the cardholders derive any benefits through the more efficient process of processing. [Although initially Shoprite was promised some relief for its investment in EMV (funds were apparently set aside by the card association's, Master and Visa), nothing has been forthcoming from the banks; in fact, the original offer of financial assistance is now denied.]

As appears from 2.2.2 above, Shoprite's attempts to negotiate the merchant's fees with several acquiring banks have come to naught. Once there is some transparency the composition of merchants' fees and the extent to which their size is dictated by the use of the NPS, alternatively by bi- or multi lateral agreements between banks and/or required by the card associations or even by banks' operations, the Commission will be in a better position to assess their relevance and how, if at all possible, they can be reduced or avoided. At this stage, the obfuscation by the Banks makes that impossible. One could even conclude that given the reticence of the Banks to free up acquiring functions amongst themselves, is either collusive, or designed to maintain inefficiencies supporting high bank costs in an environment that is technologically advanced and changing.

3. **ANTI-COMPETITIVE OUTCOMES OF THE NPS AND CURRENT UTILISATION**

Concerns about systemic risks of the NPS are unfounded given that South Africa maintains a most efficient settling and processing system. The systems run by the Banks as well as the major retailers in South Africa are probably among the best in the world, but payments systems have changed significantly over the past decade. However, the Banks and Resbank practices coupled with VISA and Master Card association rules do not seem to allow or accommodate modern day payment structures and innovations.

Recent innovations and technological advances within the banking sector have resulted in increased access and reduced costs for the consumer for a variety of banking services and

no good reason exists why increased efficiency and reduced costs cannot become more commonplace in the NPS. It would appear that the vested interests of incumbents may raise entry barriers.

For example, the fact that any switch operator can apply to become a payment clearing house ("PCH"), is negated by the requirement of Resbank that an applicant must have the support of two banks. Obviously, the major banks are not keen to become involved with any PCH other than Bankserv, which they own collectively. The smaller banks can appreciate the benefits of more PCH's and are only too willing to participate in any move that will make their entry into the card processing market cheaper, and easier.

Another example is the requisite certificate by VISA and Master Card to allow a bank to become an acquirer unless they also issue cards. Licence- and maintenance fees are also involved. A bank must route transactions internationally rather than locally until they can become certified. Also required is the certification by Bankserv and the other banks on the reconciliation and settlement procedures. Although PASA is supposed to support the small banks in their endeavours, the experience is that the larger acquiring banks will not make it easy for a small bank seeking certification. Examples of less costly banking services are given below.

3.1 **CAPITEC**

A small bank, Capitec, has managed to produce a banking model that is cheaper than Mzansi, the low cost alternative promoted by Government, introduced 2 (two) years ago in order to reach the "unbanked" consumer. As it appears from the newspaper report (Sunday Times Business 7 May 2006) annexe "S4", Capitec is managing to offer affordable banking services to consumers taking into account the latter's convenience and needs. It does this by the use of systems, reduced administration, coupled with immediate service, smaller front office services and centralised management. A large part of its business is transacted by debit cards issued by it.

If the debit card transactional costs levied by Capitec as per a newspaper extract attached as "S5" are compared to those of larger banks, one can conclude either

that Capitec through innovation has reduced costs unlike the mainstream banks who continue operations in an expensive manner; or it may be that bi- or multi lateral arrangements between banks are such that their costs are so high. Interesting is the high costs levied by Capitec (and Pick 'n Pay's Go Banking) in respect of the use of other banks' infrastructure (notably ATM), if compared to that charged by mainstream banks, that indicates that probably different considerations apply to Capitec as a smaller bank making use of another's infrastructure.

The other aspect highlighted by these differential fees charged for the use of another bank's infrastructure is that there appears to be no systemic reason why the charges of banks should be similar at all.

(The banking costs per annexe S5 seem to be somewhat different to those set out in table 5 of the Feasibility report, but the disparity illustrated remains obvious.)

3.2 **MONEY MARKET**

Money Market is a Shoprite financial services initiative in Shoprite stores for the payment of accounts ("EFT"), and it provides a number of third party financial services for customers, for example, short term insurance, Lotto tickets and other ticket sales. The Money Market is subject to Resbank's directives in respect of the EFT transactions.

With the backing of Capitec and as part of its Money Market offerings, Shoprite has introduced a financing product that enables its customers to transfer money to a third party via any Shoprite store. In the near future, customers will also be able to transfer money from a Capitec branch, collectable at any Shoprite store, and *vice versa*.

The money transfer system for Money Market was first developed by Shoprite with Postbank, but that project came to naught as the parties could not agree on a business model, the charge of R 17.99 plus an *ad valorem* of 3% that Postbank

intended to levy on transfers and Postbank's insistence to use Bankserv were unacceptable to Shoprite.

In conjunction with Capitec, Shoprite is now providing a money transfer product at a flat fee of R9.99, regardless of the money value. The Mzansi money transfer fee is R19.99.

3.3 **INCIDENCE OF COSTS**

Absa is Shoprite's current and only acquiring bank at this stage. An analysis of the card business done with Absa for the period July to December 2005 as appears from table 2 below, reveals that [CONFIDENTIAL] of the card business passing through Shoprite's checkouts is on cards issued by Absa. The total Master/Visa business at Shoprite amounted to [CONFIDENTIAL] in the same period.

For six months, Absa charges merchant fees of approximately [CONFIDENTIAL] to Shoprite, which equates to about [CONFIDENTIAL] per annum. This is about [CONFIDENTIAL] of Shoprite's annual total merchant's fee expense.

Shoprite's figures also show that for "not on us" transactions, Absa is paying the [CONFIDENTIAL] interchange fee on debit card transaction, but is only charging Shoprite [CONFIDENTIAL], a net shortfall of [CONFIDENTIAL]. That supports the conclusion that the actual cost of clearing is much less than the interchange fee claimed, that charges are levied under the guise of interchange that seem to have nothing to do with it at all and that such "losses" are probably cross-subsidised by the merchant's fees and others (see Feasibility report page 4).

[CONFIDENTIAL]

This real experience of Shoprite illustrates the following:

3.3.1 acquiring banks can negotiate the interchange fee with merchants;

- 3.3.2 other charges levied by the bank make up any shortfall in the interchange fee recovered, alternatively the actual cost of interchange to the bank is less than the fee;
- 3.3.3 banks raise charges on customers and merchants that clearly have little to do with the processing through NPS, and probably more due to the exercise of market power or arising out of bi- or multi lateral agreements.

3.4 **AD VALORUM CHARGES ON DEBIT CARDS**

Historically, and until the end of 2000 the originators of debit card processing at points of sale (thus the merchants), were paid a fixed transaction fee by the issuers on any debit card processed, with a minimum of R0.25 per transaction. After 2000, the *ad valorem* fee on debit card transactions payable was introduced.

This complete change probably came about as more debit cards were introduced by more banks. They then used the same principle for debit cards as is used for determining the merchant's fee on credit cards. This is an *ad valorem* charge that probably reflects a measure of the risk banks undertake in respect of credit card accounts, which is entirely absent in respect of debit card accounts (that are *akin* to savings and cheque accounts). Important is that the new charge clearly has no bearing on costs as the Banks actually previously paid merchants to process debit cards and the process now is no different to that applied before 2000. This is indicative of market power on the part of the Banks as retailers and consumers have had no choice, but to accept the changed basis of the charges (that is higher than the flat rate) and their incidence.

Shoprite believes that the current *ad valorem* fee on debit cards is opportunistic and that a fee per transaction is more appropriate given the following-

- 3.4.1 Debit card transactions are real time operations involving no risk for the Banks.

- 3.4.2 In Australia, banks currently charge an equivalent of R0.06 per debit card transaction.
- 3.4.3 The cost of processing a transaction is not based on the value of the transaction passing through the system, but rather on volume of transactions that determines the type of equipment required. A large volume requires a different magnitude of hardware to that demanded by a low volume of card transactions.
- 3.4.4 Figure 2 on page 21 of the Feasibility report reveals that Bankserv only receives R0.09 per debit card transaction. Bankserv performs most of the processing operations involving the messages sent between issuing and acquiring banks. Compared to the fees levied by the Banks (even compared to the interchange fee that is some 600% higher than the processing fee), the charges of the actual processor, Bankserv, are low, but are also probably indicative of the actual cost of the processing of a transaction (in line with the Australian example above).

3.5 **DOUBLE CHARGE**

Merchants and the cardholder are also charged fees for card transactions that apparently have no relevance to the effort and risk involved, as the same duplication of costs applies to credit and debit cards (see figure 2 on page 21 of the Feasibility report). Cases of unwarranted charges known to Shoprite are as follows-

- 3.5.1 Absa hosts an ATM service placed in merchants' premises by the firm, ATM Solutions, under the Absa banner. If an Absa cardholder uses these ATM's, he is charged an additional R2.60 for the transaction (over and above the normal bank fees). According to ATM Solutions, this is an "administrative fee" levied by Absa. The use of any card at these ATM's other than those issued by Absa, attracts no additional "administrative" charge! This makes no sense whatsoever, as any

services performed by ATM Solutions in respect of these ATM transactions must at least be the same for all cardholders. In fact, for cards issued by Absa, the cost should be less as no interchange fee involved.

- 3.5.2 Another example is that a purchase of goods, and a simultaneous cash withdrawal at Shoprite's checkouts, is charged two transaction fees to a FNB debit card holder, thus both on the sale and on the cash withdrawal, although the consumer in fact only signs one transaction slip and one message is transmitted to the acquiring bank. Shoprite has had numerous complaints from customers who are under the impression that it is Shoprite who is raising additional charges for the privilege of withdrawing cash at its checkouts. Shoprite does not levy any fees for this service.

3.6 **CASH HANDLING FEES**

Cash handling fees paid to banks are a huge expense to Shoprite (approximately [CONFIDENTIAL] per annum). These fees include the actual processing of the cash, the cash in transit charges, the insurance cover for robberies, and other in-store theft.

[CONFIDENTIAL]

A change to the Banks Act allowing retailers, or processors of cash above certain cash volumes, to process cash directly into the Resbank, would have major benefits for large retailers.

4. **CONCLUSION**

It appears from the above outline that Shoprite's experiences accord with the findings in the Feasibility report; more particularly that the fees charged to merchants and customers are not attributable to the cost of a transaction and more likely due to the fact that the

present system engenders the practice of overcharging by the banks that has little to do with the activities and operations of the NPS.

Kindly note that Shoprite claims confidentiality in respect of this submission. Should the Commission wish to raise any of the issues with other parties, kindly revert to us to obtain clearance to release such information.

Yours faithfully

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12 April 2006

Mr CG Goosen
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Dear Carel

"SORTING AT SOURCE" OF PAYMENT INSTRUCTIONS

In response to your request to start discussing the way forward on so-called "sorting at source" of debit card transactions by Shoprite Checkers, I would like to start off with a brief summary of the background to this very complex matter - before ending up with some suggestions on the way forward.

Background:

The concept of "sorting at source" is probably unique to South Africa, and is totally unknown as a term and as a practice in any other sophisticated market anywhere in the world. In all other markets the "sorting" and routing of payment instructions (generally referred to as "clearing") is the exclusive domain of regulated entities (mainly, but not necessarily exclusively banks) and is strictly out of bounds for non-regulated entities.

Sorting at source is not clearing

In essence, this is also true for South Africa, where at present only banks with a SAMOS settlement account at the South African Reserve Bank (SARB), and who have Payment Association of SA (PASA) membership (as well as membership of a specific PCH related to the payment stream in which they wish to participate), may conduct payments business and clear payment instructions.

The practice of bypassing the regulated inter-bank clearing process (including Payment Clearing House or PCH agreements and the designated PCH systems operators), and as a consequence, also the SAMOS settlement system, by certain corporates sorting these instructions and sending them directly to the issuing/ homing bank (which is defined as "Sorting at Source") is a phenomenon that crept into the South African market a few years ago - mainly in the EFT (debit order) and debit card payment streams. When the SARB started noticing this and realised both the immediate and potential long term impact of this, they in conjunction with PASA, expressed their aversion and opposition to this practice and eventually issued a moratorium on all new sort-at-source agreements between banks and corporates as from November 2004.

This same rule was also incorporated in the South African Credit Card PCH and Debit Card PCH agreements. In addition, both major card associations - Visa and MasterCard - strongly support the so-called four-party model (which is fundamental to all payment systems and which is at the core of ensuring global interoperability) - to the point where they both have successfully gone to

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court in various jurisdictions to defend this paradigm. While multiple acquiring is certainly allowed by both PASA and the card associations, the bypassing of the acquiring system itself is certainly not allowed. ?

Early this year, after taking extensive legal advice, the SARB realised that the current definition of clearing as contained in the National Payment Systems (NPS) Act, was not clear enough or wide enough to - purely of a narrow legal-technical basis - prevent sorting-at-source arrangements between issuing banks and corporates. As a consequence, the NPS Department of the SARB communicated this legal dilemma in writing to PASA in a CONFIDENTIAL letter. In this same letter, the SARB also confirmed their ongoing objection and opposition to the practice. Unfortunately, this letter somehow became known to the public - a fact that the SARB was and still is very unhappy about.

In essence, the regulatory stance by PASA and the SARB therefore remains unchanged. There is NO blanket authorisation to proceed with any sorting-at-source arrangements, and at present an investigation is in progress under the auspices of the Standing Committee of the NPS Act (which includes legal representatives from SARB, Department of Finance, PASA and selective individual from banks) with the task to propose ways of legally closing any current "loopholes" in the Act.

Dave Mitchell (head of the SARB NPSD) also has yet to formally revert to the SARP/IF representatives whom he met with late last year, in order to communicate the formal SARB position on the matter. Until this formal communication has taken place (as agreed last year), the SARB will probably not entertain any approaches from any corporates or banks in this regard.

I trust that the above summary of the current legal/regulatory background has been of some help in clarifying the current situation.

Other considerations in this regard might, however, also be worth mentioning:

Commercial/ costs implications:

One of the "promises" of sorting at source arrangements to corporates is that this would effectively by-pass the interchange fee, and either substantially lower such fees or even completely neutralise them.

While it is true that sorting at source will enable the large corporates to use their substantial "muscle" to negotiate directly with issuing banks on an individual basis, the fact is that the REAL costs and risks do not disappear or diminish. ~~In fact, the opposite is true. The whole system becomes less efficient and less effective, and economies of scale are lost.~~ Issuing banks can generally not receive transactions directly from a merchant, but only via their acquiring division or via another bank's acquiring system. As a result, the acquiring systems of each bank will still be in place, but instead of receiving one big batch of files through one acquirer, a lot of much smaller files are received via a number of acquiring systems. The economies of scale are therefore lost, and the costs must go up.

As the existing 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, the costs to accommodate only your own transactions for that particular bank would be substantially higher. This principle is true, unless the issuing bank is willing to cross-subsidise the costs to you by over-charging a less powerful competitor.

In terms of the existing Absa acquiring agreement with Shoprite Checkers, the first consequence of moving to sort-at-source arrangements would be that our merchant service fee would INCREASE (for the reasons above), and the rebate would immediately fall away (as it is based on ensuring the complete Shoprite Checkers business, not just "on-us" transactions).

Service reliability:

On a number of occasions Absa has reviewed the whole value chain for debit card processing both internally, and with your systems people. The net result of these investigations was that we could ensure very high levels of availability and business continuity for all components, except for Telkom and TSS/ EasyPay - which were not within our control. Bankserv has very stringent BCP in place (in terms of the license they get from PASA), and are also able to re-route via Visa and/or MasterCard. In the same way, Absa's acquiring systems can be backed-up by an alternate acquirer if this is a major concern. Our own internal BCP will ensure the utmost levels of availability of both the acquiring and issuing systems. (It might be worth noting in this regard that Absa's acquiring uptime for the past 12 months was 99.74% as measured by the Card Associations).

In short, moving to a sort-at-source construct will NOT improve systems reliability as two of the systems most likely to fail will not have been removed.

Other negative consequences:

Especially from a regulatory perspective, there are a number of other negative consequences resulting from a wide-spread move to sorting-at-source, which must be considered. These longer-term national-level considerations include:

- banks could follow suit, thus bypassing the regulatory environment (eg. PASA, PCH agreements, interoperability rules etc)
- settlement would take place in the interim in commercial bank currency and not in central bank currency, which means that settlement at that point is not final and irrevocable
- reporting of transactions per payment stream will be inaccurate as the settlement between banks will take place primarily via EFT (or cheques) as debit/ credit card limits are much too low
- Bankserv volumes will dramatically decline
- The whole system will become less efficient as economies of scale are lost
- Interoperability will decline, and therefore customer service levels, and the ability of banks to innovate with new products
- No "level playing fields" for all payments participants; smaller banks will be severely disadvantaged
- SME's will be severely disadvantaged as the bigger corporates will have far more market power
- Regulation will be severely hampered, and as a consequence South Africa's ability to meet the criteria of the BIS Core Requirements for Systemically Important Payment Systems will be severely compromised. As a result, the country rating could suffer a setback

In conclusion, therefore, it is our view that embarking on sort-at-source arrangements will not be desirable or beneficial either for the National Payment System as a whole, nor for the Shoprite Checkers - Absa relationship in particular.

Further, there are still some regulatory impediments in place which would not make it an immediate possibility. These include the current Card PCI rules, the current SARB registration

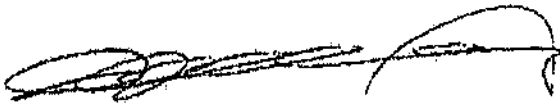
and reporting requirements (still to be defined and communicated), as well as the pending conclusion of the work of the NPS Act Standing Committee.

Our expectation of the conclusion of this process is that it would once again be prohibited within the NPS Act itself. We therefore suggest that a "wait-and-see" approach be maintained until formal communication is given by the SARB to the SARPIF representatives in this regard.

In the meanwhile, two final suggestions:

1. You are welcome to approach the SARB directly for confirmation of the status of this matter; and
2. Walter Volker is willing to meet you on a personal basis to discuss any or all of the points raised in greater detail

Yours sincerely



Louis von Zeimer

1 December 2003

Mr H A J Pelsler
Chief Operating Officer
PASA
P O Box 61380
Marshalltown
2107

Dear Hendrik

**SORT-AT-SOURCE AND THE IMPLEMENTATION OF SINGLE ACQUIRING IN
THE ELECTRONIC FUNDS-TRANSFER AND CARD ENVIRONMENT**

As a result of the investigation into the abovementioned, by the National Payment System Department (NPSD) of the Reserve Bank, and the responses received from the banking industry, the NPSD has decided to place a moratorium on all new sort-at-source developments and rollouts, with immediate effect. These developments include all processes and systems that may facilitate sorting-at-source. The moratorium will be effective while issues pertaining to a Position Paper in this regard, and/or the proposed amendments to the NPS Act, are finalised.

The main aim of the moratorium on sort-at-source, and our support for the implementation of single acquiring in the EFT and card environments, is to halt the practice where payments are off-sorted to many banks from a point, thereby eliminating any inter-bank clearing.

Should inter-bank obligations not arise from these payments, no central bank settlement can be effected via the established clearing and settlement process, nor are exposures from these payments visible to the Reserve Bank. This, in itself, impacts negatively on the soundness of the payment system.

On the other hand, the NPSD believes that the process of single acquiring in the EFT and card environments should be developed by the industry to include the dissemination of real-time information to the users of these services.

Furthermore, it is essential that the industry provide inter-operable systems where inter-bank payments can be effected via single acquiring, thereby resulting in inter-bank obligations and resultant clearing and inter-bank settlement via the SAMOS system. Single acquiring, in itself, will also require less infrastructure.

PASA is requested to disseminate this information to all affected parties operating within the national payment system, and to ensure the implementation of the moratorium. In addition, PASA is requested to provide the NPSD with regular feedback relating to the matters addressed in this letter.

Should any further information be required, please contact either Johann Bence at (012) 313 3679 or Mike Stocks at (012) 313 3497.

Yours sincerely


Dave C Mitchell
HEAD: NATIONAL PAYMENT SYSTEM DEPARTMENT



South African Reserve Bank

National Payment System Department

Confidential

2006-01-03

Mr H A J Pelsaer
Chief Operating Officer
PASA
P O Box 61380
MARSHALLTOWN
2107

Dear Hendrik

SORTING-AT-SOURCE

1. I refer to previous correspondence in the abovementioned regard including submissions by PASA, certain banks, retailers and other stakeholders in the National Payment System (NPS) and various letters issued by this department (NPSD).
2. Based on the many exchanges that have taken place regarding sorting-at-source and the varying opinions relating to its legitimacy and desirability in the NPS, the NPSD requested the Legal Services Department (LSD) of the South African Reserve Bank (SARB) to provide it with an opinion in this regard. The major conclusions which were reached in the subsequent opinion (provided to us in October 2005), in the context of this letter, are as follows:
 - 2.1 In terms of the NPS Act clearing is the domain of banks.
 - 2.2 Sorting-at-source is not clearing.
 - 2.3 There are no legislative grounds for the SARB to outlaw sorting-at-source, other than if the practice should lead to a form of systemic risk.
3. Furthermore, LSD are of the opinion that a claim that sorting-at-source will hide exposures from the NPSD does not hold water as the NPSD may call for any information it may require relating to a payment system, in terms of Section 10 of the NPS Act.

-2-

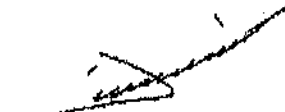
Other issues that we have considered in this regard include, inter alia, the following :

- 3.1 Sorting-at-source is a practice that was introduced into the NPS by banks, or in collaboration with banks, for various reasons, including to provide preferential treatment to customers payment instructions, to provide faster information to the customer on the results of processing (e.g. failed or successful payments) and for pricing and profit motives.
 - 3.2 Sorting-at-source arrangements may still be required within the NPS, as is evidenced by your letter dated 31 October 2006 requesting exclusion for tollgate transactions from the phasing out of sort-at-source arrangements.
 - 3.3 The EDO PCH's resulting from the Collection Forum activities will go a long way to resolving the issue of providing faster information to the customer on the results of processing of payment instructions.
 - 3.4 Consequential amendments to the NPS Act as a result of the National Credit Bill, will prohibit the preferential treatment of payment instructions in any particular payment system. The use of sort-at-source arrangements to provide such preference will, therefore, be prohibited.
4. Based on the considerations above, the NPSD has no legislative grounds to continue the moratorium placed on new sort-at-source arrangements in December 2003. However, please take note that the NPSD remains averse to arrangements that allow for the by-passing of the clearing system. Other than for reasons previously mentioned (our letter of 2004-08-23) we are concerned that the proliferation of such arrangements could lead to a distortion in the pricing of inter-bank clearing and seriously affect the ability of smaller banks to participate in the process. This could also impact on the interoperability of the payment system, a capability which is of prime importance to the NPSD.
 5. Therefore, banks that allow this practice will be required, from the end of March 2006, to register all sort-at-source arrangements with PASA. Furthermore, they are required to provide to PASA, on a monthly basis, a report per institution (customer) involved in such arrangements, as to the volumes and values processed in each different payment system for the month concerned, and any other information that may be required from time to time. The format and monthly timing of submission of such reports is to be agreed between PASA and the NPSD. This information will be used by the NPSD to monitor these arrangements and to decide on possible future action in this regard.

-3-

Kindly contact Ms Margaret Olivier or myself should you have any queries in this regard.

Yours sincerely



Dave C Mitchell
Head : National Payment System Department

"S5"

Sunday Times May 7 2006

MONEY

Getting a measure of mass banking

Richard Stovin-Bradford finds Mzansi loses to Capitec in cheapness stakes

A MAJOR thrust of The National Payment System and Competition in the Banking Sector, a report commissioned by the Competition Commission, is to question the make-up of bank charges levied on payments.

Although bank charges are currently a popular target of governments, watchdogs and consumers the world over, bankers counter that, for all their anti-bank-charge cant, few consumers do much to manage them or to seek cost-effective alternatives.

A further theme of the commission's recently released report is the imperative to improve access by under-served consumers to competitive financial services — whether these be provided by banks or non-banks.

In South Africa, the Mzansi account, launched as a low-cost product by major banks and Postbank in October 2004, was a concerted initiative aimed at attracting the then 12.4 million unbanked South Africans into the economic mainstream.

Mzansi was created in response to the Nedlac financial sector summit of August 2002.

In the subsequent 2003 Financial Sector Charter, banks undertook to provide access to first-order retail financial services within 20km of 80% of South Africans in LSM 1-5 (a measure of living standards, denoting South Africa's lower-income corners).

Ironically, Mzansi nearly did not see the light of day because the competition authorities were concerned that the banks might be colluding in setting the pricing of what was designed to be a standardised, easy-to-understand product.

Through the banks agreed on a standard interchange fee between themselves for handling payment transactions, the different pricing charged to customers put paid to concerns about anti-competitive practices.

The latest figures on the take-up of Mzansi are not available, but Postbank has been the most successful in attracting customers, followed by Absa, Standard Bank, FNB and then Nedbank.

Bankers say the Postbank take-up is distorted by its mass conversion of existing accounts to the Mzansi platform.

Though designed to have rock-bottom pricing — to the extent that it is not really profitable for the banks to operate — and though it is the most widely available basic banking product in South Africa, Mzansi turns out not to be the cheapest way of doing conventional banking.

Relative newcomer Capitec walks off with the laurels for providing the cheapest banking. Its low charges and high-interest accounts are clearly designed to attract customers away from the big four and Postbank.

Though it does not yet have the same footprint as its far bigger competitors, it has been careful to position its outlets in high-traffic areas for the entry-level segment.

Another bank that has not generated the sort of response expected is Pick 'n Pay Go Banking, which is operated as a division of Nedbank.

Ironically, Mzansi nearly did not see the light of day because the competition authorities were concerned that the banks might be colluding in setting the pricing of what was designed to be a standardised, easy-to-understand product.



	Postbank	Standard Bank	FNB	Absa	Nedbank	Capitec	Pick 'n Pay
Monthly fee	R0.00	R0.00	R0.00	R0.00	R0.00	R0.00	R0.00
Own ATM withdrawal	R0.00	R0.00	R0.00	R0.00	R0.00	R0.00	R0.00
Other ATM withdrawal	R4.75	R4.75	R4.75	R4.75	R4.75	R4.75	R4.75
Branch withdrawal	R8.75	R8.75	R8.75	R8.75	R8.75	R8.75	R8.75
Branch cash deposit	R0.00	R0.00	R0.00	R0.00	R0.00	R0.00	R0.00
Debit card purchase	R1.00	R1.00	R1.00	R1.00	R1.00	R1.00	R1.00
ATM balance enquiry	R1.00	R1.00	R1.00	R1.00	R1.00	R1.00	R1.00
TOTAL FEE	R22.00	R22.00	R22.00	R22.00	R22.00	R22.00	R22.00

NOTE: 1. Assumes all payments via cash.
 2. FNB has Pick 'n Pay ATMs where customers can withdraw cash for R1.00. If an FNB Pick 'n Pay ATM is used instead of FNB's own ATM, the monthly fee would fall to R15.00.
 3. FNB levies a card-holding fee of R50.00 for the first six months.
 4. The first branch cash deposit per month is free then other branches R10.00 and R10.00 for each subsequent deposit.
 5. Balance enquiries Absa allows two free cash per month per customer per branch. Standard Bank allows one free cash per month per customer per branch.
 6. Pick 'n Pay Go Banking is available on customers doing most of their banking at Pick 'n Pay. In such cases the monthly cost could be as low as R15, especially if deposits are made electronically and customers perform no more than four combined branch withdrawals and purchases per month, of up to R100.00 (R2.00) or all purchases (R2.00).

but uses the retailer's stores. Although Go Banking appears expensive in the example in the comparisons table, a customer whose salary was paid by electronic transfer and who performed four combined withdrawals and purchases a month at a Pick 'n Pay store would pay bank charges of only R12.

In a bid to pare costs, Mzansi's functionality — the range of operations that can be performed — was intentionally limited compared with the major banks' next tier of entry-level products, marketed as Absa FlexiSave, FNB Smart, Nedbank Transactor and Standard Bank E Plan.

Transactions on Mzansi are limited to deposits, withdrawals, shopping or cashback at shops, and balance enquiries. Interest is paid on credit balances (which cannot exceed R15 000) and there is no monthly service fee. FNB and Postbank have added debit-order functionality.

Some banks apply limits on the number of basic fee transactions that can be conducted before the costs start to ratchet up — generally more than five cash deposits or five

Curiously, for all the hype surrounding Mzansi's launch and the more than two million customers it has attracted since, bankers report surprisingly (and satisfyingly) brisk take-up of their more sophisticated entry-level products by customers initially seeking an Mzansi account.

This suggests that the greater functionality (such as debit orders for regular payments) and bundled products (such as educational disciplines or funeral cover) have real appeal in the entry-level segment.

This is confirmed by Saks Ntombola, Nedbank's retail product solutions managing director, who notes that customers appear to be prepared to pay more for the greater functionality of Nedbank Transactor.

Depending on how they used the more sophisticated account, he said they could save money over time compared with Mzansi account fees because there are no transaction limits.

However, Ntombola explained:

Mzansi products with other entry-level banking products using an average entry-level customer profile, Mzansi still turns out to be cheaper than other entry-level products.

It is this "average entry-level customer profile" that is the key to cost comparisons.

The banks create their own picture of an "average entry-level customer profile" by monitoring the transacting patterns of their own customers and those of other banks who use their infrastructure.

In a competitive marketplace, each bank naturally uses its own picture to illustrate that its proposition is cheapest.

In the comparisons table, we have used an FNB profile. Other banks will offer a different combination of typical transactions.

So, in Nedbank's case, Ntombola's own average profile for the entry-level segment shows that Mzansi is the cheapest Nedbank product, followed by Nedbank Transactor, then Go Banking.

banks — largely because its product is tailor-made for this segment.

However, the absolute cost of bank charges is not necessarily an issue to every consumer.

What is telling, given the concern raised in the Competition Commission's report, is that customers have responded so favourably to banks' pro-active marketing of their more sophisticated products (which are more profitable in the longer term for the banks).

This suggests that entry-level customers are prepared to pay for different levels of service according to the value proposition offered.

Given that much of the anti-bank charge noise in the market comes from the middle-to-upper market segments, Ntombola's affirmation that Nedbank Transactor is available to all customers — and not just to the entry-level segment — should set people thinking.

If complaints about bank charges are genuine, he and his colleagues at other banks should expect wholesale migration of customers from their entry-level products, which is most of what customers want.

Functionality holds real appeal for the entry-level users

from European Retail Round Table
(ERRT)

Global pressure on the banks and card companies

Retailers have taken different approaches to tackling card fees in different parts of the world.

- In the US, retailers brought a class action suit against Visa and MasterCard for anti-competitive behaviour in forcing retailers to accept all cards bearing the Visa and MasterCard logos and to pay artificially high prices for debit card transactions. In an out-of-court settlement, Visa and MasterCard agreed to change their behaviour, cut debit card fees and pay damages of US\$3 billion.
- In Australia, the Reserve Bank (RBA) forced Visa and MasterCard to cut their credit card fees (bringing them to an average which could be as low as 0.55% of the cost of the transaction), to increase transparency in the way fees were calculated, and to allow non-banks to enter the card market, thereby increasing competition. The RBA also said card companies should not be allowed to prevent merchants from passing on the fee to the end-consumer.
- In Europe, there have been attempts to bring about change both nationally and at EU level. In 2002, the European Commission (acting as the EU's competition authority) imposed a series of conditions on the way Visa prices its cross-border debit and credit card transactions. This was in response to intensive lobbying and legal action by Europe's retailers. The Commission ordered Visa to cut the cross-border interchange fee to an average of 0.7% for credit transactions and to an average flat rate of €0.28 for debit transactions. This is the wholesale price of a transaction and makes up most of the fee paid by the retailer.
- In the UK, the Office of Fair Trading (OFT) has issued preliminary conclusions which go the furthest so far towards dismantling the anti-competitive pricing structure used by the card schemes. The OFT described the interchange fee as a 'tax on retail transactions'. The OFT says the merchant should not be paying for two of the three services bundled in MasterCard's interchange fee, namely the interest-free period and the payment guarantee. It also regards the level at which the interchange fee is set as anti-competitive. Providing MasterCard does not persuade the authorities otherwise, the final decision, which is due any time now, will become a benchmark for future European efforts to effect change.

The interests of the card companies:

*The joint market share of Visa and MasterCard is about 80%.
Visa's global sales volume was US\$2,4 trillion in 2002;
MasterCard's was US\$1,14 trillion; a total of over US\$3,5
trillion: that's US\$3,500,000,000,000.*

Building a coalition to get a better deal

- The European Commission decision in 2002 delivered some real benefits, but it does not go far enough. First, it covers only cross-border transactions. Second, it allows the interchange fee covering three categories of service to continue because the Commission believes these are of benefit to merchants.