Chapter 3

Costing and Pricing

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3.1 Introduction and synopsis

The tendency of South African banks to charge a fee for almost every service associated with a bank account sets them apart from banks in many other countries.

In a 2005 study for the FinMark Trust, in which South Africa was compared with India, Kenya, Malaysia, Mexico, and Nigeria, it emerged that South Africa was the only country that charges a fee for cash deposits and one of only a few that charges a fee for branch and ATM cash withdrawals.[1] When compared with developed countries, a similar picture emerges. For example, in the 2004 Task Group Report (Falkena III), it was noted that South African banks charge a fee for transaction services for which there is no explicit fee in many other countries.[2]

The charging of an explicit price for a service is generally a desirable practice insofar as it conveys useful information to consumers. This can be contrasted with a situation where services that are not directly charged for are subsidised by revenue collected from the consumer in other ways. That can lead to inefficient outcomes as it may convey misleading information to consumers.

We note that the mere absence or presence of an explicit price for a service does not say anything about whether or not competition is effective with respect to the provision of that service. A service which appears to be free may convey misleading information to the consumer about the true cost of the service. However, an explicit price may be either higher or lower than the competitive price, also conveying misleading information to the consumer.

In a competitive market consumers should be able to make rational choices on the basis of appropriate price signals. This is because effective competitive pressure tends to align the incentives of producers with the preferences of consumers. In particular, this balancing of consumer and producer interests should result in an efficient allocation of resources in which the price reflects both the value of the service to the consumer and the underlying costs associated with providing the service.

In our analysis of market power in chapter 2, we have shown that the banks do not compete fundamentally on price and that clear price signals are very difficult for customers to obtain.

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1 GENESIS: "An inter-country survey of the relative costs of bank accounts", 14 March 2005, p 36. (Quoted in Absa, October 2006, First Submission, Annex 4, p 22).

2 *Task Group Report for National Treasury and the South African Reserve Bank, Competition in South African Banking,* April 2004, pp 114-115. Certain transaction services, associated with cash deposits, cash withdrawals, statements, account payments, debit orders, and returned cheques were identified. South Africa was compared with the United Kingdom, Ireland, the USA, Canada, Singapore, New Zealand, Australia, and Switzerland to determine which country does or does not levy a charge for each transaction service. South Africa was the only country in which charges are levied for each and every transaction service identified. See also the Appendix on Updated statistics in Task Group (Falkena III) report .

With a view to assessing whether or not competition is effective as far as the provision of retail banking and/or payment services is concerned, the terms of reference of the Banking Enquiry required us to address the following subject matter:

- The relation between the costs of providing retail banking and/or payment services and the charges for such services
- The process by which charges are set
- The level and scope of existing and potential competition in this regard.

In this chapter, we focus on the first two points above, and not the level and scope of fees and charges. However, subsequent chapters of this report are devoted to particular pricing issues such as ATM and penalty fees, and their impact on consumers.

We commence (section 3.2) by providing an overview of the charging practices of the banks. In this regard we look at the pay-as-you-transact and bundled packages of the banks and examine the fee structures applicable to them. We find considerable price complexity in the fee structures of the banks, who apply a combination of *ad valorem* and flat fee formulas. Although bundled packages with fixed fees are easier to understand for consumers, they are currently differentiated to such an extent that comparison is almost impossible. Further, complex pay-as-you-transact pricing is applied to bundled packages for transactions which exceed the limits set by the bank providing the package. Such transaction pricing is also applied to transactions which the bank does not include in the bundle.

Next we examine the process by which charges[3] for personal transaction accounts are generally set. Section 3.3 deals with unbundled options and section 3.4 with bundled options). We find that pricing decisions of the banks are driven by a number of considerations but are generally constrained only by what the customer will bear. Competition is not driven by price but rather by strategic positioning on the basis of differentiated product offerings, the prices of which are difficult to compare. In particular, the banks employ a strategy of differentiated packaging that seeks to segment customers into groupings based largely on patterns of usage and divided on the basis of income levels and ability and willingness to pay. In this regard each bank will conduct market research and, on the basis of their understanding of customer preferences and behaviour, will implement price structures and set price levels which they calculate will maximise profit generated from these customers in the medium to longer term.[4]

We go on to examine the relationship between the costs of providing transaction services and the charges for those services (section 3.5). We find that banks do not consider per transaction costs in the setting of transaction fees. Until recently, most of them have been

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3 The terms charges, fees and prices are used interchangeably.

4 See the analysis of oligopoly behaviour in Chapter 2.

either unable or unwilling to find out what these costs are. We find that – while there may be objective difficulties of measurement and interpretation arising from the high fixed and common cost nature of multi-product banking – the fact that the banks have not had direct reference to the costs of transactions in the setting of prices reinforces our conclusion that they are sheltered from effective price-competitive pressure.[5] The fact that banks in South Africa have not been subject to vigorous price competition explains, in part, why they have had little or no interest in determining costs at the transaction level – and why fees for transaction services do not bear any identifiable relation to the costs of providing those transaction services.

3.2 Overview of charging practices of the banks

Banks offer an array of transaction accounts and pricing options to consumers. Transaction accounts are broadly divided into current (i.e. cheque) accounts and transmission accounts. The services provided by these transaction accounts generally include:

- Receiving deposits either from the customer directly or indirectly by receiving payments to the credit of the customer from third parties (whether by cash, cheque, or electronic transfer)
- Repaying funds deposited, either directly to the customer (e.g. by cash dispensing through an ATM or otherwise) or indirectly by way of payments to third parties on the customer's behalf.

The pricing structures on each of the transaction services within the transaction accounts, as well as the pricing packages for transaction accounts themselves differ greatly. There are two main transaction account charging packages.

3.2.1 Unbundled (pay-as-you-transact) options

With this option the bank charges a fee per transaction or service. The structure of the fee – i.e. whether it is a flat fee or an *ad valorem*[6] fee – will depend on the type and value of the transaction. There will also usually be other basic charges, like subscription fees and monthly account fees, which do not directly relate to transactions on the account.

3.2.2 Bundled package options

Most package options offer a specified bundle of transactions for a fixed fee. Limits are placed on the type and number of transactions included in the bundle. If the allowed number

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5 Under effective competition the banks would surely need to better understand per transaction costs to determine whether internal resources are being allocated efficiently.

6 A fee paid according to the value of the transaction.

of transactions is exceeded there will be additional charges. Transactions which are excluded from the bundle (e.g. in many instances off-us ATM withdrawals) are available to the consumer but are charged on a pay-as-you-transact basis. Some banks offer packages where a specified bundle of transactions are provided 'free' for as long as the customer maintains a minimum balance in their account.[7] If the balance falls below the required minimum, per transaction charges are applied.

3.3 Pricing of unbundled options

Banks apply a number of different pricing formulas. Transactions are charged on a flat fee basis, an *ad valorem* basis, or on a banded fee basis. There are certain accounts offered by banks which charge a monthly account administration fee in addition to charging on a per transaction basis. We describe each type of pricing formula below.

3.3.1 Flat fees

A flat fee simply refers to a fixed amount that is charged per transaction. For example, Absa Flexi Account holders are currently charged a flat fee of R5.50 for external debit orders.[8] The fee stays the same for each debit order transaction, regardless of the value of the transaction.

For some accounts a tiered flat fee structure applies whereby a limited number of transactions are charged at a lower flat rate per transaction, after which a higher flat rate applies per transaction for all subsequent transactions beyond the limit. This penalty applies in varying degrees to specified transactions on the Mzansi accounts provided by the banks.[9] For example, for Absa Mzansi Account holders in 2006 the following transaction limits applied:

> You are allowed 5 credit transactions for depositing money into your account (e.g. cash deposits or transfers into your account) and 5 debit transactions for using the money in your account (e.g. cash withdrawals or debit card purchases) per month on your Absa Mzansi account.
>
> From the sixth debit or credit transaction onwards you will be charged the normal transaction fee plus R12.50 per transaction.[10]

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7 This option is not truly free because the customer will forgo the interest that would have been earned had the money been placed in an account that does earn interest.

8 Absa 2008 Pricing Brochure, Absa Flexi Account, p 7. By an "external debit order" we mean one where the beneficiary is a customer of another bank.

9 Mr. Rowlinson of Wizzit pointed out "I have never heard of a product ...that penalises you for use. [With Mzansi], you get your first few transactions really cheap and or nearly free, but if you go and do ten transactions a month, you [are] actually penalised to the extent that those extra five are more expensive than [charges on] one of the traditional accounts." Transcript, 9 November 2006, p 167.

10 Absa 2006 Pricing Brochure, Absa Mzansi, p 2.

3.3.2 *Ad valorem* fee structures

Under an *ad valorem* formula the fee will increase as the value of the transaction increases. There are three different *ad valorem* pricing formulas that can be applied.

Three-part formula

Most *ad valorem* fees have a three-part formula that consists of:

- A minimum fee
- A value-related fee
- A maximum amount that can be levied.

The second part of this formula, the value-related fee, can either be inclusive of the first R100 paid or exclusive of that first amount. To illustrate:

Table 1 Three-part *ad valorem* fee

	Absa Flexi Account - ATM withdrawal	SBSA Classic Current Account - Debit orders
Pricing structure	R 3.00 / R0.60/ R 12.50	R3.25 / 1.10% / R29.00
Result	R3.00 for the first R100 withdrawn;	R3.25;
	R0.60 for each subsequent R100 withdrawn (or part thereof); and	Plus 1.1% of the value of the transaction
	A maximum charge of R12.50 which can be levied per transaction.[11]	A maximum charge of R29 which can be levied per transaction.[12]

Source: Pricing Brochures, 2008.

Two-part formula

In a two-part *ad valorem* formula only the following apply:

- A minimum fee
- A value-related fee.

The third element in the three-part formula is not shown, and this means that no maximum fee limit will be applied per transaction. Once again the second part of this formula, the value-related fee, can either be inclusive of the first R100 paid or exclusive. For example, see Table 2.

11 Absa 2008 Pricing Brochure, Flexi Account, 2008, p 6.

12 Standard Bank 2008 Pricing Brochure, Classic current account.

Table 2 Two-part ad valorem fee

	Absa Flexi Account - ATM deposits	SBSA Classic Current Account – Autobank withdrawals
Pricing structure	R0.90 / R0.90	R3.25 / 0.95%
Result	R0.90 for the first R100 deposited; and	R3.25;
	R0.90 for each subsequent R100 deposit (or part thereof).[13]	Plus 0.95% of the value of the transaction.[14]

Source: Pricing Brochures, 2008.

One-part formula

In other cases a simple one-part *ad valorem* formula applies. For example, an Absa FlexiSelect account holder wishing to make a branch counter deposit will be charged 1.05 per cent of the deposit value.

Other *ad valorem* formulas

In the above examples we have used the Absa Flexi Account transaction account products to illustrate the application of standard one-part, two-part, and three-part *ad valorem* formulas. Standard Bank and Nedbank apply similar *ad valorem* formulas in their pricing structures, although not necessarily for the same transaction types. [redacted].[15] Confidential: FRB

In addition to applying the standard *ad valorem* formulas discussed above, Nedbank also applies its own, somewhat different, *ad valorem* formulas to certain transactions. For example, in the Nedbank pricing brochure for 2006/2007 the following formula is applied to cash deposits:

R1.10 / R10 min R10; which means, according to Nedbank:

> ...you will pay R1.10 per R100 or part thereof, with a minimum of R10. To illustrate: on a R750 cash deposit you will pay: (R1.10 X 8) = R8.80. However, the minimum applies and you will therefore pay R10.[16]

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13 Absa 2008 Pricing Brochure, Flexi Account, p 6.

14 Standard Bank 2008 Pricing Brochure, Classic current account.

15 FNB, March 2007, Second Submission, Response to Data Request Part A, pp 2-3.

16 Nedbank 2006 Pricing Brochure, p 5.

Other formulas are also applied which mix a flat fee with an *ad valorem* formula. For example, a Nedbank Ordinary Current Account holder (in 2006/2007) was charged according to the following formula for a Nedbank ATM cash withdrawal:

R2.85 + R0.90 / R100; which means:

- R2.85 per transaction, plus
- R0.90 per R100 or part thereof.

Absa applies the following formula to off-us[17] ATM withdrawals on FlexiSelect Accounts: R6.00 + R3.00 / R0.95; which means:

- R6.00 per transaction, plus
- R3.00 for the first R100 withdrawn, and
- R0.95 for each subsequent R100 withdrawn.[18]

3.3.3 Banded fee options

FNB has argued that the three-part *ad valorem* formula is not well understood by customers. In order to simplify pricing for their customers FNB replaced the three-part formula with a banded fee for certain transactions.[19] For example, in November 2005 FNB introduced the following three-band formula for FNB ATM cash withdrawals:
R5 | R10 | R15; which means:

- R5 for up to R500 cash withdrawal
- R10 from R501 to R1000 cash withdrawal
- R15 for more than R1001.[20]

Banded fee options like this have not, as yet, been adopted by the other banks.

FNB also stated that:

> It is likely that a banded fee option will be retained for ATM Cash Withdrawals, as the reduced fee charged to customers making smaller withdrawals encouraged usage by account holders who would not otherwise use ATMs.[21]

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17 " Off-us" in this context refers to a withdrawal from another bank's ATM. Absa refers to this in its pricing schedule as a "Saswitch ATM" cash withdrawal.

18 Absa 2008 Pricing Brochure, FlexiSelect, p 15.

19 FRB, March 2007, Part A Data request , pp 2, 3, 4, and 5.

20 *Id.*, p 4.

21 *Id.*

Nevertheless, revenue per transaction on FNB ATM cash withdrawals increased by [redacted] per cent following the introduction of the banded formula.[22] Confidential: FRB

We now examine the banks' rationale for adopting *ad valorem* pricing formulas.

3.3.4 Rationale for *ad valorem* pricing formulas

In February 2007, the Enquiry Technical Team addressed a number of questions to the four biggest banks regarding *ad valorem* fee formulas.[23] In addition to providing detailed information regarding *ad valorem* fee formulas, the banks were asked to explain:

- Their rationale for applying *ad valorem* formulas to particular transactions.
- The implication for each bank of changing from an *ad valorem* formula to a simple or flat fee formula.
- Why it would not be feasible to change from an *ad valorem* formula to a flat fee per transaction.

In their submission, Absa identified three main factors to justify the use of an *ad valorem* pricing mechanism:

[redacted] Confidential: Absa

(1) [redacted]

(2) [redacted]

(3) [redacted].[24]

[redacted][25] [redacted].[26] [redacted] Confidential: Nedbank

22 *Id.*, p 6.

23 Competition Commission Data Request Part A. Addressed to Absa, Standard Bank, FNB and Nedbank. February 2007. Question 5 Regarding *ad valorem* formulas.

24 Absa, March 2007, Second Submission, Data Request Part A, p 12.

25 "*Ad valorem* pricing prevents subsidisation of wealthy customers by lower income customers." Standard Bank, June 2007, Second Submission, Costing and Pricing, p 5.

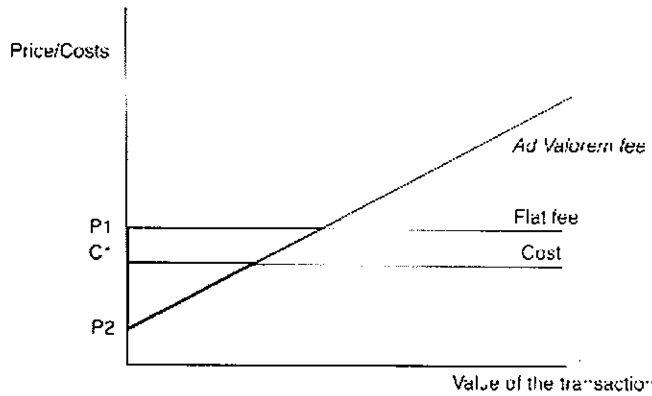
26 [redacted] Confidential: Nedbank

Confidential: Nedbank

[redacted].[27] FNB has over time changed most of its *ad valorem* fees to flat fees or banded fees, stating that customers better understand banded or flat fee formulas. They do, however, argue that with certain transactions, where risks and costs increase with the value of the transactions, flat fees would not be feasible.[28]

The subsidisation argument, which the banks claim as a consumer welfare justification for *ad valorem* pricing, implies that in the absence of an *ad valorem* formula and in the presence of a flat fee structure, the current pricing to low income customers would not be sufficient to cover the costs of providing the services to those customers. Accordingly, a higher flat fee would have to be charged for low value transactions. The concomitant implication is that, at least in respect of transactions where transaction costs do not vary significantly with value, *ad valorem* prices for low-value transactions are generally set below cost. This is illustrated in the figure 1.

Figure 1 Flat fee vs. *ad valorem* fees



The banks' subsidisation argument, regarding the application of an *ad valorem* fee structure, seems to imply that for low value transactions, the cost of the transaction is above the prices charged to those consumers (i.e. C1>P2). The application of a flat fee would require a price higher than the current price charged for low value transactions (i.e. P1>P2).

However, the banks have not provided any costing information to substantiate this. We therefore cannot accept the subsidisation argument implicit in the banks' consumer welfare justification for *ad valorem* pricing, plausible though it may sound. Given the presence of market power in the provision of personal transaction accounts, it may well be the case that

27 Absa, March 2007, Second Submission, Part A Data Request, p 11. In some instances, low-income customers prefer to make only a few high value transactions. See Transcript 4 April 2007, p 21, where Capitec point to the difficulties of steering client behaviour away from withdrawing all their funds on pay-day.

28 FNB, March 2007, Second Submission, Part A Data Request, pp 3 and 6.

even the lowest *ad valorem* prices applied are enough to cover those transaction costs that are not value-dependent. Furthermore, it is likely that at current *ad valorem* fee levels in respect of such transactions, customer preferences regarding high value and low value transactions would be distorted relative to what one would find in a competitive market.

We find that there is not a straightforward relationship between the pricing formula applied and the benefit to the consumer. It would be naïve to accept that banks are driven simply by consumer welfare objectives when deciding what pricing formula to apply. In this regard it is instructive to examine the response of the banks to the question of the implication and feasibility of a shift from an *ad valorem* formula to a flat fee.

In its submission of 10 August 2007 Standard Bank confirmed that there is no simple answer to this question. Regarding the revenue implication for the bank of such a change, banks noted that the impact could be either positive or negative depending on the level at which that flat fee is set. If the flat fee is set at a level higher than the current average fee value then the revenue of the bank will increase. However, if the flat fee is set at a level that is lower than the average fee value then revenue to the bank will decrease, all else equal.[29]

Unfortunately none of the banks was able to quantify the impact on revenue of a shift from an *ad valorem* formula to a flat fee formula. As noted by Absa in its submission: "the amount by which customer fees for low transaction amounts would increase, the impact on customer transaction behaviour, and hence the precise magnitude of the impact on Absa's revenues will depend on factors including the pricing structure and level of competitor offerings and customer reactions to changes in fees".[30]

We do not suggest that *ad valorem* pricing is never appropriate. Competitive, cost-related pricing would itself imply that price would vary with transaction value in respect of those transactions where cost varies with value. But in that case, a subsidy would not enter into the variations in price.

[redacted] Confidential: Nedbank

Standard Bank points out that the transaction costs and risks of cash and cheque withdrawals and deposits at the branch are directly related to the underlying transaction value and tend to increase as the transaction value increases. Therefore, for these transactions a flat fee would not be appropriate.[31]

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29 Standard Bank, August 2007, Part A Data Request, question 5.

30 Absa, March 2007, Second Submission, Part A Data Request, 2007, p 17.

31 Standard Bank, August 2007, Part A Data Request, question 5.

While not referring explicitly to risk considerations regarding the application (or not) of an *ad valorem* formula, FNB stated:

> ... ATM cash withdrawals, branch withdrawals and deposits, could NOT feasibly be charged at flat fees. Under a flat fee system, the average fee paid would have to increase above the current average paid in order to maintain revenues that cover the fixed costs of providing these services. A flat fee at the current average rate would not be sufficient due to the decline in transaction volumes that would result from some of those customers previously paying the discounted rate for low value transactions not being willing to pay the higher flat fee.[32]

As we have pointed out, in the absence of adequate costing information from the banks we are unable to accept the bald assertion that the average flat fee paid would have to increase in order to cover fixed costs. Nevertheless, we accept in principle that *ad valorem* pricing may well be appropriate in instances such as those pointed out above where transaction costs obviously rise with transaction value. Whether or not it might be acceptable in other cases would depend upon *first* establishing reliably what a competitive cost-related price for the transaction would be, and *then* considering the consumer-welfare argument for differentiating between customers based on their ability to bear the true cost burden. No bank has put us in a position to make such an evaluation, and we remain unconvinced by the consumer-welfare argument advanced.

FNB acknowledges that for certain transaction types the demand for low value transactions is very price elastic while the demand for high value transactions is relatively price inelastic. The *ad valorem* fee also has the effect of "creating demand by charging less for small value transactions".[33] The *ad valorem* formula is therefore a mechanism by means of which banks price-differentiate between low value transactions and high value transactions based on the different price elasticities of demand for these transactions, irrespective of differences in cost between low value and high value transactions. That they are able to do so is itself a manifestation of a degree of market power, or, put differently, of the degree to which they are sheltered from simple and direct price competition in respect of each of these services.

A bank's decision on whether or not to shift to a flat fee would depend on the extent of revenue losses arising from reduced volumes of low value transactions. This reduction in volumes would be due to the increase in the fee for low value transactions that would be required to bring the level of revenue generated from the flat fee on par with *the current level of average revenue* (which is not to be equated with the average level of costs). If there are economies of scale the loss of volumes of low value transactions would push up average costs – thus reducing profitability (or potentially leading to losses) for the bank.

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32 FRB, March 2007, Second Submission, Part A Data request, p 6.

33 *Id.*, p 3.

Calculating the magnitude of loss or profit arising from a move to a particular flat fee for a particular transaction would require knowledge of the average cost of that transaction. However, as will be discussed subsequently in this chapter, the banks have submitted that they do not set fees on the basis of per transaction costs. Rather, fees are reviewed with reference to the overall revenue generated from the customer's entire transaction basket. To repeat, without reference to the cost of the transaction one cannot say what level for the flat fee would be sufficient to cover costs. Given the presence of appreciable market power on the part of the banks it is likely that the prevailing average fees under *ad valorem* structures for particular transactions are above competitive levels. Any change to a flat fee structure would thus result in a fee that would be high relative to the competitive benchmark so long as the banks are able to exercise market power in their pricing decisions.

The claimed benefit of *ad valorem* pricing to lower income customers transacting on standard transmission accounts – the claim that such pricing enables the banks to reduce the charges faced by such customers[34] – is not reflected in the actual pricing structures applied by the big four banks (see Table 3). In the table, the first four accounts (Absa's Flexi account, Standard's EPlan, FNB's Smart account and Nedbank's Transactor account) are low income customer accounts. The application of *ad valorem* fee structures, bundled pricing options and banded fee options takes prominence in the middle to higher income products, not readily available to the low income and low-middle income customers. Hence lower income customers do not benefit from these pricing initiatives.

Table 3 Flat fees vs. *ad valorem* fees

	Cash withdrawals from Own ATM	Electronic account payments	Debit Orders External (Furniture/ HP/Car/Loans)	Debit Card Purchase
Absa Flexi Account	*Ad valorem*	Flat	Flat	Flat
Standard Bank E-Plan	Flat	Flat	Flat	Flat
FNB Smart Account	*Ad valorem*[35]	Flat	Flat	Flat
Nedbank Transactor	Flat	Flat	Flat	Flat
Absa Silver Current account	*Ad valorem*	Flat	*Ad valorem*	*Ad valorem*
Standard Bank Classic Current account	*Ad valorem*	*Ad valorem*	*Ad valorem*	*Ad valorem*
FNB Personal Cheque Account	*Ad valorem*[35]	Flat	Flat	Flat
Nedbank Current account	*Ad valorem*	Flat	Flat	Flat

Source: Pricing Brochures, 2007/08.

[34] See e.g. Absa, March 2007, Second Submission, Part A Data Request, p 12; Standard Bank, June 2007, Costing and Pricing, p 5.

[35] This is a banded fee, and changes with the value of the transaction. Hence this cannot be seen as a flat fee.

For example, in the case of Mzansi Accounts, ATM withdrawals are priced on a flat fee basis at a lower price for a limited number of transactions and at a higher price for subsequent transactions. Absa notes that the flat fee on Mzansi ATM cash withdrawals is "to ensure Financial Sector Charter compliance". Absa also applies a flat fee for cash withdrawals on the Mega Save account to "ensure affordability for youth market customers".[36] Both Mzansi and Mega Save account holders are likely to be low-income customers. This does not reconcile with their earlier arguments advanced regarding the benefits of *ad valorem* fees.

Standard Bank applies a flat fee to its low income Mzansi and E Plan customers. However, unlike Absa, the majority of Standard Bank's current account customers are on bundled packages where neither *ad valorem* nor flat fee structures apply. FNB argued that a banded flat fee formula benefits consumers because it is easier to understand than an *ad valorem* formula and "the reduced fee charged to customers making smaller withdrawals encourages usage by account holders who would not otherwise use ATMs".[37]

While an *ad valorem* structure may result in a lower unit charge for low value transactions, it does not necessarily lower the overall cost and utility to customers of doing transactional banking. There are a number of reasons behind this:

- The *ad valorem* formula contains a built in mechanism for fees to increase over time with inflation. As average transaction values rise, *ad valorem* fee revenue rises per transaction without the fees having to be explicitly raised. While this generates more revenue for the banks it is harmful to consumers who end up paying more in fees. In its submission FNB acknowledged that average revenue from *ad valorem* based fees increases over time as transaction values increase with inflation. So if the *ad valorem* fee remains unchanged, average revenue will increase with inflation.[38]
- An *ad valorem* structure is likely to increase the demand (and thus volume) of low value transactions relative to high value transactions. This will not necessarily lower the cost to the consumer. For example, it is possible that an increase in the number of low value transactions relative to the number of 'high value'[39] transactions could be more costly for consumers. The outcome here would depend on consumers' behaviour, preferences and incentives regarding the optimum number of transactions to minimise overall costs.
- *Ad valorem* fee structures are not always understood properly by consumers, who may end up making sub-optimal decisions.

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36 Absa, March 2007, Second Submission, Part A Data Request, p 13.

37 FRB, March 2007, Second Submission, Part A Data request, p 4.

38 *Id.*, p 5-6.

39 Simply because a transaction is classified as high value does not mean that a low income consumer will not want to make it. For example, a low income consumer who earns R2000 a month may prefer to make a single withdrawal of R1000 rather than a number of smaller low value transactions.

- While the *ad valorem* structure may well result in a lower unit charge for low-value transactions, low-income customers are not afforded this benefit.

3.3.5 Findings regarding pay-as-you-transact fee structures

We have recognised that there may be potential benefits for consumers in *ad valorem* fee structures insofar as they may prevent high income customers from being subsidised by low income customers in cases where transaction costs do increase with transaction values. However, as explained above, in the absence of costing information the banks' consumer welfare justification for *ad valorem* fee structures has not been substantiated.

The *ad valorem* fee formulas (especially the three- and two- part *ad valorem* formulas) of the banks have tended to be complicated and are often not well understood by consumers and thus potentially convey misleading price signals to consumers. Although there has been some movement to introduce simpler fee structures this problem still remains.

The sheer number of transaction types that are charged on a pay-as-you-transact basis and the variety of formulas applicable to each of them further complicate choices for consumers. In particular, it is very difficult for consumers to calculate the total cost for their entire transaction basket without detailed and predictable information about their expected transaction usage and without a proper understanding of the various pricing formulas. As we have found ourselves, this process of estimation and calculation is difficult and time consuming. It is therefore not surprising to find that South African consumers are not well informed about what they pay in bank charges. It is also not surprising to find that their choices are largely driven by considerations other than price.[40]

We find that overall the existing pay-as-you-transact options and applicable pricing structures have not been conducive to effective competition and have tended to support the maintenance of prices at above competitive levels. It has been shown in the chapter on market power that despite benefiting from economies of scale, the banks have failed to pass these unit cost savings through to lower prices.

The results of international fee comparison studies like Capgemini[41] and the Monitor Report[42] also reveal interesting results regarding the impact of pay-as-you-transact pricing structures on product level prices. Capgemini based its study on unbundled pay-as-you-transact current account products and found that fees paid *per annum* by South African current account customers on this basis were approximately double the international average.

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40 See the chapter on Market power for a discussion of the evidence in this regard.

41 Capgemini, World Retail Banking Report, 2007.

42 Monitor Group, Competitiveness Report, 2006.

The fee comparison study in the Monitor report was also based on unbundled pay-as-you-transact products. Like Capgemini, Monitor found that South African banks' pricing was high in relation to other countries.

The South African banks criticised the validity of these reports on a number of grounds. Among other things the Capgemini and Monitor reports were criticised for failing to take into account the bundled or package fee options of the banks. However, information obtained through the submissions to the Enquiry and Technical Team meetings with the banks indicate that the majority of customers at the big four banks are on pay-as-you-transact options,[43] not on bundled or package fee options. Moreover, the criticism does not adequately answer the point. It appears to be acknowledged that unbundled or pay-as-you-transact pricing structures have involved higher fees being paid on average by customers transacting on that basis.

In the next section we examine the package fee options of the banks and assess whether or not the pricing structures associated with bundled options are conducive to more competitive and affordable transactional banking.

3.4 Pricing of bundled options

For this option the bank charges a fixed monthly fee for a bundle of transactions. For each package the bank will specify the type and number of transactions included in the bundle. The customer is charged on some or other pay-as-you-transact basis for transactions exceeding the number allowed. For those types of transactions not included in the bundle the customer will also be charged on some or other pay-as-you-transact basis. For some packages the standard pay-as-you-transact fees are applied for transactions not included in the bundle whereas for other packages special charges are applied.

Table 2 in Chapter 2 shows a comparison of bundled current account options with the pricing and the terms and conditions applicable to each of them. Given the value proposition of the bundles provided by the big four banks, uptake of the bundles seems to be very low.[44] The bundled packages have the benefit of a single monthly fee for a basket of transactions and this simplifies to some extent the calculation required to determine the customer's total monthly cost of banking. Also, because the transaction bundles are structured around defined profiles of customer behaviour they have the potential to be less costly for customers whose behaviour falls within the parameters of those profiles.

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43 SBSA is the leader with regards to the provision of packaged options. Yet according to the data provided by SBSA (June 2007, Costing and pricing, Appendix 1) only 8,6 per cent of all their personal transaction accounts are packaged options. We do not have information regarding what percentage of accounts of FNB and Absa are bundled and what percentage are unbundled[redacted] (Nedbank, May 2007, Second Submission, Part A Data Request). Confidential: Nedbank

44 Information provided regarding the number of personal transaction accounts in the banks' Submissions, March 2007, Costing and Pricing.

In criticising the Capgemini report, Standard Bank stated that its bundled current account customers paid 45 per cent less than the international average claimed by Capgemini.[45] Standard Bank claims it has had success with packages – over 60 per cent of its existing current account customers use bundled options.[46] However, it appears that bundled options are not available to basic saving and transmission account customers – the overwhelming majority of the bank's account holders. Only 8,6 per cent of the total number of personal transaction accounts at SBSA are bundled.[47]

The result is that the customers most in need of the cheapest transaction options facilities are not provided with them. We tested whether or not a bundled option would be cheaper than the unbundled pay-as-you-transact option for a particular profile.

We could only carry out this test on a current account as this is the only account type where bundled options are provided. Standard Bank Classic current account customers choosing the bundled option typically carry out more transactions than those choosing the unbundled option and do so for much lower aggregate fees. If a pay-as-you-transact customer carried out all the transactions provided for in the bundle, the monthly fee would be more than R700, compared to the bundled fee of R80 per month according to SBSA's 2008 pricing brochure. Not surprisingly, bundled customers tend to be less constrained in the number of transactions they perform relative to pay-as-you-transact clients.

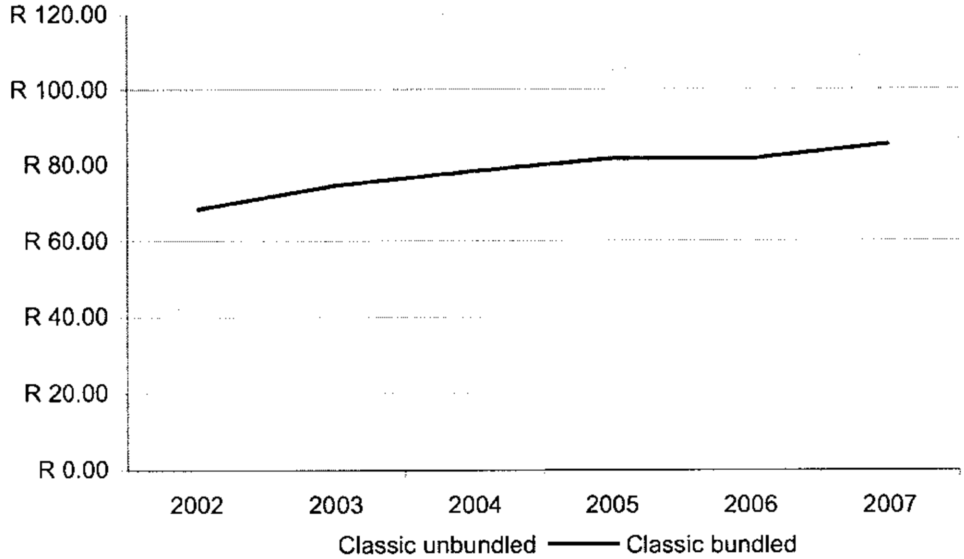
The following graph shows fees, based on a median profile, as paid by customers of Standard Bank's Classic bundled and unbundled options:

45 SBSA, August 2007, Response to Outstanding Issues Raised by the Banking Enquiry, Annexure 7, p 1.

46 SBSA, June 2007, Costing and Pricing, p 5.

47 See SBSA, June 2007, Costing and pricing, Appendix 1.

Figure 2 Total cost to customer: bundled versus unbundled options



Source: SBSA, August 2007, Response to outstanding issues raised by the Banking Enquiry, Annexure 4.[48]

In chapter two, we have shown how the product offerings between the big four banks are differentiated to such an extent that it is difficult to compare them. On top of these difficulties, customers, even within a single bank face difficulties in choosing the most cost effective product offering. Capitec, for example, referred to the difficulty associated with comparisons:

> Many complaints are lodged by the public about high bank fees. More simplified comparative models may be needed to enable financially unsophisticated clients to compare bank fees.[49]

Customers who exceed the limits imposed on a bundle or who make transactions not included in the bundle can end up potentially paying much more than the fee charged on a pay-as-you-transact basis. (See Table 2 in the chapter on Market Power.) A customer who selects a package which turns out to be unsuitable for his or her purpose could end up being severely penalised as a consequence of charges incurred for out of bundle transactions. Customers transacting on packages incompatible with their needs can also end up paying for items that are never used.

Given the presence of search and switching costs consumers cannot easily switch to more appropriate packages. This implies greater costs for consumers but potentially increased revenue for banks. It is important that high standards are set for transparency and disclosure and that measures are introduced to improve comparability of bundled options.

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48 SBSA, August 2007, Response to Outstanding Issues Raised by the Banking Enquiry, Annexure 4.

49 Capitec, October 2006. First Submission, p 22.

3.5 The process by which charges for transaction services are set

In their submissions the banks have pointed to a bewildering variety of factors, some of them overlapping, that are taken into account in setting prices:

- Competitive environment
- Typical customer transaction profiles
- Price signals to customers
- Customer education objectives
- The economic and social environment
- The regulatory framework
- The social and Financial Sector Charter objectives
- Cost recovery and cost recovery method per customer
- The convenience provided to the customer
- Client's needs
- The need to meet shareholder expectations
- Competitor activity in new product design
- Pricing of existing products and services
- Competitors' market shares
- The life stage of the customer
- The channels to be used
- Value to client
- Market level
- Product and market maturity
- Price transparency
- Minimize complexities
- Client behaviour
- Total cost paid by the customer.

The banks announce their fee changes to the public on an annual basis. Standard Bank announces their annual fee changes in January, Absa in April, and Nedbank and FNB in July. The new fees will usually become effective for customers at the beginning of the month after the fee changes have been announced.

Each bank usually has an executive committee which manages the price setting process and decides on the level and structure of fees. These pricing committees consist of representatives of different business units who make inputs regarding the relevant cost, revenue, and strategic interests of their business units. The committee is responsible for making sure that these interests are balanced, consistent, and aligned with the overall pricing principles and strategy of the bank.[50]

3.6 Value-based pricing

The on-line *Investopedia* (a Forbes Media publication) defines value-based pricing as a pricing strategy in which a product's price is actively dependent upon its demand. "This method of pricing allows companies to take advantage of highly demanded products by charging more. A good example is how refreshments generally cost more at sporting events."[51]

Stated more generally, value-based pricing occurs where the firm's product is not readily substitutable by other products or by the offerings of other firms.

Value-based pricing is distinguished conceptually from both cost-based pricing and pricing that is competition-based. It depends either on the absence of rivals or on the good or service being sufficiently differentiated from its rivals so as to enable a degree of market power to be exercised in the supplier's pricing decisions. In other words, it is designed to exploit inelasticities of demand. Value-based pricing makes conscious and systematic the identification of what different customers or segments of customers can be expected to bear in paying for the goods or services offered.

It is, of course, not remarkable that firms price to what the market will bear. An emphasis on value-based pricing suggests simply that effective competitive constraints on price are either absent or relatively weak. The question, then, from society's point of view, is how to reduce or eliminate the factors conferring on firms the power to price their goods or services without reference (or at least without primary reference) to competition or unit cost. Where market power is appreciable, the question also arises whether or not that power is being abused in the prices charged.

In their submissions the banks emphasised that value-based pricing is applicable to retail banking. At the hearing on 9 July 2007 Mr Shuter of Nedbank submitted that value based

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50 SBSA, June 2007, Second Submission, Costing and Pricing, p 16; Nedbank, March 2007, Second Submission, Part A Data Request, p 6; and Absa, May 2007, Second Submission, Part B Data Request, page 4.

51 http://www.investopedia.com/terms/v/valuebasedpricing.asp

pricing is a well established technique often applied in service industries, particularly in banking.[52] In its written submission Nedbank described this approach as follows:

> Nedbank adopts a value-based approach to pricing, taking multiple factors into account, of which cost is only one consideration. Additional considerations include value to client (perceived and actual as identified through market research); market level: product and market maturity; cost and client behaviour.[53]

During the same hearing Mr Ntombela of Nedbank elaborated on the value-based approach to pricing, with reference to Nedbank's pricing strategy:

> MR NTOMBELA: We get feedback from clients on their transactional needs and preferences from a number of channels. From interaction with them through our branches, call centre, and a complaints tracker system we analyse the feedback from clients regarding their needs and preferences. We also run specific research to get feedback from clients around their needs and preferences. What we then do is go into an analysis of local and international features and functionality to fulfil those needs and we then run research using; (a) client focus groups; (b) surveys with clients, to get a feedback from them around which of these features and functionalities would they like in an offering that they regard as offering them value to fulfil their needs. This is not an exact science. ... The value that people attach to services varies. It varies with customers, it varies with the segment the people are in, it varies with the way that they interact with the banks. ... We then specifically ask questions from clients around price: What do you think?, what are you prepared to pay for this that will in your mind make this a good offer to you?, what do you think you are currently paying for a similar service if it exists? We then do a competitive analysis to get a view of what the market is charging for similar services. We will then consider what strategic objectives we are trying to achieve with this offering. ... We then estimate how many clients are going to take this up: [expected volumes, values etc]. The next step is then to consider the revenue that this new offering is going to generate and then test this against the incremental costs that providing a new service will incur. In this process we do not look at the cost of specific transactions.[54]

This approach to pricing is broadly in line with the approach adopted by all the other banks. Essentially, this is a strategy of differentiated pricing that seeks to segment customers into groupings based largely on patterns of usage and according to income levels. In this regard each bank will conduct market research and, on the basis of their understanding of customer preferences and behaviour, will implement price structures and set price levels which they calculate will maximise profit generated from customers transacting across the different channels.[55] Costing information obviously plays a role to the extent that banks must check whether or not revenue generated is sufficient to cover overall costs across the range of products or, in the case of new products, is sufficient to cover the incremental costs in this regard. As noted by Mr Ntombela, no consideration is given at all to the cost of specific transactions.

In addition to differentiating within and across their own product ranges, each bank uses pricing to differentiate their offerings from those of their competitors. Again this is based on

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52 Transcript 9 July 2007, p 39

53 Nedbank, April 2007, Second Submission, Part A Data Request, p 3.

54 Transcript 9 July 2007, p 88 – p 90.

55 SBSA, June 2007, Second Submission, Costing and Pricing, p 16 and Absa, May 2007, Second Submission, Part B of Data Request, p 4.

market research which seeks to determine the sensitivity to price of different customer segments. For example, Standard Bank claims to differentiate itself from the other banks through its product offerings, associated price levels, price structures, and competitive strategy.[56]

The channel strategy of the banks is an important consideration affecting the setting of prices. Absa, for example, has noted that price structures are implemented and price levels set in order to signal to customers to use lower-cost and more efficient channels.[57] For example, ATM transactions are generally less expensive than equivalent branch transactions because the branch is a more costly channel than ATMs. FNB submitted that an important part of its strategy is "to encourage customers to use more efficient transaction channels, for example to move from branch to Internet banking".[58]

The banks have submitted that they take account of competing transaction types and competing accounts – both from accounts within each bank and from accounts offered by competitors. For example, pricing structures applicable to Mzansi are such that there is little chance of Mzansi cannibalising the other mass market account products within each bank. *Ad valorem* pricing is also effective in maintaining segments within banks and preventing unwanted competition or arbitrage between products within banks. For example, Absa noted that "if personal banking fee structures were changed from *ad valorem* to flat fees, fees would have to be set at a level sufficiently high to discourage Business Banking customers from using personal accounts in lieu of business accounts for cash deposits".[59]

Given the extent to which the product offerings of the banks are differentiated there is little scope for direct price competition on the level of fees for transaction services on unbundled pay-as-you-transact options. Bundled fee options are also not subject to direct price competition on the fixed fee because the bundles in each bank's package are differentiated to such an extent that they cannot be compared directly.

Each bank does have reference to the pricing of its competitors – but only to ensure that its own pricing is not significantly out of line with that of the other banks. In this regard we find, particularly for unbundled transactions which are more directly comparable across banks, that fees tend to follow each other (upwards on average) within a fairly narrow range.

Nedbank provides a good example of what happens when fees step too far out of line. Nedbank lost market share by focussing its pricing on a high income niche which, it believed,

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56 Genesis: Report prepared for Standard Bank "Critique of the Monitor Group's Report "Competitiveness Report": International Price Comparison and Competitiveness Analysis, page 2.

57 Absa, May 2007, Second Submission, Part A of Data Request, p 4.

58 FRB, March 2007, Second Submission, Part A Data Request, p 6.

59 Absa, May 2007, Second Submission, Part A Data Request, p 17.

would absorb the higher fees. It ended up losing customers and, further, did not have appropriately priced options to attract customers in the growing middle and mass market.[60] As a consequence the other banks, who had positioned themselves for the middle and mass market, were able to grow their share of the market while Nedbank lost ground. Insofar as Nedbank has begun to reposition itself to serve the middle and mass market, its pricing seems merely to have moved broadly into realignment with the pricing of the other banks. With the exception of Capitec, which is limited at present to a particular (i.e. lower) segment of the market, we found no evidence in the unbundled fee data we examined of undercutting of each other by any of the banks.

In conclusion, we find that the banks implement price structures and set price levels on the basis of a strategy of differentiated pricing which seeks to extract maximum sustainable profit from a segmented customer base. The customer base is segmented according to transactional behaviour patterns which tend to be associated with different income groups.

With each subsequent price review the banks learn more about consumer behaviour and preferences and adjust their pricing structures accordingly with a view to achieving a more accurate segmentation of the market. As a consequence, banks have been able to increase revenue and volume.

3.7 The relationship between the costs of providing transaction services and the fees charged for those services

It is clear from the above discussion that prices for transaction services are not set on a cost plus margin basis. Rather, sophisticated qualitative and quantitative techniques are used to assess price sensitivities and other aspects of consumer behaviour in order to determine price structures and price levels.

In competitive markets, there is a tendency for forces to drive prices down to the level of costs. In such markets firms face downward pressure on price and are thus driven to reduce cost in order to increase or maintain their margins. Prices and costs therefore tend to move together.

As we noted in the introduction to this chapter effective competitive pressure tends to align the incentives of producers with the preferences of consumers. In particular, this balancing of consumer and producer interests should result in an efficient allocation of resources in which the price reflects both the value of the service to the consumer as well as the underlying costs associated with providing the service.

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60 See Nedbank, May 2007, Second Submission, Part A, Data Request, p 5, and Transcript, 9 July 2007, pp 32, 37, 38, 79, for example.

It is to this end that the terms of reference of the Enquiry have included in the subject matter to be considered, the relationship between the charges for retail banking services and the costs of providing those services. The Enquiry Technical Team requested the four largest banks to submit detailed information regarding the costs of transactions. In particular, a template was presented to the banks, with the following request:

> As part of the Competition Commission enquiry into banking services, the [Technical Team] needs to gain a better understanding of the costs and revenues that are attributable to services that are supplied through different banking products and banking channels. To this end, we have constructed a template for each of the three main, entry level accounts maintained by banks...[61]

The template was to be completed along the following lines:

> Costs per transaction should be specified in the column "Cost per transaction", for each transaction type in the left hand column. If a direct costing allocation per transaction is not undertaken by the bank, please indicate how costs are allocated, and show the cost apportionment methodology workings in the space provided. Where the cost allocation keys are different to those indicated in the template, please specify the allocation methodology that you believe more appropriate. The end result is that we are seeking your calculation or best endeavour to allocate costs per transaction. In the absence of known costs or allocated costs, please apply the methodology outlined in the template.[62]

In response, each bank provided comprehensive descriptions of their approach to costing and cost allocation. Although there were differences in detail in the approach to costing by each bank, they were unanimous in insisting that the difficulties of allocating costs and revenues to particular transactions are such that no meaningful conclusions can be drawn about the level and structure of charges from a comparison of revenues and costs on particular transaction types and particular account types.

We summarise their main arguments below:

- Banks are multi-product firms with substantial common and fixed costs which cannot be directly allocated to particular transaction services, or even to products.[63] Banks offer multiple products including transaction accounts, personal loans, mortgages, credit cards, and insurance products. Products are also offered to a variety of customers including individuals, small businesses and corporate customers. Many of the costs incurred by banks are common or shared across the different transaction types, products, and customers. For example:
  - Branch costs – Branches are used for the sale and delivery of a variety of products and services to a variety of customers. The staff, building, and equipment costs are shared across all these products and services.[64]

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61 Part B Data Request: Costing and Pricing Template for Basic Banking Products.

62 *Id.*

63 SBSA, April 2007, Second Submission, ATM Transaction, p 11.

64 Absa, May 2007, Second Submission, Part B Data Request, p 3.

- Information Technology infrastructure – The IT infrastructure, the data communication links between branches and ATMs, and IT data centres themselves incur costs which are common to the provision of multiple products and services of the bank.[65]
- Head office infrastructure – The infrastructure, office space, staffing and equipment in the head office support the full range of products and services of the bank. While staff and office space may be allocated to certain product lines, many of the head office functions are shared across all products and services of the bank and thus cannot be easily allocated to product lines.[66]

• There is a distinction between Economic Costs and Accounting Costs. The latter cost method fails to take into account measures such as brand image, development costs, and the position of the product or service in the stage of the life cycle of the product or service.[67]

• Approximately 80 per cent of costs are fixed and will therefore not vary significantly with changes in account or transaction usage. Different methods of allocating such fixed costs to individual transactions would give varying results, depending upon the method of allocation used. Standard Bank says: "The vast majority of our costs (our capital, our computer systems, our branches and ATM networks, our staff in the distribution network and our head-office expenses) are fixed".[68] Staff costs appear to be the single largest expense item for banks in general. Staff costs for Absa accounted for [redacted],[69] for FNB staff expenses represented [redacted] per cent of its total cost base of [redacted].[70] The banks therefore argue that it is not clear how staff costs should be allocated and what proportion of these costs should be considered fixed or variable.[71] Confidential: Absa Confidential: FNB

• A number of different costing approaches can be used. Each will yield different results and each can be used for different purposes. It has been argued that because cost allocation exercises will be carried out differently by different banks it is unlikely that cost information provided by different banks will be comparable.[72] Nevertheless, to the Enquiry, the relationship between costs and prices of each bank still takes precedence over comparability between banks.

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65 SBSA, April 2007, Second Submission, ATM Transaction, p 12.

66 *Id.*

67 FRB, March 2007, Second Submission, Part B Data Request, p 7.

68 SBSA, October 2006, First Submission, p 14.

69 Absa, May 2007, Second Submission, Part B Data Request, p 3.

70 FRB, October 2006, First Submission, p 35.

71 Nedbank also mentioned staff costs as a significant component of overall costs. See Transcript 9 July 2007, p 40. Standard Bank discussed the significance of staff costs in its second submission, June 2007, Costing and Pricing, p 6.

72 Absa, May 2007, Second Submission, Part B Data Request, p 4.

- There are activities and transactions which incur costs but do not generate revenue. These include telephonic and branch queries, and the opening and closing of accounts. This means that revenue to cover these costs must be obtained from other sources. This further complicates any attempt to allocate revenues and costs to particular transactions.[73]

Absa and Standard Bank were not able to complete the costing information in the template, as requested by the Technical Team.

In this regard Absa stated:

Confidential: Absa

[redacted].[74]

In a written submission Standard Bank repeated its stance, communicated at a meeting with the Technical Team on 5 April 2007, as to why it was not able to "populate the cost elements of the template":[75]

> In relation to Part B, SBSA is unable to provide average cost per transaction ... Costing data not generated. The data that SBSA is not able to provide is not generated by SBSA in the course of managing its business. Whilst the data could, in theory, be generated by a large team of accountants working for a period of time, such a once-off exercise would, in any event, be unreliable. Plausible costing can differ widely depending on the set of assumptions that are used. SBSA believe that for a costing approach to be accepted it must be proven through adoption and use. This view is mirrored in the Basel II approach to capital adequacy, which includes the so-called "use-test", where estimation methodologies are considered to be reliable only to the extent that they are used in the day-to-day management of a bank.[76]

Although FNB and Nedbank did complete the costing information in the templates, they nevertheless submitted that there is no meaningful relationship between costs and revenues (and therefore between costs and prices) at the level of the transaction.

FNB submitted:

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73 FRB, March 2007, Second Submission, Part B Data Request, p 4.

74 Absa, May 2007, Second Submission, Part B Data Request, p 4, 5.

75 SBSA, June 2007, Costing and Pricing, p 2.

76 *Id.*, p 5,6.

> The relationship between costs and revenues is not meaningful at the "revenue generating transaction" line as [redacted] per cent of the actual costs required to service these accounts are not accounted for. Costs are generated to support the ongoing servicing and support of the account. Since the cost allocation to specific transactions is not very meaningful, FRB, as noted in their first submission, assesses profitability at a product level.[77]

Confidential: FRB

In its submission Nedbank noted:

> [redacted]
>
> [redacted].[78]

Confidential: Nedbank

Table 4 presents a comparison of costs of similar transactions as calculated by FNB and Nedbank. (Standard Bank and Absa did not supply comparable figures.)

Table 4 Average cost per transaction

Transaction	FNB	Nedbank
Mzansi		
Electronic Deposits (Salary/Pension/Other)	[redacted]	[redacted]
Cash withdrawals from Own ATM	[redacted]	[redacted]
Cash withdrawals from Other ATM	[redacted]	[redacted]
Cash deposits Own ATM	[redacted]	[redacted]
Cheque Deposits Own ATM	[redacted]	[redacted]
Balance Enquiry ATM	[redacted]	[redacted]
Cheque Payments	[redacted]	[redacted]
Electronic account payment	[redacted]	[redacted]
Cheque deposits at teller	[redacted]	[redacted]
Cash withdrawal at teller	[redacted]	[redacted]
Debit Orders Internal (Homeloan/Card etc)	[redacted]	[redacted]
Debit Orders External (Furniture/HP/Car/Loans)	[redacted]	[redacted]
Rejected Debit orders	[redacted]	[redacted]
Airtime top-up	[redacted]	[redacted]
Cheque card purchases	[redacted]	[redacted]
Cash deposit at teller	[redacted]	[redacted]

Confidential: FRB Nedbank

77 FRB, March 2007, Second Submission, Part B Data Request, p 11.

78 Nedbank, May 2007, Second Submission, Part A Data Request, p 3.

Transaction	FNB	Nedbank
Transmission		
Electronic Deposits (Salary/Pension/Other)	[redacted]	[redacted]
Cash withdrawals from Own ATM	[redacted]	[redacted]
Cash withdrawals from Other ATM	[redacted]	[redacted]
Cash deposits Own ATM	[redacted]	[redacted]
Cheque Deposits Own ATM	[redacted]	[redacted]
Balance Enquiry ATM	[redacted]	[redacted]
Cheque Payments	[redacted]	[redacted]
Electronic account payment	[redacted]	[redacted]
Cheque deposits at teller	[redacted]	[redacted]
Cash withdrawal at teller	[redacted]	[redacted]
Debit Orders Internal (Homeloan/Card etc)	[redacted]	[redacted]
Debit Orders External (Furniture/HP/Car/Loans)	[redacted]	[redacted]
Rejected Debit orders	[redacted]	[redacted]
Airtime top-up	[redacted]	[redacted]
Cheque card purchases	[redacted]	[redacted]
Cash deposit at teller	[redacted]	[redacted]
Basic Cheque		
Electronic Deposits (Salary/Pension/Other)	[redacted]	[redacted]
Cash withdrawals from Own ATM	[redacted]	[redacted]
Cash withdrawals from Other ATM	[redacted]	[redacted]
Cash deposits Own ATM	[redacted]	[redacted]
Cheque Deposits Own ATM	[redacted]	[redacted]
Balance Enquiry ATM	[redacted]	[redacted]
Cheque Payments	[redacted]	[redacted]
Electronic account payment	[redacted]	[redacted]
Cheque deposits at teller	[redacted]	[redacted]
Cash withdrawal at teller	[redacted]	[redacted]
Debit Orders Internal (Homeloan/Card etc)	[redacted]	[redacted]
Debit Orders External (Furniture/HP/Car/Loans)	[redacted]	[redacted]
Rejected Debit orders	[redacted]	[redacted]
Airtime top-up	[redacted]	[redacted]
Cheque card purchases	[redacted]	[redacted]
Cash deposit at teller	[redacted]	[redacted]

Source: Nedbank and FNB, March 2007, Second submission, part B data request.

We note that while costs appear similar for some transactions, they differ considerably in respect of many others. Given that this information was submitted with caveats and, given the objective difficulties of interpretation and measurement, we are unable to draw meaningful conclusions from a comparative analysis of this data. However, to the extent that they are indicative, it is clear that the prices charged for these transactions bear no relationship to the costs of providing them.

3.8 Conclusion

Banks do not consider per transaction costs at all in the setting of transaction fees. Until recently, most of them have been either unable or unwilling to find out what these costs are. There are objective difficulties of measurement and interpretation arising from the high fixed and common cost nature of multi-product banking. For example, it would be unrealistic to expect that there should always be a very close relationship between fees for transactions and the direct costs of providing them.

On the other hand, however, the fact that the banks have not had any reference to the unit costs of transactions in the setting of prices suggests that they are sheltered from effective competitive pressure. Under effective competition the banks would need to know what these costs are in order (at the very least) to determine whether internal resources are being allocated efficiently. Consider, for example, the possible entry of non-bank ATM service providers. If competition from these providers threatened to undermine the revenue stream of the banks from ATM transactions, then one would expect that the banks would require detailed information regarding the costs of providing ATM transaction services. This is because they would need to know how the allocation and utilisation of resources hinders or facilitates their strategic positioning in respect of the provision of these services.

The same argument applies in respect of the provision of any other payment service that could potentially be a substitute for any of the transaction services traditionally provided by the bank to its account holder. This is because these providers would themselves incur costs that would have to be covered by appropriate pricing. To the extent that these providers could potentially impose a significant competitive constraint on the banks, this would bring into sharp focus the costs of providing these services – for both the banks and the new providers. The fact that banks in South Africa have not been subject to vigorous price competition explains, in large part, why they have had little or no interest in determining costs at the transaction level – and why fees for transaction services do not bear any identifiable relation to the costs of providing those transaction services.

However, with advances in technology expanding the scope for alternative and innovative payment service providers, this situation may be beginning to change. A number of banks have indicated a move towards adopting procedures to estimate costs more accurately at the transaction level.[79] Absa indicated that in 2005 it commissioned an activity based costing project which is to be implemented in early 2008, by which time Absa will have consistent costing data at the transaction and account level.[80] [redacted][81] FNB is already engaged in sophisticated costing and has noted that "these models are continuously improved over time as new information is collected".[82] Standard Bank, on the other hand, appears sceptical about the benefits of detailed costing studies. Although it has done some limited activity based costing, it submitted that data and methodological problems have hampered its application at Standard Bank. However, as we have noted above, competitive pressure and advances in technology, may mean that all banks, including Standard Bank, will eventually be able to conduct detailed costing exercises. If competition for payment services is allowed to develop – by improving access conditions and otherwise lowering barriers to entry – then one would expect to see prices and costs for transaction services aligning more closely with one another. This is further discussed in the chapter on Access to the Payment System.

Confidential: Nedbank

In a market characterised by direct price competition firms price their products to attract and hold their customers. In such a world competition tends to drive prices towards costs and so one would expect a reasonable and rational relationship between price and cost.

In the case of retail banking it appears that banks capture their customers to price to them. Such capture is a consequence of the market power of the banks. Search, switching costs and information asymmetries are all important factors in this regard and have been dealt with in some detail in the chapter on Market Power. This market power allows the banks to segment the market through the application of differentiated price and product options. The application of complicated fee structures, the addition of new fee categories, and general increases in the level of fees are all manifestations of this power. In this regard it is very important that high standards are set for transparency and disclosure and that measures are introduced to improve comparability of bundled options.

The pricing initiatives said to be aimed at reducing the fee-burden on customers – such as *ad valorem* pricing, banded fee options and appropriate bundled packages – which were highlighted by the banks during the course of the Enquiry, do not appear to be generally offered to lower-income customers. It is puzzling that the benefits of such initiatives do not accrue to those who most need it. Building on from our recommendations in the Market Power chapter, we recommend that together with improving transparency, standardising

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79 Absa, May 2007, Second Submission, Part B Data Request, p 5; Nedbank, May 2007, Second Submission, Part A Data Request, p 2.

80 *Id.* (Absa).

81 *Id.* (Nedbank).

82 FRB, March 2007, Second Submission, Part B Data Request, p 4.

terminology and educating customers, the Banking Association should encourage the appropriate application of these pricing initiatives to entry level accounts by the banks.

The Mzansi initiative, which is making considerable progress in extending banking services to the previously unbanked, also needs constant scrutiny to ensure that the structure of its bundling and pricing is truly pro-poor.

Consideration should also be given to ensuring that recipients of social grants are not disadvantaged by the cost of receiving and accessing their grants through bank accounts.